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Bargaining with Uncertainty, Moral Hazard, and Sunk Costs: A Default Rule for Precontractual Negotiations

by
JULIET P. KOSTRITSKY*

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* Professor of Law, Case Western Reserve University School of Law. B.A. 1976, Harvard College; J.D. 1980, University of Wisconsin. This Article is dedicated to Penny Kostritsky, 1925-1991, Chief Clerk of the District Court of Maryland, a great lawyer and humanitarian. I gratefully acknowledge the helpful comments of participants in the Northwestern University Law School faculty workshop series and Ronald J. Coffey, George W. Dent, Jr., Daniel A. Farber, and Robert N. Strassfeld. Jill M. Dickey (J.D. candidate, 1993) and Eric E. Kinder (J.D. candidate, 1994) provided valuable research assistance. Special thanks are also due to the Everett D. and Eugenia S. McCurdy Endowment in Contract Law, which provided financial support for this project. Responsibility for any errors remains mine alone.

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Introduction

Traditional bargain theory requires strong evidence that any promise sought to be enforced was given in exchange either for some conduct or for a return promise by the promisee.¹ It also requires a fully contingent contract, a contract that provides for all contingencies and comprehensively specifies the time, price, quantity, and quality of performance.²

1. Traditional bargain theory requires the promisor to signal, in the most unequivocal way, the terms of the exchange linking her promise to the promisee's conduct or promise. From this express linkage, the law infers that the promisor is willing to issue a claim of performance against herself and still consider herself better off, primarily by virtue of what the promisee could withhold or furnish. Put differently, this required linkage—bargained-for consideration—signifies a reciprocal inducement theory under which the promisor explicitly seeks, in exchange for her promise, either some conduct or a return promise that "is given by the promisee in exchange for that promise." RESTATEMENT (SECOND) OF CONTRACTS § 71 (1979). Under this traditional view, a bargain is "reciprocal," and enforceable, when "there is a manifestation of mutual assent to the exchange and a consideration." *Id.* § 17(1).

Of course, bargain theory is no longer the exclusive criterion for promissory enforcement. The doctrine of promissory estoppel allows enforcement of promises that induce unbargained-for reliance by promisees. See *id.* § 90, quoted *infra* note 45. For a discussion of the emergence of reliance as an alternative enforcement theory, see Stanley D. Henderson, *Promissory Estoppel and Traditional Contract Doctrine*, 78 YALE L.J. 343 (1969).

2. As Professors Charles Goetz and Robert Scott have described,

The perfectly contingent contract is a paradigm in which parties in a bargaining situation are presumed able, at reasonable cost, to allocate explicitly the risks that future contingencies may cause one or the other to regret having entered into an executory agreement. Its polar opposite is the "relational" contract, in which one or more future contingencies are peculiarly intricate or uncertain, thus preventing accurate allocation of risks at the time of contracting.

Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CAL. L. REV. 261, 267 n.10 (1985) [hereinafter Goetz & Scott, *The Limits of Expanded Choice*]; see also Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1090 (1981) [hereinafter Goetz & Scott, *Principles of Relational Contracts*].

Of course, "[i]n the real world, as opposed to the standard economic model, complete, fully contingent, costlessly enforceable contracts do not exist." Benjamin Klein, *Contracting Costs and Residual Claims: The Separation of Ownership and Control*, 26 J.L. & ECON. 367, 367 (1983). Given the prevalence of complex contractual relationships, the importance of fully contingent contracts has declined significantly over the past several decades. As Professors Richard Speidel and Edward Murphy explained, there has been

a shift from a strict view that no contract can be formed until clear and complete agreement is reached on material terms to a more flexible standard, such as those announced in [the] UCC . . . and . . . [the] Restatement (Second). There are several explanations for this shift According to Professor Ian Macneil, a possible reason is a different perception of the nature of contractual relationships. The assumption underlying the so-called "strict" view was that the parties could and should "presentiate," that is, express all of the material elements of the future exchange in the present agreement. In its extreme form, the transaction model was the "one shot deal" involving the sale of Dobbin or Blackacre. . . . But the assumptions underlying the traditional theory of mutual assent are hardly consistent with . . . long-term relationships

Several aspects of human behavior in the context of precontractual negotiations, however, can easily prevent parties from forming a contract that is enforceable under this traditional view by restraining them from explicitly signalling that a promise is given in exchange for some conduct or return promise, thereby causing them to fail the test of bargained-for consideration.³ Alternatively, even if the parties achieve the bargain element, the incompleteness of important terms might preclude the bargain from being fully contingent.⁴ These impediments to fully contingent contracts frequently hinder the achievement of the bargain element: because the promisor does not know enough to designate what conduct she seeks from the promisee, the parties never achieve an explicitly reciprocal bargain.

They may, however, have an implicit bargain.⁵ A paradigm for the recognition of an implicit bargain might involve preliminary negotiations

EDWARD J. MURPHY & RICHARD E. SPEIDEL, *STUDIES IN CONTRACT LAW* 411-12 (4th ed. 1991); see Ian R. Macneil, *Restatement (Second) of Contracts and Presentation*, 60 VA. L. REV. 589, 592-94 (1974).

3. See *infra* note 29 and Part II.A (describing the natural barriers created by strategic withholding and opportunism, the use of trust as a substitute for formalities, asymmetries of information and knowledge of legal requirements, and transaction costs and uncertainty).

4. The law often resorts to implication to resolve contractual incompleteness. For example, a party to a long-term supply contract might promise to supply as much of a product as the buyer needs. If the buyer then demands a quantity that the seller deems inordinate, a court resolving the dispute would likely recognize and enforce an implied term—perhaps most often of generalized formulation, such as an obligation to buy in good faith. See, e.g., *Orange & Rockland Utils. v. Amerada Hess Corp.*, 397 N.Y.S.2d 814, 818 (App. Div. 1977); see also *Wood v. Lucy, Lady Duff-Gordon*, 118 N.E. 214, 218 (N.Y. 1917) (Cardozo, C.J.) (imposing a duty on a clothing retailer to use “reasonable efforts” in marketing designs for which he had secured exclusive marketing rights; holding that “such a promise is fairly to be implied”). The same problem presents itself in the different context of traditional unilateral contracts—contracts in which a promise is exchanged for a performance. Such contracts clearly satisfy the bargain element: the promisor expressly bargains for the promisee’s act. Yet, section 45 of the *Restatement (Second) of Contracts* sanctions a role for implication in this setting by recognizing an “invitation to begin performance” once the offer for performance has been made. *RESTATEMENT (SECOND) OF CONTRACTS* § 45 cmt. d (1979). The law supplies a term in the form of a promise to let the promisee perform here for the same reasons that it supplies terms in other contexts: the promisee’s sunk costs upon beginning performance are such that without an implied promise to let the promisee perform, the promisee would withhold performance. See *infra* note 15 (definition of sunk costs); cf. *infra* Part IV.B.4 (describing the benefits of a law-supplied agreement between parties in preliminary negotiation to prevent the promisee from incurring uncompensable sunk costs).

5. A focus on implicit bargains underlies much modern analysis of corporations—analysis that views the corporation as a complex set of “explicit and implicit contracts.” Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1426 (1989). “An ‘implicit contract’ in the economic sense involves a tradeoff of one benefit, such as job security, for another, such as wages.” Larry E. Ribstein, *Takeover Defenses and the Corporate Contract*, 78 GEO. L.J. 71, 77 n.17 (1989).

Tradeoffs of this sort occur in the corporation when, for example, the shareholders

for a grocery store franchise. Suppose that during the course of the negotiations, the putative franchisor tells the putative franchisee that he would ultimately be willing to reach an explicit bargain. But first, the franchisor wants the franchisee to take a series of initial steps, such as the acquisition of a small grocery store (for experience), the sale of his existing business, the investment of a specified amount of capital, and the

accept one form of monitoring or incentives rather than another to achieve the ultimate goal of optimizing agency costs. Although there may be no legally enforceable right to the benefit sought by the tradeoff—such as lower agency costs—the tradeoff itself gives rise to an enforceable contract. . . . In short, the fact that some contracts in the corporation are implicit does not mean that they are not enforceable contracts

.....
Id.; see also Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 16 (1990) (analogizing implicit bargains to real bargains because both “involve an economic quid pro quo”).

In suggesting a role for legal rulemaking, my analysis differs from this contractarian view by assigning much greater importance to the economic literature on implicit contracting. For example, in structuring their relationship, the managers and owners of a corporation must make many background tradeoff decisions, weighing the costs and benefits of various approaches to achieving a particular goal—such as the minimization of agency costs. An owner who wishes to control managerial shirking will likely decide on the appropriate strategy after balancing the costs and benefits of incentive alignment schemes, monitoring, screening, bonding, and express contractual arrangements, whether of a fully contingent or a more generalized nature. See *infra* Part III.A.1. Contractarians focus on these tradeoffs in the minds of individuals, regardless of whether the individuals advert to them, and view these background decisions as an explanation for why parties ultimately reach a bargained-for arrangement, whether it is fully contingent or generalized. They see no reason to invoke the parties' background thinking as terms of a deal beyond that for which they explicitly bargained. Discussion with Ronald J. Coffey, Professor of Law, Case Western Reserve University School of Law, in Cleveland, Ohio (July 1991); see also Ribstein, *supra* at 79 (“The most important implication of the contractual theory of the corporation is that, whatever the source or nature of the individual terms, they should be enforced. They should not be retroactively modified through either legislation or court-imposed fiduciary duties.” (footnote omitted)).

Based on economic models of implicit contracting and parties' likely behavioral responses to alternative legal rules, I argue that the courts should supply terms *beyond* those for which parties in incremental negotiations have expressly bargained. Parties fail to reach express bargains in this context because bargaining involves “a gradual process in which agreements are reached piecemeal in several ‘rounds’ with a succession of drafts.” E. Allan Farnsworth, *Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations*, 87 COLUM. L. REV. 217, 219 (1987) [hereinafter Farnsworth, *Precontractual Liability*]. I argue that implicit contracts often exist here, in what would otherwise be considered mere preliminary negotiations, and should be enforceable through the adoption of a default rule. Cf. Randy E. Barnett & Mary E. Becker, *Beyond Reliance: Promissory Estoppel, Contract Formalities, and Misrepresentations*, 15 HOFSTRA L. REV. 443, 455-57 (1987) (discussing implicit bargaining in the context of promissory estoppel). But cf. Lewis A. Kornhauser, *The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel*, 89 COLUM. L. REV. 1449, 1451 (1989) (suggesting that any given unwritten agreement is “frequently ambiguous . . . and often not an agreement at all”).

procurement of an option to purchase a site for the proposed store.⁶ Traditionally, none of these interim steps taken by the franchisee-promisee in reliance on the consummation of the transaction would be compensable, because the parties had not expressly linked the promisee's conduct to the franchisor's promise. Any apparent agreement resulting from the preliminary negotiations would also fall short of a highly specified contract and potentially be unenforceable for lack of definiteness.

Parties' recurrent failure to achieve the ideal of highly contingent contracts—or to achieve the bargain element at all—raises the fundamental question of what role, if any, the law should take in either circumstance when there has been reliance in the prebargain phase of negotiations, particularly when that reliance has little or no value outside the transaction.⁷ Resolving that question requires us to consider whether legal decisionmakers should intrude into the private bargaining process by furnishing default rules,⁸ either for the bargain element or for particular terms.⁹

Traditionally, courts refused to impose liability and showed little sympathy for reliance undertaken without the protection of a bargained-for contract.¹⁰ Recently, however, more and more courts have created liability rules that allow compensation for prebargain reliance.¹¹

6. This paradigm derives from the facts of *Hoffman v. Red Owl Stores*, 133 N.W.2d 267, 268-71 (Wis. 1965). For the court's decision in *Red Owl*, see *infra* note 58.

7. As Professor Richard Shell has noted, the investment of contract-specific reliance poses dangers of "socially and economically undesirable" precontractual opportunism. See G. Richard Shell, *Opportunism and Trust in the Negotiation of Commercial Contracts: Toward a New Cause of Action*, 44 VAND. L. REV. 221, 227, 251-64 (1991). He suggested the adoption of a new cause of action to mitigate such opportunism and foster "the process of building trust." See *id.* at 227; *infra* Part II.B.2 (comparing Shell's approach with a default rule solution to the problem of precontractual investment); see also OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 30-31 (1985) [hereinafter WILLIAMSON, *ECONOMIC INSTITUTIONS*] (discussing the difficulties of structuring contracts in light of contractual opportunism and transaction costs).

8. For a brief definition of default rules, see *infra* note 25.

9. In most preliminary bargaining situations, the failure to achieve a fully contingent agreement occurs simultaneously with the failure to achieve the bargain element. When the parties have reached a bargain that is not fully contingent, however, the law may intervene by supplying an implied term of generalized formulation to resolve the contractual incompleteness. See *supra* note 4. Courts formulate such terms based on the actual expectations of the parties (to the extent that these can be determined), the rational expectations of hypothetical parties, and basic notions of justice and fairness. See E. ALLAN FARNSWORTH, *CONTRACTS* §§ 7.16-7.17 (2d ed. 1990) [hereinafter FARNSWORTH, *CONTRACTS*].

10. Farnsworth, *Precontractual Liability*, *supra* note 5, at 221-22. They also hesitated to supply terms beyond those for which the parties had expressly bargained. See *infra* Part I.A.

11. Professor Allan Farnsworth identified three justifications that courts have recognized for imposing precontractual liability: Unjust enrichment, misrepresentation, and specific promises. See *id.* at 229-39. Others have explained prebargain liability in the more compre-

Resolving whether, how, and why the law should intervene when the parties fail to conform to traditional bargain rules requires a theory of how parties bargain. Such a bargaining model must account for how parties structure their relationships; how they allocate risks and make choices;¹² what potential problems, including uncertainty,¹³ moral hazard,¹⁴ and sunk costs,¹⁵ affect the bargaining process; what goals contracting parties seek, on average, to achieve;¹⁶ and how legal rules are

hensive terms of an obligation of good faith or fair dealing. *See, e.g.*, Robert S. Summers, "Good Faith" in *General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 216 (1968); *see also* Charles L. Knapp, *Enforcing the Contract to Bargain*, 44 N.Y.U. L. REV. 673, 685-86 (1969) (noting that some withdrawals from negotiations may be in bad faith). More recent scholarship has rationalized liability in terms of consent theory, *see* Randy E. Barnett, *A Consent Theory of Contract*, 86 COLUM. L. REV. 269 (1986), or assent-based obligation, *see* Juliet P. Kostritsky, *A New Theory of Assent-Based Liability Emerging Under the Guise of Promissory Estoppel: An Explanation and Defense*, 33 WAYNE L. REV. 895 (1987). None of these attempts, however, has closely tailored a liability rule to the behavioral and structural attributes of precontractual negotiation and justified that liability rule by exploring the relative costs and benefits of alternative approaches. Such scholarship fails to explain why parties themselves might prefer such a rule and thus cannot provide an instrumental justification for precontractual liability.

12. Robert E. Scott, *A Relational Theory of Default Rules for Commercial Contracts*, 19 J. LEGAL STUD. 597, 600 (1990) [hereinafter Scott, *A Relational Theory*].

13. Economists have only recently begun to systematically analyze the problems posed for economic actors by decisionmaking under uncertainty.

[O]nly in the period after the Second World War did an accepted theory of uncertainty and information begin to evolve. This theory provides a vigorous foundation for the analysis of individual decision-making and of market equilibrium, under conditions where economic agents are unsure about their own situations and/or about the opportunities offered them by market dealings.

JACK HIRSHLEIFER & JOHN G. RILEY, *THE ANALYTICS OF UNCERTAINTY AND INFORMATION* 1 (1992) (emphasis omitted). For an extended treatment of the uncertainty problem, *see id.* *See also infra* note 29 and Part II.A.

14. "Moral hazard" refers to the "propensity of human agents to behave opportunistically." WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 7, at 51; *see also infra* note 118.

15. "Sunk costs are like spilt milk: they are past and irreversible outflows." RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 95 (3d ed. 1988); *see also* Shell, *supra* note 7, at 229 ("investments in assets that are specifically tailored to the transaction and cannot be fully salvaged outside the transaction").

16. This Article's paramount focus is on facilitating private decisionmaking through an examination of the "comparative advantage" among alternative rules for achieving private choices. *See* Robert E. Scott, *An Economic Perspective in Contracts Courses*, in *Association of American Law Schools Conference on Contracts: Discussion Outlines* 59, 60 (June 3-8, 1989) (unpublished pamphlet of discussion outlines, on file with author) [hereinafter Scott, *An Economic Perspective*] [pamphlet hereinafter cited as AALS Conference Outlines]. Critical legal theorists would condemn this approach as inherently flawed. Such a focus "sharply conflict[s] with the aims of promoting equality, altruism and solidarity," Robert W. Gordon, *Outline for AALS Contracts Workshop*, in *AALS Conference Outlines*, *supra* at 51, 51 n.1 [hereinafter Gordon, *Outline*], and "tends to legitimate the basic social relations, however un-

likely to advance or hinder those goals.¹⁷ Only by examining the bar-

just they are," Jay M. Feinman, *Critical Approaches to Contract Law*, 30 UCLA L. REV. 829, 854 (1983).

Treating contract law as a device for implementing private choice, I rely on behavioral assumptions to predict whether a proposed liability rule or its alternatives would better facilitate that choice. See *infra* note 17. Although communitarian values might provide an important alternative basis for choosing between legal rules, the implementation of such values could easily conflict with the primary goal of minimizing transaction costs. Professor David Charny noted the possible conflict between proponents of fairness and those favoring transaction cost minimization: He posited that "the [fairness] adjudicator should idealize the construction of hypothetical bargains by conforming the terms of the contract to arrangements that ideally rational transactors would view as fair," but admitted that "[t]he adjudicator might affirm these goals even though the resulting hypothetical bargains raised the cost of transacting." David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 MICH. L. REV. 1815, 1839 & n.89 (1991) [hereinafter Charny, *Hypothetical Bargains*]; see also *infra* Part I.B (describing other difficulties with allocating liability based on notions of contractual morality).

17. "The achievement of desired goals depends on assumptions about how those who will be subject to a rule will be affected by and react to it." Ronald J. Coffey, *Perspectives on Legal Methods* 4 (July 6, 1990) (unpublished manuscript, on file with author) [hereinafter Coffey, *Perspectives*]. This Article focuses on the effect of legal rules on the probable goals of contracting parties. This connection between a model of behavioral reality and the suggested default rule is premised on a fundamental tenet of rule justification.

The formulation of a rule justification . . . requires the decisionmaker, either on the basis of evidence that has been collected and processed or, where empirical evidence is lacking, on the basis of a priori hypothesis, to make assumptions about how things (including people) behave in reality. What goals do individuals of the type involved in the controversy pursue in making their private choices? And how do they go about pursuing those goals? These must be estimated so that, when the decisionmaker, in settling the controversy, situates a property right or fashions a liability rule one way or another, she can project how those subject to the rule will react to it.

Id.

Once that model of reality is constructed (or hypothesized), we might infer bargaining parties' consent to a proposed default rule. Jules L. Coleman et al., *A Bargaining Theory Approach to Default Provisions and Disclosure Rules in Contract Law*, 12 HARV. J.L. & PUB. POL'Y 639, 644 (1989); see *infra* note 25 (definition of default rules). The argument proceeds on the following logic: Since people are rational, if a proposed default rule would be rational (from a Pareto-improving state), then we can infer that the parties "would have consented to it. Consent follows as a matter of logic from considerations of rationality." *Id.* Rationality dictates that parties will choose the ordering of their affairs that is most efficient—they will seek Pareto-superior transactions. "A Pareto-superior transaction is one that makes at least one person better off and no one worse off." RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* § 1.2, at 13 (4th ed. 1992). Thus, this analysis assumes, if "all the relevant parties are made better off by the Pareto improving state (or at least are made no worse off by it)" and parties "prefer the Pareto improving state to the Pareto inferior one," then "[t]o say that they prefer one state to the other is to say that under normal conditions they would choose the former to the latter." Coleman et al., *supra* at 644.

Professors Ian Ayres and Robert Gertner have offered a different approach to determine whether the law should intervene through a default rule. Ayres and Gertner suggested that it is sometimes preferable to choose a default rule that "diverge[s] from the 'what the parties would have contracted for' principle." They proposed a penalty default rule, one "purposefully set at what the parties would not want—in order to encourage the parties to reveal infor-

gaining process and the likely behavioral effect of proposed alternative rules on the parties can we determine whether and how the law should supply a liability rule.¹⁸

Preliminary negotiations involve elements of uncertainty, moral hazard, and sunk costs. From the perspective of the putative promisee, the negotiation process necessarily involves all three elements. Because the person upon whom the promisee must depend to form an offer may opportunistically exploit her sunk investments in the prebargain phase, there is a moral hazard problem.¹⁹ This problem cannot easily be solved through contracting, however, because of the bounded rationality or uncertainty problem: the putative promisee cannot foresee all the possible decisions that might develop, and it is thus not a simple matter to structure a contract that would effectively curb precontractual opportunism.²⁰ Even in the face of uncertainty over the promisor's potential choices,

mation to each other or to third parties." Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 91 (1989).

Under Ayres and Gertner's view, penalty defaults are particularly appropriate when it is costly for the courts to determine *ex post* what the parties would have wanted. In such cases, "it may be efficient to choose a default rule that induces the parties to contract explicitly." *Id.* at 93. As an example, they identified a zero-quantity default: when parties fail to specify a quantity in a sales contract, the courts will not enforce the transaction. *See id.* at 95-96. Since it is easier for the parties to figure out the appropriate quantity *ex ante* than it is for a court to arrive at that amount *ex post*, the law adopts a penalty default in the hope that the parties will affirmatively opt out—"it encourages both of them to include a quantity term." *Id.* at 97.

Although we can rationally justify default rules constructed to enforce a hypothetical bargain that the parties would have wanted, we can also rationalize an implied penalty default rule that forces the disclosure of information. The penalty default framework, however, is less efficient in the preliminary bargaining context. *See infra* Part IV.B.3, IV.C.

18. A similar debate regarding the role of government regulation in the affairs of corporations has prompted controversy between the contractarians and anticontractarians. *See* Butler & Ribstein, *supra* note 5, at 2-3. Contractarians view the corporation as a "nexus of contracts," and accordingly maintain that "the parties involved should be totally free to shape their contractual arrangements." Lucian Ayre Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1397 (1989); *see, e.g.*, Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 777-78 (1972). Anticontractarians, on the other hand, argue that mandatory rules regarding corporate structure and operation are appropriate in certain instances. *See, e.g.*, Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1555 (1989). Like the contractarians, adherents to the once-dominant classical liberal view of contracts posit that parties who meet and negotiate should not be subject to rules for which they do not explicitly bargain. *See infra* Part I.A.

19. When a promisee makes transaction-specific investments without the protection of a formal bargain, her dependence on the promisor resembles that of a principal on her agent in several meaningful ways. This similarity has important implications for the obligation that a promisor who benefits from precontractual reliance ought to owe to such a promisee. *See infra* note 27 and Part III.A.1.

20. WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 7, at 58-59, 66; *see also infra* note 29 and Part II.A.

those choices could be controlled by "a 'general clause' whereby parties to a contract promise to disclose all relevant information candidly and to behave in a cooperative fashion during contract execution and at renewal intervals."²¹ When the problems of uncertainty and opportunism converge, however, as they do in precontractual bargaining that involves sunk investments by the promisee, there will be "difficult contracting issues" and general clause contracting is unlikely to be feasible.²²

Drawing from a model of bargaining behavior based on transaction cost economics, relational theories of contract,²³ Williamsonian models of contracting behavior,²⁴ and other economic insights, this Article argues that achieving the optimal solution for the complexities of bargaining relationships demands the adoption of a new legal default rule.²⁵ This new default rule should have two aspects: First, the law should substantively recognize an implicit bargain, even in the absence of explicitly reciprocal communications. Second, the law should impose an obligation to perform that incorporates the terms of the parties' unexpressed, implicit bargain.²⁶

The terms of the implicit bargain in preliminary negotiation might take the form of a promise by every promisor with the following substance:

In exchange for your taking steps toward making it possible for me to finalize our subsequent relations, which steps will be valuable to me, I promise to keep you informed of any change in my willingness to

21. WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 7, at 66.

22. *Id.* at 67; *see id.* at 50-51, 66-67.

23. *See, e.g.*, Ian R. Macneil, *Economic Analysis of Contractual Relations: Its Shortfalls and the Need for a "Rich Classificatory Apparatus,"* 75 *NW. U. L. REV.* 1018, 1025-36, 1062-63 (1981) (rejecting the discrete transaction model as an inaccurate paradigm for relational contracts in ongoing relationships).

24. For Professor Williamson's views on contracting behavior, see WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 7.

25. Scholars increasingly have considered nonlegal sanctions as a means of achieving "co-operative adjustments" between parties. *See* Scott, *A Relational Theory*, *supra* note 12, at 614; *see also* David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 *HARV. L. REV.* 373 (1990) [hereinafter Charny, *Nonlegal Sanctions*]. Nevertheless, I find legal sanctions to be the most cost-effective means of achieving parties' private wealth-maximization goals. I propose to implement these sanctions through a generalized, majoritarian "default" or background rule—a rule that enforces an implicit agreement in certain preliminary bargaining situations on the assumption that most parties would have expressly adopted it themselves had transaction costs and other barriers not prevented them from doing so, yet allows the parties to contract around the initial legal rule if they prefer some other arrangement. *See* Ayres & Gertner, *supra* note 17, at 87-91; *infra* note 34.

26. Of course, the default rule proposed here may be inappropriate in some cases. Therefore, "court[s] should not always assume that the parties have adopted the default . . . term[s], and should not apply them if the parties have opted out." Butler & Ribstein, *supra* note 5, at 30.

reach a more complete and explicit bargain and to assume legal responsibility for any steps you take prior to my warning you that my willingness to make the projected deal has changed.²⁷

The default rule proposed here would have several advantages. Based on a model of rational decisionmaking and average actors, it would protect transaction-specific investments, or sunk costs,²⁸ and promote the goals that both parties presumably seek.²⁹ In so doing, the de-

27. Discussion with Ronald J. Coffey, *supra* note 5. For possible alternative formulations, see *infra* text accompanying notes 211-213. This implicit bargain is akin to the general performance obligation—the fiduciary duty—that agents owe their principals, albeit more narrow in scope. The law supplies a fiduciary duty in agency relationships, even when the parties could have but failed to expressly provide for such an obligation, based on assumptions similar to those that motivate the adoption of default rules. See *infra* Part III.A.1.

28. See *supra* note 15.

29. Proceeding from a model of behavioral assumptions, we may determine what “goals . . . individuals of the type involved in the controversy pursue in making their private choices.” Coffey, *Perspectives*, *supra* note 17, at 4. Various theoretical approaches afford different basic assumptions about individual goals and means. Neoclassical economics, for example, assumes that contracting humans exhibit a “maximizing orientation” and a “strong form” of rationality. WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 7, at 44-45. Under a neoclassical scheme, rational actors seek to maximize the joint benefits of the contract. As Scott explained, “[c]ommercial contracting parties will, all things equal, prefer results that enhance the joint benefits of contracting.” Scott, *An Economic Perspective*, *supra* note 16, at 60. The maximization of joint benefits makes sense when we focus on the parties’ *ex ante* consensus. *Ex post*, of course, each party will focus on his individual interests and try to appropriate as much of the individual “gain as he can on each occasion.” WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 7, at 63. *Ex ante*, however, “both have a long-term interest in effecting adaptations of a joint profit-maximizing kind.” *Id.*

If we assume rationality, then it follows that, regardless of the risk attitudes of particular parties, the dominant strategy for contractual risk allocation is to maximize the expected value of the contract for both parties. Only by allocating risks in order to maximize the joint expected benefits from their contractual relationship can the parties hope to maximize their individual utility.

Scott, *A Relational Theory*, *supra* note 12, at 602. Under this model of behavior, courts should fill contractual gaps attributable to the parties’ failure to be explicit by attempting to replicate the would-be bargain based on the parties’ presumed joint goal of wealth maximization—by positing a hypothetical bargain that “the parties would have selected, in their joint interest, if they had contracted explicitly.” Easterbrook & Fischel, *supra* note 5, at 1433. Under these assumptions, “optimizing is ubiquitous,” contingent contracting is feasible, and thus the world is “reduced to a single gigantic once-for-all higgler-haggle.” WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 7, at 45 (citing J.E. MEADE, *THE CONTROLLED ECONOMY* 166 (1971)).

According to this view, gaps occur in a contract because the parties found it too costly to specify what was to be done in certain states of the world. The implicit argument is that, with costless contracting, the parties would have adopted the terms of the complete contingent claims contract.

Kornhauser, *supra* note 5, at 1454. The failure to reach an explicit bargain in preliminary negotiations, however, does not call for the imposition of law-supplied terms. If the parties had the opportunity to bargain but failed to contract for *any* express obligation, the neoclassicist would probably reject an implied-in-law term, in part because such an obligation would lack “the moral authority that attaches to the consensual decisions of autonomous actors.” *Id.* at 1451 n.2. Moreover, neoclassical economists treat a contract agreement as evidence that the

fault rule would save the costs of negotiating for the preferred provisions,

transaction is value-maximizing; absent the parties' agreement, a law-supplied obligation would lack justification on utilitarian grounds. Jason Scott Johnston, *Opting In and Opting Out: Bargaining for Fiduciary Duties in Cooperative Ventures*, 70 WASH. U. L.Q. 291, 293 (1992).

The transaction cost model of behavioral assumptions provides a broad basis for deciding both how people "behave in reality," Coffey, *Perspectives*, *supra* note 17, at 4, and accordingly what approach a court should take when parties fail to contract for any obligation. This model views human behavior as guided by bounded rationality, under which economic actors are assumed to be "intendedly rational, but only limited so," HERBERT A. SIMON, *ADMINISTRATIVE BEHAVIOR: A STUDY OF DECISION-MAKING PROCESSES IN ADMINISTRATIVE ORGANIZATION* at xxviii (3d ed. 1976), and opportunism, which it defines as "self-interest seeking with guile," WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 7, at 30. Bounded rationality refers to the parties' inability to foresee all possible future contingencies. Given the difficulty and costs of predicting future events, transaction cost economists conclude that "[c]omprehensive contracting is not a realistic organizational alternative when provision for bounded rationality is made." *Id.* at 46. Recognizing limits on rationality allows us both to explain why parties may initially fail to reach fully contingent contracts and to identify those situations in which "they can't conveniently bargain over risks in advance." Scott, *An Economic Perspective*, *supra* note 16, at 61. Because the costs of dealing explicitly with particular contingencies may be great, especially during preliminary bargaining, the transaction cost model assumes that "parties may prefer to leave the contract incomplete." Ayres & Gertner, *supra* note 17, at 93. I argue to the contrary: parties might prefer a default rule that minimizes costs by supplying the terms most parties would have wanted. *But see id.* (questioning the efficiency of the "would-have-wanted" approach to default rules).

This Article extends the approach based on wealth maximization and transaction costs beyond a gap-filling role. My approach would supply a bargain when parties have reached no bargain by failing to unequivocally link the promisor's promise with the promisee's conduct or return promise. Based on the model developed in Parts II and III, I suggest that the law should treat similarly the failure to reach any bargain and the failure to reach a fully specified bargain by supplying rules based on the preferences of hypothetical bargainers. I argue that average hypothetical bargainers would prefer that the law recognize implicit, incomplete bargains in order to facilitate the investment of sunk costs by promisees and thereby provide putative promisors with the information needed to complete the negotiation of contingent, bargained-for contracts. In effect, the default rule proposed here amounts to both a particular implied term, imposing a performance obligation on the putative promisor, and an implied bargain in which transaction-specific investments by the promisee are exchanged for a generalized performance obligation undertaken by the putative promisor.

Some commentators have used another economic model, based on game theory and strategic bargaining, to critically analyze issues of contract law. Yet game theory (or concession rationality) focuses on the question of how people achieve the division of gains from trade—a "problem of agreeing how to divide the stakes in the game. . . . If they cannot agree, then the surplus is lost. Bargaining proceeds through an exchange of offers and counteroffers for dividing the stakes." Robert Cooter, *The Cost of Coase*, 11 J. LEGAL STUD. 1, 21 (1982). These theories posit that parties often strategically hide from one another the value each ascribes to the proposed transaction in order to extract greater concessions from the other. In situations in which "neither party can predict her opponent's demands with certainty, but both may do so probabilistically," Avery Katz, *The Strategic Structure of Offer and Acceptance: Game Theory and the Law of Contract Formation*, 89 MICH. L. REV. 215, 233 (1990), game theory helps economists model the effect of strategic behavior on the division of gains from trade and the likely course of the bargaining process. Rather than center on the division of gains from trade, this Article addresses situations in which impediments to bargaining prevent the achievement

and thus minimize transaction costs for most parties.³⁰ It would also “encourage[] the socially optimal interaction between . . . promising parties” and increase social welfare by providing the optimal enforcement scheme for promises.³¹ Finally, the default rule would ameliorate problems that derive from the uncertainty, moral hazard, and sunk costs inherent in certain bargaining situations.³²

Because this Article proposes a default rule for the prebargain context, Part I describes and exposes the deficiencies of traditional approaches to prebargain liability. Part II examines improved approaches to the problem of precontractual reliance, approaches that incorporate realistic models of bargaining based on transaction cost economics. These transaction cost theories help explain the impediments to bargaining, but remain incomplete. Specifically, they fail to justify suggested liability rules from the perspective of private choice and leave unresolved two critical, analytically distinct questions: First, why would the parties have reached the suggested terms had obstacles not frustrated an explicit bargain? Second, what obstacles prevented the parties from expressly agreeing to the suggested law-supplied terms? Part III then addresses an important issue that current transaction cost approaches have failed to resolve: Whether private strategies have the capacity to overcome the admitted barriers to bargaining in the precontractual context. Identify-

of reciprocal contracts—situations in which there is no trade at all under current legal rules. Drawing on assumptions about the average goals and behavior of parties in the context of precontractual bargaining allows us to specify whether and when the law should, by virtue of the parties' default, impose an implied performance obligation.

30. “This theory of implying default rules is ‘[t]he Coasean Contractual Theory’ [I]t says that because it is costly to bargain around the law, courts should imply standard form or ‘default’ rules that mimic the terms that most parties would have explicitly included in their contracts.” Johnston, *supra* note 29, at 293.

31. Charles J. Goetz & Robert E. Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 YALE L.J. 1261, 1266 (1980) [hereinafter Goetz & Scott, *Enforcing Promises*]. Any conclusion regarding the maximization of “the net social benefits of promissory activity” and the optimization of “the interactions between promisor and promisee” must proceed from a comparison of the costs and benefits of promissory activity. *Id.* at 1274-75. As Professors Goetz and Scott explained, determining whether a legal sanction for prebargain reliance is warranted in any particular type of transactional situation requires weighing the costs and benefits of imposing such prebargain liability and determining how the parties would have allocated the risk of prebargain investments. They concluded that optimization requires allocation of the risk to the promisee. *Id.* at 1295; *cf. infra* notes 234-241 and accompanying text (responding to Goetz and Scott's hypothetical optimization in the precontractual context). For a fuller discussion and a comparison of the costs and benefits of alternative approaches to legal sanctions for prebargain reliance, see *infra* Part III.A.2.

32. Requiring promisors to comply with a general performance obligation of the type suggested here would presumably give promisees a greater incentive to incur precontractual sunk costs that would be valuable to promisors. See *infra* Part IV.B.

ing certain "types of transactional situations"³³ in which private strategies fail to overcome barriers to contracting raises the fundamental question whether the law should intervene to overcome these deficiencies. This Article concludes in Part IV that the inadequacy of private strategies for overcoming defects in the bargaining process often justifies legal intervention. Based on the justifications for default rules in other specific contexts, on the similarity between the factors that prevent the formation of bargains and those that prevent the formation of fully contingent contracts—informational asymmetries, opportunism, and transaction costs—and on the high cost of private strategies for overcoming such barriers, the law should supply a generalized, off-the-rack default rule to govern preliminary bargaining.³⁴ Finally, Part V offers some ap-

33. Charny, *Nonlegal Sanctions*, *supra* note 25, at 426. Part III explores two contexts in which "information deficits" impair the bargaining process. *Cf. id.* (discussing decisionmakers' responses to information deficits). First, Part III.A examines other contexts, such as agency relations, in which natural barriers of incomplete information and unforeseeability impair the bargaining process and hinder the parties from reaching fully contingent contracts. *See generally* Kenneth J. Arrow, *The Economics of Agency*, in *PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS* 37 (John W. Pratt & Richard J. Zeckhauser eds., 1985) (offering a theoretical analysis of the economics of agency relationships). Second, natural barriers such as market failures and information deficits also affect the sale of products. Because of these similarities, Part III.B draws on scholarly literature documenting the deficiencies of private strategies for combatting market failures—deficiencies that justify the imposition of minimum product quality standards. *See* Hayne E. Leland, *Minimum-Quality Standards and Licensing in Markets with Asymmetric Information*, in *OCCUPATIONAL LICENSURE AND REGULATION* 265 (Simon Rottenberg ed. 1980) [hereinafter Leland, *Minimum-Quality Standards*]. I suggest reasons for the failure of the bargaining process in these contexts and in preliminary contracting, and evaluate the nature and costs of private strategies that parties might use to address the reality of incomplete, unbargained-for promises.

34. In proposing the imposition of a generalized default rule, I accept Professor Scott's explanation and justification for the "law's preference for generalized or 'off-the-rack' default rules in commercial contracts." Scott, *A Relational Theory*, *supra* note 12, at 599; *see also infra* note 189 (discussing untailored default rules). For general discussions of default rules, *see* Ayres & Gertner, *supra* note 17, Scott, *A Relational Theory*, *supra* note 12, and *infra* Part IV.B.

Professor Scott sought to justify a preference for generalized default rules over more complex or particularistic default rules. *See* Scott, *A Relational Theory*, *supra* note 12, at 598; *see also* Charny, *Hypothetical Bargains*, *supra* note 16, at 1820 (describing the problem of generality as the "extent to which the adjudicator particularizes her formulation to the particular transactors whose dispute is before her"). Recognizing that different levels of generality are possible, I nevertheless argue for the adoption of a generalized default rule by examining the costs of *not* adopting it—including the costs of private strategies that parties might otherwise adopt to overcome certain inhibiting barriers to explicitly reciprocal contracting.

The advantage of a preformulated rule is efficiency—it "eliminate[s] the cost (and the error) of negotiating every detail of the proposed agreement." Scott, *A Relational Theory*, *supra* note 12, at 607. Accordingly, the adoption of any particular default rule should proceed from an objective theory of rationality. Under this conception, the choice among various possible preformulated default rules turns on "what risk allocation the majority of similarly situated rational actors would have devised were they to bargain costlessly over the question in

plications and advantages of the proposed default rule. By enforcing the default rule proposed here, courts would avoid the deficiencies of current approaches to prebargain liability and reach better results than are possible today.

I. Evaluating Traditional Approaches to the Failure to Reach a Bargained-For Contract

Traditional theories of precontractual liability are deficient. Such theories alternately lack a model of behavior against which to gauge the effect of a legal rule on parties in preliminary bargaining, are too indeterminate for consistent application, or fail to focus on the conduct that is most relevant to whether prebargain liability is appropriate.

A. The Classical Liberal Framework

The classical liberal view of contracts holds that the law should remain indifferent to bargaining failures, notwithstanding the presence of transaction-specific investments. Because this theory presumes equality among parties, expecting them "to signal their intentions unambiguously to others and the legal system"³⁵ and to conform their conduct to the operative legal rules,³⁶ it treats a failure to conform as a choice not to be legally bound.³⁷ Under classical assumptions about human behavior,

advance." *Id.* This objective approach "undercuts the relevance of particular characteristics of particular bargainers." *Id.* An alternative approach would tailor the default rule to the hypothetical bargain that individual bargainers with individual preferences or idiosyncracies would have struck. As Scott pointed out, such reliance on subjective rationality "reflect[s] an incomplete understanding of the systematic functions of contract law." *Id.* One of the basic purposes of contract law is to reduce transaction costs for the majority of parties. Presumably, adopting a particularistic default rule imposes added costs on the parties that share the typical characteristics. It is more efficient to require the narrow subset of atypical bargainers to opt out. *Id.* at 607-08; *see also infra* note 188 (discussing tailored default rules). This objective approach subscribes to the "Expanded Choice postulate," under which typical parties save the costs of negotiating detailed agreements and atypical parties suffer no disadvantage because they can opt out of the generalized rules. Goetz & Scott, *The Limits of Expanded Choice*, *supra* note 2, at 262. *But cf. id.* at 263, 289-305 (noting that generalized default rules often stifle innovative contractual responses to bargaining problems, and that the "opting-out burden of those who prefer a different allocation of risks" increases with the more systematic use of default rules).

35. Gordon, *Outline*, *supra* note 16, at 53.

36. *See* Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1698 (1976) ("If the rules are clear, people will invest time and energy in finding out what they are. They will then adjust their behavior. . .").

37. According to the classical liberal view of contract law, the refusal to uphold agreements not conforming to formal rules "encourage[s] parties to plan and reliably signal their commitments to one another and prevent[s] courts from overriding 'the will of the parties,' i.e. enforcing either greater or lesser obligations than the parties have formally assumed."

parties' failure to explicitly signal a reciprocal bargain indicates their intention that contract liability not attach.³⁸ Thus, parties should not be subject to contract rules during preliminary negotiation.³⁹ So long as the putative offeror does not specify the reliance undertaken by the alleged offeree *as the price of her promise*, the failure to phrase the promise in explicitly reciprocal terms makes the reliance ineligible to serve as the consideration for a formal contract, and the putative offeror may withdraw without liability.⁴⁰

The difficulty with the classical vision lies in the fundamental flaws of the bargaining model on which it is premised. It mistakenly presumes that promisors always have sufficient information to specify *ex ante* the terms of a projected deal to which they might ultimately be willing to bind themselves. It fails to account for the incremental nature of the bargaining process, and assumes that no transactional barriers prevent the parties from explicitly signalling to each other the basis on which they might be willing to agree.⁴¹ By ignoring the natural barriers to ex-

Gordon, Outline, *supra* note 16, at 53. If these assumptions about parties' ability to conform their conduct to operative legal rules are unjustified, however, then the classical rule against precontractual liability may frustrate the ultimate goal of enforcing consensual agreements. See Coffey, Perspectives, *supra* note 17, at 4 (suggesting that "formulation of a rule justification with respect to the model facts of a controversy requires the decisionmaker . . . to make assumptions about how things (including people) behave in reality"); Kennedy, *supra* note 36, at 1699 (noting that "real as opposed to hypothetical legal actors may be unwilling or unable" to conform).

38. The refusal to enforce nonreciprocal agreements can also be justified in economic terms. See Goetz & Scott, *Enforcing Promises*, *supra* note 31, at 1295. Goetz and Scott explained the prevailing restriction of contract liability to the reciprocal bargain by reference to the "efficient risk allocation," *id.* at 1296, that both parties would prefer:

Because the outcomes of negotiations are uncertain and gains and losses are indefinite, risk-averse parties will choose to forego uncertain gains rather than incur equally uncertain losses of the same magnitude. In other words, risk-averse bargainers will prefer to bear uncertain risks as promisees rather than as promisors. Moreover, because a promisee can control reliance costs more easily than can a promisor, the risk of detrimental reliance is lower if borne by the promisee rather than the promisor. An enforcement rule would encourage excessive precautionary adjustments by risk-averse bargainers

Id. at 1295. Contrary to Goetz and Scott's arguments, economic theories justify an enforcement scheme that imposes some liability on promisors in preliminary bargaining despite the absence of an explicit bargain. See *infra* Part IV.

39. See Farnsworth, *Precontractual Liability*, *supra* note 5, at 221 ("Courts have traditionally accorded parties the freedom to negotiate without risk of precontractual liability.").

40. Macneil, *supra* note 2, at 592-94.

41. For discussions of the incremental nature of the bargaining process, see Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233 (1979) [hereinafter Williamson, *Transaction-Cost Economics*], Farnsworth, *Precontractual Liability*, *supra* note 5, at 218-20, and *infra* note 84. The natural barriers to explicitly reciprocal bargains include uncertainty about the future, which makes specification of a pro-

licitly reciprocal contracting, the classical theory begs the fundamental question whether legal intervention is justified when the parties fail to reach an explicitly reciprocal bargain.

B. Regulating Contractual Morality

Another possible approach to precontractual liability issues relies on notions of contractual morality.⁴² This theory decides formation questions according to such generalized social goals as fairness or altruism, and suffers from several defects. First, it provides no means for differentiating when enforcing a liability rule for precontractual reliance will or will not advance such a generalized goal as fairness. Second, social goals or needs often conflict with each other, making the resolution of liability in any particular case problematic.⁴³ Finally, a moral theory of promissory estoppel, by itself, gives courts no guidance in deciding

what goals or objectives will be served or jeopardized . . . by a response awarding (or withholding) a property right or imposing (or not imposing) liability, in light of the response's likely effect on those who will be affected by litigation . . . or on those who will avoid litigation by adjusting their behavior.⁴⁴

The moral theory contains no inherent framework of assumptions about behavioral reality for predicting how those subject to a rule will react to it or to an alternative rule. Without such an analytical framework, the legal decisionmaker cannot hypothesize whether liability will advance or hinder any particular preselected goals.

C. Restatement Doctrine

Courts often use a doctrinal technique for deciding whether to impose liability for transaction-specific investments made during precontractual negotiations. This approach attempts to resolve liability questions by applying the elements of section 90 of the *Restatement (Second) of Contracts*.⁴⁵ Courts seek to determine, in myriad fact settings,

jected promise's terms extremely costly, especially in incremental negotiations. For a discussion of this and other natural barriers to contracting, see *infra* Part II.

42. See, e.g., Kennedy, *supra* note 36.

43. See Robert W. Gordon, *Historicism in Legal Scholarship*, 90 YALE L.J. 1017, 1035 (1981).

44. Coffey, Perspectives, *supra* note 17, at 2.

45. Section 90 provides:

Promise Reasonably Inducing Action or Forbearance.

(1) A promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee or a third person and which does induce such

the existence of a promise, the foreseeability of the reliance, and the reasonableness of the reliance.⁴⁶

Doctrinal formulations such as that of section 90 are, however, inherently incapable of resolving their "application to any particular situation."⁴⁷ In applying these elements, courts have vacillated as to how unequivocal the promise must be and how substantial the reliance must be.⁴⁸ Since not every promise suffices to establish liability under section 90 and not all reliance is compensable, courts must resort to other factors and a supplementary framework⁴⁹ to decide whether recovery is justified in any particular case.⁵⁰ Because doctrinal elements are not self-interpreting, a doctrinal approach cannot suffice.

D. Empiricism

Empiricism attempts to settle liability for prebargain reliance by reference to "questions about the parties' intentions and expectations."⁵¹ In any prebargain situation, the empiricist asks a series of questions that usually derive from Restatement doctrine, such as whether the promisee could "reasonably rely" on the putative promisor's assurances, and then develops empirical answers to these questions based on "the parties' reasonable expectations" to decide whether to allow recovery for prebargain reliance.⁵²

action or forbearance is binding if injustice can be avoided only by enforcement of the promise. The remedy granted for breach may be limited as justice requires.

(2) A charitable subscription or marriage settlement is binding under Subsection (1) without proof that the promise induced action or forbearance.

RESTATEMENT (SECOND) OF CONTRACTS § 90 (1979).

46. See *supra* note 45.

47. Jay M. Feinman, *Promissory Estoppel and Judicial Method*, 97 HARV. L. REV. 678, 697 (1984); see *id.* at 698, 698-716 (examining different methodological approaches for deciding promissory estoppel cases, each of which "is a response to the problems of individual and community, of freedom and coercion").

48. See *id.* at 690-96 (detailing various approaches).

49. The inevitability of a supplementary framework in cases that purport to apply the doctrinal approach raises the issue of what supplementary framework is preferable. This Article proposes a supplementary framework for deciding some reliance cases, based on an economic model that accounts for the effect of alternative rules on the parties' behavior, given assumptions about their average goals and how a particular legal rule is likely to affect the achievement of those goals. Only such a supplementary framework makes it possible to decide cases, since the elements of section 90 are ambiguous and susceptible to contradictory interpretations in any given situation.

50. Feinman, *supra* note 47, at 697.

51. Gordon, Outline, *supra* note 16, at 55; see also Feinman, *supra* note 47, at 698 (focusing on the methodology of promissory estoppel cases "in light of the nature of the parties and their place within the sphere of commerce").

52. Gordon, Outline, *supra* note 16, at 55.

The empirical method fails to reveal a "route out of indeterminacy,"⁵³ however, because the questions it addresses have no single empirical answer; they are not susceptible to abstract resolution. Professor Robert Gordon demonstrated the difficulties of trying to resolve liability through empirical inquiries into the parties' intentions and expectations by analyzing the *Red Owl* case from an empirical perspective. Ultimately, he explained, the empiricist must ask: "Could [Red Owl] have predicted that [Hoffman] would reasonably rely on its assurances?"⁵⁴ But the parties' reasonable expectations may be reconstructed in a variety of different and conflicting ways, for example:

(a) By reference back to assumptions of classical contract: nobody has reason to expect any commitment until the deal is closed. (b) By stereotyping [Hoffman] as [a] cautious businessman: [Hoffman] would not have expected anything until the deal was closed. (c) By stereotyping [Hoffman] as an unsophisticated businessman, who might have counted on [Red Owl] to disclose problems he might face in meeting financial qualifications before inducing him to invest so much time and effort in applying and training for a franchise. (d) By hypothesizing, or getting evidence (if there is any) of customary practices that might orient expectations. (e) By hypothesizing that these deals are idiosyncratic enough so that there are no stable customs, at least none that parties may be aware of. (f) By hypothesizing that in this situation the parties' reasonable expectations may have conflicted, because their dealings were ambiguous. [Red Owl] may have supposed (as it claimed) that the \$18,000 was only a ceiling on the *unencumbered* funds [that Hoffman] had to contribute, while [Hoffman] meant it as a ceiling on his total contribution. Lukowitz, Red Owl's representative, may have misunderstood [Red Owl]'s financial policies, and miscommunicated them to [Hoffman]. [Red Owl] may have supposed that [Hoffman] would take everything [Lukowitz] said merely as estimates, and rely at his own risk until [Red Owl]'s headquarters gave its formal approval (i.e. that [Hoffman] would form his expectations from [classical contract] assumptions); while [Hoffman] was assuming [Lukowitz] had full backing from [Red Owl]'s headquarters] and his assurances were reliable.⁵⁵

A court might plausibly justify a judgment for either party according to this method. Or, if it decides that the parties' reasonable expectations conflicted, the court must find some other way to allocate the risk of prebargain reliance.⁵⁶ The lack of any determinate method for assessing the content and reasonableness of parties' assumptions underscores the limited value of empiricism as a theoretical model for precontractual liability.

53. *Id.*

54. *Id.*

55. *Id.*

56. *Id.* at 56.

E. Negligent Misrepresentation

In a recent article, Professor Mark Gergen advocated the adoption of a contractual cause of action for negligent misrepresentation to resolve the problem of reliance undertaken without an explicitly reciprocal contract.⁵⁷ Such a cause of action would help to explain cases that arguably involve a negligent misrepresentation, like *Hoffman v. Red Owl Stores*.⁵⁸ Professor Gergen argued that his theory "more precisely describes the conduct we are trying to regulate."⁵⁹

The conduct that the law should attempt to regulate in the preliminary bargaining process, however, often consists of a promissory statement that contains neither explicit nor implicit factual assertions. The promisor is trying to determine whether to commit to an offer or to acquire more information first. If she commits prematurely, she risks losses from a bad deal that could have been avoided by acquiring the information.⁶⁰ During this period, the promisor may request conduct from the promisee (without, however, specifying it as the price of an offer) and give the promisee vague assurances without making any statements that contain an untrue factual underpinning.

Because the tort cause of action traditionally "lies only for false statements about present facts and not for false predictions about future events or behavior,"⁶¹ a negligent misrepresentation theory would probably not permit recovery for false predictions about future events unless the speaker actually misrepresented her state of mind. The *Red Owl* example is instructive. If Red Owl told Hoffman that he would have to invest no more than \$18,000 but at the same time actually believed that \$18,000 might be insufficient, then it would have misrepresented its state of mind as to the amount of capital required. If, however, as is more

57. Mark P. Gergen, *Liability for Mistake in Contract Formation*, 64 S. CAL. L. REV. 1, 4 (1990). Specifically, Gergen argued that "we must create a new contract action for losses that result from reliance on negligent misrepresentations in negotiations." *Id.* at 39.

58. 133 N.W.2d 267 (Wis. 1965). For a brief rendering of the facts of *Red Owl*, see *supra* text accompanying note 6. During the two-year period in which the plaintiff, Hoffman, negotiated for a grocery store franchise with the defendant, Red Owl, Red Owl made a series of promises to Hoffman about the amount of capital required (assuring him that \$18,000 would be sufficient) and about other prerequisites to the franchise acquisition. Hoffman broke off the negotiations and sued when Red Owl demanded substantially more money than the parties had earlier discussed. *Red Owl*, 133 N.W.2d at 268-71. The Supreme Court of Wisconsin held that Hoffman was entitled to recovery for reliance damages suffered by reason of Red Owl's failure to keep its promise to grant Hoffman the franchise, even though the promise was not in the nature of a fully contingent, bargained-for contract. *Id.* at 274-75.

59. Gergen, *supra* note 57, at 42.

60. HIRSHLEIFER & RILEY, *supra* note 13, at 204-06.

61. Gergen, *supra* note 57, at 34.

likely, Red Owl was estimating its capital requirements and did not actually misrepresent either its state of mind or the amount it then required for the franchise, it would be hard to regulate Red Owl's conduct under the law of misrepresentation.⁶² The question that Gergen left unanswered is how to treat such nonfactual promissory statements.⁶³

II. Transaction Cost Economics and Current Behavioral Approaches to Precontractual Liability

Because traditional approaches to preliminary negotiation have failed to develop a realistic model of how parties subject to a legal rule might react to it, they cannot address the next-order question of how to choose among possible legal approaches. Drawing on models formulated by transaction cost economists and on relational theories of contracting, some theorists in recent years have sought to remedy the defects of traditional approaches to this question by constructing a complex model of behavioral reality. Such a model allows us to determine parties' responses to alternative legal rules, and thus to evaluate whether and on what terms the law should impose prebargain liability.

A. The Model of Behavioral Reality

The transaction cost model of reality recognizes the impediments to fully contingent contracting. It posits that the ideal vision of contract, under which parties are able to bargain in advance to a complete and contingent agreement, cannot be realized.⁶⁴ Transaction cost models of informational barriers to fully contingent contracting inform the law's approach to parties' failure to achieve such complete contracts. The very barriers that hinder the achievement of fully contingent contracts, however, also hinder the achievement of bargained-for contracts—at least if the law requires a highly specified bargain in which the promisor explicitly specifies some conduct or promise of the promisee as the basis of the exchange. In contracting that proceeds incrementally, the promisor cannot specify the price (broadly conceived) of the exchange in a highly contingent manner *ex ante* because she lacks the information to do so. The

62. Although, as Gergen noted, a "prediction of a future event may be recharacterized as a representation about the present facts that are expected to bring that event about," *id.* at 36, courts would be reluctant to gloss over the distinction between statements of fact and statements of opinion in this context.

63. Of course, to the extent a case involves statements of a factual nature or that contain implied factual assertions, Gergen's approach may be an appropriate vehicle for allocating liability (as would traditional deception law in general).

64. See generally Goetz & Scott, *The Limits of Expanded Choice*, *supra* note 2, at 265-73 (discussing the costs of contract formation).

promisor does not know what she seeks from the promisee in these situations until the bargaining process proceeds.

Though transaction cost models of informational barriers explain failures to achieve fully contingent bargains, they do not explain failures to achieve the bargain element, at least when one party is willing to rely on the other's very general statements of performance requirements. Other barriers, however, interfere directly with the achievement of the bargain element and help to explain its absence. The following discussion highlights the contracting parties' different behavioral characteristics, including opportunism, trust, and the exploitation of information imbalances—characteristics that interfere with both fully contingent and explicitly reciprocal bargains—and then revisits the informational barriers to fully contingent contracting.

(1) Strategic Withholding and Opportunism

The propensity among many contracting parties for opportunism, or strategic withholding of information, often explains why they dispense with formal, bargained-for contracts. Opportunism "includes but is scarcely limited to more blatant forms, such as lying, stealing, and cheating."⁶⁵ It may also appear in an "incomplete or distorted disclosure of information" or other "calculated efforts to mislead."⁶⁶

Opportunism may manifest itself in several ways during preliminary bargaining. A promisor may deliberately exploit ambiguities in language, withhold information about what is required to close a deal, misrepresent her continued willingness to deal,⁶⁷ or exploit a knowledge differential as to the applicable legal rules. It is easy to understand why parties do not reach explicitly reciprocal bargains when promisors en-

65. WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 7, at 47.

66. *Id.* "Opportunism is an effort to realize individual gains through a lack of candor or honesty in transactions. It is a somewhat deeper variety of self-interest seeking assumption than is ordinarily employed in economics . . ." Oliver E. Williamson et al., *Understanding the Employment Relation: The Analysis of Idiosyncratic Exchange*, 6 *BELL J. ECON.* 250, 258 (1975).

Many forms of opportunistic behavior are acceptable under traditional classical liberalism. "Persons are presumed to be selfish and self-reliant. They may be expected to exploit any advantages and use any tactics short of gross coercion or deception to extract maximum gains from any transaction, and to act as if other parties will do likewise." Gordon, *Outline*, *supra* note 16, at 53.

67. These misrepresentations may take the form of "self-disbelieved promises." Williamson et al., *supra* note 66, at 259. Of course, if the promises are accompanied by a misrepresentation of the speaker's intention, a deceit action may be available. See Gergen, *supra* note 57, at 1; see also *RESTATEMENT (SECOND) OF TORTS* § 530 (1976) ("Misrepresentation of Intention. [¶] (1) A representation of the maker's own intention to do or not do a particular thing is fraudulent if he does not have that intention.").

gage in such strategic behavior and by their assurances lull promisees into waiving formalized bargains, particularly in one-time negotiations or when promisees lack experience. One party strategically avoids making a formal commitment during preliminary negotiations and the other party's trust or ignorance stifles any urge to insist on a formalized bargain before making transaction-specific investments.

Another form of opportunism that characterizes the preliminary negotiation context appears when a putative promisor seeks to exploit transaction-specific investments made by the putative promisee at the promisor's request. A party who seeks to acquire a franchise, for example, may invest assets that are not salvageable outside the transaction. This investment leaves the putative franchisee vulnerable to opportunistic exploitation by the putative promisor, who may use the information garnered from that investment without paying for it and without proceeding to offer the putative franchisee a contract.

(2) *Trust as a Substitute for Formalities*

Interpersonal trust may interfere with the negotiation of an expressly reciprocal bargain. Trust often characterizes dealings between family members, for example, and also appears in ongoing relationships or when one party has superior status or expertise.⁶⁸ Parties may dispense with explicitly reciprocal contracting in these contexts because they see no need for the protection of a formalized legal contract.⁶⁹ Each party assumes that the other will act in accordance with the trust, or at least give warning should the trust become inapposite.

68. Kostritsky, *supra* note 11, at 927-29. In *Ricketts v. Scothorn*, 77 N.W. 365 (Neb. 1898), the court enforced a decedent's promissory note to his granddaughter because the granddaughter, trusting that the note would be paid when due, had been influenced to quit her job. *Id.* at 367. Presumably, the parties did not go to the trouble of creating or demanding an explicitly reciprocal bargain since the transaction took place within the inherently informal family context.

69. Parties may omit to make a formal contract because, faced with the choice between legal contract, with its attendant enforcement sanction, or a nonlegal sanction as a substitute, they deliberately opt to rely on nonlegal sanctions. See Charny, *Nonlegal Sanctions*, *supra* note 25, at 403-08 (comparing the costs of legal and nonlegal sanctioning systems); see also Goetz and Scott, *Enforcing Promises*, *supra* note 31, at 1272 (noting that nonlegal sanctions will "deter[] promises that are worth less to the promisor than the prospective cost" of such sanctions). Moreover, parties who know that courts enforce some nonlegal commitments may therefore decide they "can rely on a casual commitment." Charny, *Nonlegal Sanctions*, *supra* note 25, at 441. This Article does not explore whether it makes sense for a legal decisionmaker "to provide a legally enforceable term that more efficiently addresses the contingency than whatever nonlegal commitments the parties relied upon." *Id.* at 433.

(3) *Information Asymmetries*

Asymmetries of relevant information possessed by the parties also contribute to failures to satisfy the formal consideration requirement for an explicitly reciprocal bargain. Information asymmetries arise in preliminary bargaining when (1) the promisor has a "more accurate perception" of her own trustworthiness or of the quality of her promise than does the promisee;⁷⁰ or (2) the promisor knows more about the legal requirements for contract enforceability than does the promisee. In both situations, the promisee deciding whether to rely on a promise may find its true quality difficult to assess, and thus may rely prematurely.

Information asymmetries may lead a promisee to incorrectly judge the trustworthiness or reliability of a promise in several ways. The promisor may have private information affecting the trustworthiness of the promise. The promisor may know, for example, that the promise needs someone else's approval that is not likely to be forthcoming.⁷¹ The promisor may also possess private information about her own overall trustworthiness. The promisee's inferior knowledge in this respect might interfere with the achievement of an explicitly reciprocal bargain because the resulting uncertainty as to the existence of a knowledge differential limits her ability to decide whether and on what terms it makes sense to proceed to a reciprocal contract. Similarly, the promisee's inferior knowledge about legal rules may cause her difficulty in distinguishing a very trustworthy promise from others. The promisee untutored in legal niceties will also be unable to distinguish a promise from mere preliminary negotiation, and thus will misunderstand the importance of insisting on a formal, explicitly reciprocal bargain.

The promisor who withholds private information about her trustworthiness⁷² and willingness to deal generally does so in order to increase

70. Leland, *Minimum-Quality Standards*, *supra* note 33, at 266 (discussing the consequences of a seller's superior knowledge about the value of a proposed transaction).

71. For example, a promise would need the approval of another if it was made by an agent acting as such without actual or apparent authority to do so. Under such circumstances, it would probably be considered unreasonable for the promisee to rely without evidence of the principal's approval of the deal, and thus any reliance would not be compensable under section 90. See Daniel A. Farber & John H. Matheson, *Beyond Promissory Estoppel: Contract Law and the "Invisible Handshake,"* 52 U. CHI. L. REV. 903, 934 (1985) (discussing agency issues in the context of promissory estoppel).

72. The hiding of information about one's own trustworthiness can result in several types of private gains. If the promisor has a history of renegeing on deals even after making firm preliminary promises and withholds that information, nondisclosure might make the promisee pay more in exchange for the promise than she otherwise would. Moreover, even when the proposed deal falls through, the promisor might induce valuable promisee reliance (in a greater amount than would be possible if she disclosed her history) that helps her decide whether and

her private gains and to induce prebargain reliance by the promisee.⁷³ The putative promisor might be able to secure more promisee reliance at a lower cost through promissory assurances than she would if she fully disclosed the information.

(4) *Transaction Costs and Uncertainty*

As described above, the presence of trust and informational asymmetries may operate to hinder the achievement of reciprocal bargains. The absence of those reciprocal bargains, coupled with putative promisees' investments of transaction-specific assets, leaves promisees vulnerable to opportunistic putative promisors who request such investments and use the information developed in deciding whether and on what terms to proceed to a complete and reciprocal bargain, but never name the investments as the price of the promise and thereby escape all liability if the deal falls through. Because such exploitation may hinder future transaction-specific investments, and thus future deals, the parties or the law must find a way to curb precontractual opportunism. The parties might attempt to limit opportunism by contract. To provide background for that issue, which is explored later in this Article,⁷⁴ this subsection explains the barriers to fully contingent contracting.

Parties may fail to reach a fully contingent contract⁷⁵ because of the basic informational barriers to contracting. These barriers include the costs of collecting the information necessary to specify the terms of a proposed deal (transaction costs), and the unforeseeability of the future (uncertainty).⁷⁶ In the usual case, the promisor lacks and cannot easily

on what basis to proceed. In either case, future promisees might be less willing to incur sunk costs in preliminary bargaining without added assurances from future putative promisors, on the theory that all promisors are untrustworthy. See *infra* Part III.B.

73. See Ayres & Gertner, *supra* note 17, at 99 & n.57. For example, car buyers may withhold information about particular options or accessories that they value if this information signals to car dealers a greater willingness to pay for the underlying automobile; and professional athletes may withhold information about injuries to increase their salaries, even though as a result their team may inefficiently hire reserves.

Id. at 99 n.57; see also *infra* Part IV.C (discussing strategic withholding of information in the context of penalty defaults).

74. Part III considers the possibility of ex ante contracting to deal with opportunism and concludes that transaction costs and the problems of bounded rationality or uncertainty will almost always prevent such contracts from effectively addressing the contingencies that might arise. Part III then examines possible private responses that could overcome these barriers to fully contingent contracts regarding the particular problem of opportunistic exploitation of transaction-specific assets. As we will see, the incompleteness of such contracts is a serious and recurring problem that the parties themselves cannot resolve at reasonable cost.

75. For a description of fully contingent contracts, see *supra* note 2.

76. Klein, *supra* note 2, at 367. But see Kornhauser, *supra* note 5, at 1454 (suggesting

obtain enough information to determine the basis of an exchange—the quality of conduct that the promisee can furnish—under which she would be willing to consider herself better off, and thus cannot specify a completely contingent bargain.⁷⁷ The promisee too may face this difficulty in the prebargain phase: while she may perceive the danger of opportunistic exploitation of her transaction-specific investments, her uncertainty as to what form the opportunism might take may prevent her from specifying a fully contingent contract to control that danger.⁷⁸ In preliminary bargaining, the cost of information is usually higher than it is in other contexts, and problems of unforeseeability are likely to be particularly acute. Accordingly, any agreement to control opportunism in the bargaining process is even more liable to be incomplete.⁷⁹

B. Theories of Liability Based on the Behavioral Model

Recently, theorists have used the transaction cost model to evaluate how, if at all, the law should respond when parties to ongoing relationships or to commercial contracts fail to conform to bargain rules. Because of the nature of the relationships between parties, and the transaction costs of identifying the conduct sought by the promisor as the price for her promise, these theorists posit that parties are unlikely to achieve explicitly reciprocal, discrete bargains.⁸⁰ Therefore, when the parties reach an implicit deal but fail to channel it into a traditional bargain,⁸¹ the law, rather than ignoring their understanding, should effectuate their implicit bargain.⁸²

that parties may fail to contract over a specific contingency even when the costs of drafting are equal to zero).

77. For example, the potential franchisor in *Hoffman v. Red Owl Stores* probably did not know enough about the potential franchisee to specify the terms of the projected bargain at the outset. See *supra* note 58 and text accompanying note 6. The typical franchisor does not know *ex ante* how good a prospect the potential franchisee might be, and thus cannot know in advance what terms are appropriate (or whether a deal with the putative franchisee makes sense at all) without more investigation or inquiry.

78. For more discussion of this problem, see *infra* Part III.A.1. See also WILLIAMSON, ECONOMIC INSTITUTIONS, *supra* note 7, at 59.

79. A long-term contract is particularly unlikely to be completely contingent, because the parties usually fail to foresee all possible contingencies that might occur during the contract period. Klein, *supra* note 2, at 367; Williamson, *Transaction-Cost Economics*, *supra* note 41, at 237; see also Coleman et al., *supra* note 17, at 640 (“Although imagining problems in contract design and execution and devising adequate safeguards against all possible sources of contract failure is a logical possibility, it remains (for everyone but the gods) a practical impossibility.”).

80. See, e.g., Farber & Matheson, *supra* note 71, at 925-26 (discussing the relationship between employer and employee).

81. See Lon L. Fuller, *Consideration and Form*, 41 COLUM. L. REV. 799, 801-03 (1941) (describing the channeling function served by legal formalities).

82. See *supra* note 5 (discussing implicit bargains); see also Farber & Matheson, *supra*

(1) *Farber and Matheson's Theory*

Professors Daniel Farber and John Matheson connected a proposed rule of promissory liability to this new and expanded model of bargaining reality. They emphasized the transaction costs model of bargaining to explain failures to achieve completely contingent, explicitly reciprocal contracts. "In the context of ongoing relationships," they noted, "exchange is a continuing rather than a discrete event. Where such relationships are highly interdependent, economic benefit is likely to be sought through informal understandings that reinforce the relationship, rather than through discrete bargains."⁸³ When bargaining is likely to be incremental,⁸⁴ it is difficult to achieve highly specified, fully contingent contracts *ex ante* in a discrete bargain. Moreover, the incremental bargaining process also impedes the achievement of the bargain element, because the promisor does not know enough *ex ante* to determine what conduct or promise of the promisee might furnish an adequate basis for the promisor to issue a claim of performance against herself, and thus cannot specify a fully contingent price for the promise.⁸⁵

note 71, at 925-26 (discussing informal understandings); Kostritsky, *supra* note 11, at 905-06 (discussing factors for unexplicit bargains). *But see* Gordon, Outline, *supra* note 16, at 55 (suggesting that different models of bargaining do not resolve how the legal regime should treat any particular case).

83. Farber & Matheson, *supra* note 71, at 925-26 (footnote omitted).

84. Preliminary bargaining is likely to be incremental when the subjects of the exchange are complex and when problems of uncertainty are great. In a long-term relationship, for example, problems of unforeseeability hamper the ability to spell out all possible adaptations in advance. Bargaining is less likely to be incremental in a discrete, one-shot transaction; there the parties are likely to know the subjects of the exchange and need not pursue extended negotiations to acquire more information before deciding whether to proceed with the deal. *See* sources cited *supra* note 41. Because such brief, relatively uncomplicated negotiations are unlikely to involve significant sunk costs, legal intervention through the default rule proposed here is unnecessary. *See, e.g., infra* note 254.

85. Of course, it might be possible to achieve an incomplete bargain if the parties were willing to bargain for more generalized obligations. Thus, despite her uncertainty as to the ultimate terms of the projected promise, the promisor might be willing to agree to a general promise such as "I agree to buy all the coal that I need in exchange for your agreeing to supply such coal." The generalized nature of the performance obligations would help to solve the uncertainty problems of specifying requirements in advance over a long period of time. Whether the parties might be able to bargain over a generalized obligation to perform the contract in good faith presents problems that I address later in this Article. *See infra* Part IV.A. Of course, the obligation to perform in good faith is now recognized by the *Restatement (Second) of Contracts* as implicit in all contracts. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1979) ("Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."). In the coal requirements example, therefore, "[u]nless the parties have provided otherwise, the court will define the obligation to maintain output or requirements in terms of good faith." FARNSWORTH, CONTRACTS, *supra* note 9, § 7.17, at 551-52 (footnote omitted).

Because exchange is likely to occur in informal ways,⁸⁶ Farber and Matheson argued, contract rules should be liberalized to give effect to such implicit but nonetheless real exchanges.⁸⁷ To implement such implied bargains, they proposed that the law enforce promises made in furtherance of economic exchange.⁸⁸ Farber and Matheson defended their proposed enforcement rule on the grounds that it would promote trust in ongoing business relations—a trust that “is essential to our basic economic institutions.”⁸⁹

Working from a model of the central goals that typical economic actors are most interested in achieving, Farber and Matheson identified the natural barriers to the achievement of well-specified, express bargains. I share their view that transaction costs are likely to inhibit bargained-for consideration, causing parties to operate according to informal understandings. The case for enforcing those informal understandings, however, remains incomplete; Farber and Matheson did not focus on whether precontractual liability would promote efficient bargaining and private choice. Specifically, the admitted barriers to fully contingent contracting only explain the absence of highly specified terms. Parties still might achieve the bargain element in either of two ways: First, they could expressly bargain for a system of private incentives and disincentives that would indirectly channel each other's behavior toward jointly desired goals.⁹⁰ Second, they could reach an express bargain by exchanging highly generalized performance terms.⁹¹ We may only conclude that a proposed rule for preliminary bargaining accords with the average objectives of the parties and supplies, on average, the terms the parties themselves would have reached by comparing the proposed rule's costs against the costs associated with either expressly contracting for a private system of incentives and disincentives or expressly contracting for a generalized performance commitment.

86. Farber & Matheson, *supra* note 71, at 926.

87. *Id.* at 929.

88. *Id.* at 930. In proposing the legal enforcement of all promises regarding economic activity, Farber and Matheson explained: “The term ‘economic activity’ includes sales of goods and services, loans, insurance and employment arrangements, and similar transactions, whether involving businesses or individuals.” *Id.*

89. *Id.* at 928.

90. See *infra* Part III.A.1.

91. Generalized performance obligations might include, for example, a commitment by each of the parties to exercise an average level of efforts to remove obstacles to explicit contracting, or a commitment to give timely notice of an inability to reach an explicit agreement. See *infra* Part IV.A (explaining that the commonplace nature of such transactions might inhibit negotiation of a generalized commitment).

The comparatively high cost of overcoming the barriers to contracting through private strategies or generalized bargains illuminates the more fundamental question of why the law—on efficiency grounds—should ever infer and enforce a promise when the parties dealt with each other and presumably could have reached an express bargain themselves without legal intervention. From this perspective, I justify a default liability rule effectuating a specific implied promise attributed to promisors in precontractual negotiation in terms of efficiency and hypothetical bargaining—a more instrumental basis than Farber and Matheson's trust-centered rationale for liability. Working from "generally plausible assumptions concerning the ways in which commercial parties behave,"⁹² I address whether and why the parties themselves would have chosen the proposed liability rule over possible alternatives.

(2) *Shell's Theory*

Professor Richard Shell, like Professors Farber and Matheson, drew on a complex and detailed model of human behavior to determine whether and how the law should respond to the problems of opportunism that arise when one party invests transaction-specific assets in the prebargain phase. Shell accepted the transaction cost economists' view that bounded rationality and opportunism, among other traits, characterize human behavior.⁹³ While focusing on the likelihood of opportunism occurring at all phases of contractual relations, he found its dangers "most acute and noticeable when the transaction is accompanied by investments in assets that are specifically tailored to the transaction and cannot be fully salvaged outside the transaction."⁹⁴

To remedy the problem of precontractual exploitation of parties that have incurred sunk costs, Shell proposed a new cause of action for opportunistic breaches of the bargaining relationship.⁹⁵ Concerned about the sociology and psychology of negotiation,⁹⁶ he posited that such a liability rule is necessary to promote durable commercial relationships. Shell argued that precontractual investment is crucial for "build[ing] mutually trusting bargaining relationships," and since the prevalence of opportunism deters such investments, trust cannot be achieved without curbing precontractual opportunism.⁹⁷

92. Scott, *An Economic Perspective*, *supra* note 16, at 59.

93. *See* Shell, *supra* note 7, at 229.

94. *Id.*

95. *Id.* at 225.

96. *See id.* at 225-27.

97. *Id.* at 252; *see id.* at 225 (arguing that opportunistic behavior during bargaining undermines interpersonal trust).

By contrast, I view investments of transaction-specific assets as significant not so much because they generate a basic feeling of trust among parties, but because these investments provide the potential promisor with information that enables her to decide whether and on what basis to develop a fully contingent contract—they allow the promisor to specify the price of her promise in highly contingent terms.⁹⁸ With this focus, assuming the parties have rational expectations and are interested in a strategy to “maximize the joint benefits of contracting”⁹⁹ and to minimize transaction costs, we may treat precontractual investments as the subject of an implicit exchange.¹⁰⁰

Shell rationalized his approach by reference to the relative ineffectiveness of alternative mechanisms for promoting trust.¹⁰¹ While I agree with Shell that the law should compensate disappointed bargainers for some precontractual investments, I justify liability from the perspective of private choice: Because of the higher costs of alternative rules or approaches, the parties themselves would opt for the legal sanction of a default liability rule.

Thus, while Farber and Matheson and Shell shared an interest in developing a legal rule to promote trust, they did not examine whether their rules could be justified according to the preferences of hypothetical bargainers. This Article provides that missing analysis. By comparing the costs of private adaptations and of alternative legal approaches to precontractual negotiations against the costs of a judicially supplied default rule, I show that the proposed default rule minimizes transaction costs and promotes efficiency in preliminary bargaining.

98. Although interpersonal trust is important to successful bargaining relationships and can be promoted through a liability rule for precontractual investments, *see infra* Part IV.B.2, trust does not provide the strongest justification for viewing those investments as the subject of an implicit bargain between the parties. At the outset of negotiation, the promisor usually has in mind a range of options that might satisfy her goals. The information derived from the promisee's precontractual investments allows the promisor to determine whether a contract with the promisee might satisfy her goals and, if so, what terms that contract should include. With more information, the promisor can answer these questions with greater accuracy. In order to secure that information, average promisors would willingly assume some liability for the costs of producing it.

99. Scott, *A Relational Theory*, *supra* note 12, at 599 (citing Goetz & Scott, *Principles of Relational Contracts*, *supra* note 2, at 1095-99).

100. Discussion with Ronald J. Coffey, *supra* note 5. The law should probably enforce such an implicit exchange—for example, in which the promisor, in exchange for sunk costs incurred by the promisee at the promisor's request, agrees to cover those costs—whenever the case includes the structural attributes of barriers to express bargaining and sunk costs invested at the promisor's request that would be valuable to the promisor in formulating the terms of the projected ultimate promise. I leave the exact content of the obligation to future discussion elsewhere.

101. *See* Shell, *supra* note 7, at 253-55.

III. Private Responses to the Barriers Problem

Parties may seek to overcome the barriers to reaching explicitly reciprocal contracts through a variety of private strategies. Moreover, different liability rules would prompt different bargaining behavior. Assuming that parties would costlessly adapt to whatever legal rule prevailed, legal intervention in the form of a default rule would be unnecessary; we would simply implement a rule of enforcement or nonenforcement of ultimate promises¹⁰² on the assumption that "the initial legal entitlement might not matter if parties could bargain, perfectly, to a Pareto superior entitlement."¹⁰³ Assuming that bargaining is costly, and that parties may have difficulty reaching a Pareto-superior outcome, many commentators sensitive to such barriers advocate the adoption of default terms "that mimic the terms that most parties would have explicitly included in their contracts."¹⁰⁴ This Article addresses whether the law should supply a default rule by conducting a further analysis—comparing the costs of possible private mechanisms for overcoming the barriers to contracting with those of a law-supplied rule. To determine whether parties would opt to rely on private devices or adaptations as a means of overcoming the various barriers to explicitly reciprocal, fully contingent contracting, this Part examines the costs and benefits of each. This focus advances current behavioral theories of liability and provides a more complete justification for allowing some disappointed promisees to recover their sunk costs. I conclude that the particular barriers present in typical incremental contracting situations support a judicially supplied default rule as the least costly alternative.

A. Opportunism and Transaction Cost Barriers: Private Responses Considered

A primary barrier to the negotiation of fully contingent, explicitly reciprocal contracts results from the convergence of two interrelated behavioral assumptions: that people are given to opportunism¹⁰⁵ and that they function within the confines of a bounded rationality. Under bounded rationality, "the capacity of the human mind for formulating and solving complex problems is very small compared with the size of the problems whose solution is required for objectively rational behavior

102. See *infra* note 147.

103. Johnston, *supra* note 29, at 293 (discussing the Coase Theorem). For an explanation of Pareto superiority, see *supra* note 17.

104. *Id.* at 293.

105. See WILLIAMSON, ECONOMIC INSTITUTIONS, *supra* note 7, at 47-49, 64-67; *supra* Part II.A.

in the real world—or even for a reasonable approximation of such objective rationality.”¹⁰⁶ Manifestations of bounded rationality and opportunism may theoretically occur independently, in four different patterns:

- (1) unbounded rationality/nonopportunism—a condition of contractual utopia;
- (2) unbounded rationality/opportunism—a case where contracts can be made to work well by recourse to comprehensive contracting;
- (3) bounded rationality/nonopportunism—where contracting works well because of general clause protection against the hazards of contractual incompleteness; and
- (4) bounded rationality/opportunism.¹⁰⁷

In the second case, fully contingent contracting is possible. In the fourth case, however, when bounded rationality and opportunism occur together, the problem with requiring a fully contingent contract becomes apparent. One party may act opportunistically in a way not foreseen *ex ante*.¹⁰⁸

Although the propensity for opportunism is ubiquitous, its impetus may vary with the situation. In some instances, strategic considerations may prompt opportunism. The investment of “transaction-specific assets sets the stage for opportunistic behavior by the party less committed to the deal. Blatant opportunism occurs when the less-committed party simply exploits the part performance and breaks off negotiations.”¹⁰⁹ As a structural matter, opportunism is likely to occur whenever a putative promisee makes such unprotected investments, just as the chances for opportunistic behavior are increased by the presence of transaction-specific investments in an ongoing contractual relationship.¹¹⁰

In other cases, transaction costs and the unforeseeability of future contingencies (due to bounded rationality) may contribute to opportunism and encourage deliberate distortion. The unforeseeability of future

106. HERBERT SIMON, *MODELS OF MAN* 198 (1957) (emphasis omitted); see also WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 7, at 11 (discussing Simon's analysis of bounded rationality).

107. WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 7, at 67. Professor Williamson assumed that the prevalence of opportunism vitiates the effectiveness of “general clause contracting” under which, for example, a party “pledge[s] to execute this contract efficiently and to seek only fair returns at the contract renewal interval.” OLIVER E. WILLIAMSON, *MARKETS AND HIERARCHIES* 26-27 (1975). Even assuming that parties behave opportunistically, however, contracting parties might (were it not for the transaction costs of negotiating such clauses) agree to general terms requiring future cooperation because doing so would promote the self-interest of each. Scott, *A Relational Theory*, *supra* note 12, at 605.

108. Professor Williamson discounted the first, second, and third patterns because of the inevitability of opportunism and limits on rationality. WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 7, at 67.

109. Shell, *supra* note 7, at 239.

110. For a discussion of the problems of opportunism in ongoing relationships, see WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 7, at 62-63.

contingencies, in particular, may act as a driving force for distortion and opportunism in preliminary negotiations.¹¹¹ For example, the putative promisor, who cannot project the appropriate terms for an ultimate offer and thus will not make such an offer, nevertheless has an incentive to deliberately distort the chances of reaching an ultimate deal in order to secure transaction-specific investments from the promisee. The information produced by such investments would reduce the promisor's uncertainty about the proposed deal and lessen her risk of loss from the transaction.¹¹² In this situation, transaction costs and uncertainty give rise to strategic considerations that prompt the "players to disguise their true intentions in pursuit of an agreement, moderating or exaggerating their demands based on their view of how each will respond to the other."¹¹³

Another cause of opportunism in preliminary bargaining situations becomes apparent if we view the process of developing an offer, by analogy to agency relationships, as a delegation by the putative promisee-principal to the putative promisor-agent. The promisee pays the promisor to guard her interests by investing in the proposed transaction. Inevitably, the agent will have to make choices that involve the promisee-principal in such a manner that the latter cannot determine whether the promisor-agent's actions promote her interests or not. The promisor-agent will be tempted to capitalize on the promisee-principal's inability to characterize her actions by shirking her obligation to further the promisee-principal's interests, and advancing her own instead—a form of opportunism.¹¹⁴

Comprehensive private contracting could feasibly regulate instances of opportunism, whatever their causes, were it not for the condition of bounded rationality.¹¹⁵ When comprehensive contracting cannot feasibly control opportunism, however, various alternative strategies, both public and private, should be considered.

111. See Richard N. Langlois, *Internal Organization in a Dynamic Context: Some Theoretical Considerations*, in COMMUNICATION AND INFORMATION ECONOMICS 23 (Meheroo Jussawalla & Helene Ebenfeld eds., 1984).

112. See HIRSHLEIFER & RILEY, *supra* note 13, at 204 (describing "an 'irreversible' element in the possible loss suffered from mistaken early commitment" in situations in which acquiring more information might allow the decisionmaker to avoid the mistake).

113. Coleman et al., *supra* note 17, at 660. When parties strategically conceal or disguise their true intentions, a cause of action based on deliberate misrepresentation of intention may be appropriate. See RESTATEMENT (SECOND) OF TORTS § 530(1) (1976), quoted *supra* note 67. As noted earlier, however, a misrepresentation theory cannot serve as a systematic cure for bargaining failures and precontractual opportunism. See *supra* Part I.E.

114. This problem is explored more fully below. See *infra* Part III.A.1.

115. WILLIAMSON, ECONOMIC INSTITUTIONS, *supra* note 7, at 30-31.

(1) *Screening, Bonding, and Similar Devices*

Parties to agency relationships often adopt private strategies to overcome opportunism and minimize transaction costs—to address the barriers to fully contingent bargains between principals and agents. The following examination of these private responses indicates that, if given the choice, rational parties “seeking to maximize overall wealth or utility *would have consented*”¹¹⁶ to a law-supplied rule rather than pursue intermediate, private strategies to circumvent the natural barriers to complete and explicit contracting.

a. *The Agency Context*

An agency relationship consists of “a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent.”¹¹⁷ Agency relationships exist, for example, between the owners and the managers of most corporations. Because principals cannot effectively monitor their agents’ conduct, the problem of moral hazard or shirking arises.¹¹⁸ The agent has an incentive, and the opportunity, to promote her own interests over those of her principal.¹¹⁹ This divergence is likely to occur whenever “both parties to the relationship are utility maximizers.”¹²⁰ The principal also faces the problem of adverse selection or hidden information: even if the principal could observe the agent’s conduct, the principal could not ascertain whether the agent had furthered her own personal interests or maximized the principal’s welfare.¹²¹

116. Coleman et al., *supra* note 17, at 644.

117. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

118. Klein, *supra* note 2, at 367-68. Moral hazard refers to the specific problem that arises from the principal’s inability to observe her agent’s conduct. Economists also refer to this as a problem of “hidden action,” in which “[e]ffort is a disutility to the agent, but it has a value to the principal in that it increases the likelihood of a favorable outcome.” Arrow, *supra* note 33, at 38. Professor Williamson described these problems resulting from the unobservability of the agent’s actions as an example of the broader problem of opportunism. WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 7, at 51.

119. Kornhauser, *supra* note 5, at 1452-53 & n.5.

120. Jensen & Meckling, *supra* note 117, at 308. I assume that this is always the case—that both parties are rationally acting to maximize their wealth. This assumption is useful in providing a model for analyzing the effects of alternative legal approaches and private solutions to the problem of precontractual liability on the parties’ incentives. *But see* William C. Whitford, *Ian Macneil’s Contribution to Contracts Scholarship*, 1985 WIS. L. REV. 545, 549-50 (discussing Macneil’s insights regarding the importance of goals other than wealth maximization).

121. Arrow, *supra* note 33, at 39. Professor Kenneth Arrow observed:

One might ask why the principal does not simply specify ex ante a fully contingent contract that "would prevent all managerial shirking."¹²² The failure to draft such highly specified terms derives from the unforeseeability of future contingencies. The agent frequently is delegated long-term obligations under circumstances in which the principal cannot foresee the agent's choices.¹²³ Because the principal cannot draw a "decision tree" in advance to guide the agent through the whole array of decisions that the agent will have to make,¹²⁴ the parties cannot reach a completely contingent contract. Uncertainty inhibits the negotiation of fully contingent contracts in this context, much as it inhibits both fully contingent and explicitly reciprocal contracting in other promissory contexts.

To solve the typical agency contract's failure to fully regulate shirking, the law might rely exclusively on private devices for which the parties expressly bargained. Principals commonly implement such devices to reduce the cost of monitoring their agents' performance, and agents usually accept them when they are in line with the "shape and behavior of the optimal compensation schedule."¹²⁵ At least four distinct private strategies arise, each with varying cost and efficacy. First, principals may attempt to minimize shirking by screening potential agents before entering into a contract—trying to discern ex ante whether the agent's preferences are likely to conflict with the principal's.¹²⁶ Second, the parties

In the hidden information problems, the agent has made some observation that the principal has not made. The agent uses (and should use) this observation in making decisions; however, the principal cannot check whether the agent has used his or her information in the way that best serves the principal's interest.

Id.

122. Klein, *supra* note 2, at 368.

123. *Id.* at 367-68. In an employment relationship, for example, the employee-agent faces myriad choices that will affect the principal-employer. Yet the principal will find it extremely difficult and costly to craft a completely contingent contract to control the agent's discretion in each of those instances, since the decisions that the agent-employee will have to make are not apparent ex ante. The discretion delegated to any agent facilitates shirking and raises the question of how that shirking—an agency cost—should best be controlled.

124. WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 7, at 59; see also Discussion with Ronald J. Coffey, *supra* note 5.

125. David M. Kreps, *In Honor of Sandy Grossman, Winner of the John Bates Clark Medal*, 2 J. ECON. PERSP. 111, 130 (1988).

126. Screening describes ex ante efforts by one party to identify the individual characteristics of the other, in order to "eliminate the quacks and the lemons," Hayne E. Leland, *Quacks, Lemons, and Licensing: A Theory of Minimum Quality Standards*, 87 J. POL. ECON. 1328, 1330 (1979), thereby minimizing costly errors. In retail sales, for example, the retailer monitors its customers' tastes and screens out products with low demand in an effort to minimize inventory costs. Leland, *Minimum-Quality Standards*, *supra* note 33, at 269.

Screening devices, however, are costly. A potential agent has a strategic incentive to keep negative information about her propensities to diverge from the principal's interests a secret,

may employ bonding strategies, under which the agent agrees to special limitations on her delegated power.¹²⁷ With bonding, the agent might experience a loss if she did not perform in accordance with the principal's objectives.¹²⁸ Third, *ex ante* incentive alignment schemes, which "make the agent's compensation depend on a measure of the agent's level of effort, namely the level of output obtained,"¹²⁹ might reduce shirking.¹³⁰ Adjusting the agent's compensation to account for the likelihood of divergence, however, may not be worth the principal's efforts. Often, "letting the agent shirk and discounting his wage will not be an economical solution because the gain to the shirker and therefore his acceptable compensating wage discount is less than the cost to the firm from the shirking behavior."¹³¹ Finally, assuming that a putative promisee can be considered a principal who delegates decisionmaking authority to the promisor-agent, the principal might demand that the agent pay her up front for her sunk costs. By making such a demand, however, the principal would send an ambiguous signal about her intentions. The agent could take it to mean either that the principal is a good potential partner who simply wants payment for her future costs before they are sunk, or that the principal would be a successful shirker and divert the payment.¹³² Because

just as another potential agent would want to signal his low propensity for divergence. This is a problem of pooling and separation, in which an uninformed party attempts to devise some means of distinguishing between low- and high-risk agents, perhaps by offering a "menu" of different contractual arrangements calculated to appeal to different types of agents. However, "[d]evising a menu that induces information revelation may require a great deal of sophistication by the uninformed party and may entail large transaction costs." Ayres & Gertner, *supra* note 17, at 103; *see also infra* Part IV.C.

127. Jensen & Meckling, *supra* note 117, at 308, 325.

128. Bonding occurs when the agent "expend[s] resources (bonding costs) to guarantee that [s]he will not take certain actions which would harm the principal or to ensure that the principal will be compensated if [s]he does take such actions." *Id.* at 308. Examples include "contractual guarantees to have the financial accounts audited . . . , explicit bonding against malfeasance on the part of the [agent], and contractual limitations on the [agent]'s decision making power." *Id.* at 325. It is difficult, however, to determine when the principal's objectives have been met, and bonding devices can effectively guard against only the most blatant forms of shirking. *See infra* note 142 and accompanying text.

129. Kreps, *supra* note 125, at 129.

130. Klein, *supra* note 2, at 368 n.2.

131. *Id.*

132. A promisee-principal might "shirk" in this context by securing compensation for her sunk costs without having a serious intent to reach an ultimate bargain with the promisor-agent. A similar effect appears in employment contracting: a prospective employee who bargains for just-cause protections in exchange for a lower wage may thereby signal to the prospective employer that he is a "talented shirker"—a worker who would rather exert only enough effort to avoid dismissal for cause. Because the putative promisor will not be able to sort out the shirkers except at great cost, she will tend to treat the putative promisee as having average characteristics. David I. Levine, *Just-Cause Employment Policies in the Presence of Worker Adverse Selection*, 9 J. LAB. ECON. 294, 295 (1991) [hereinafter Levine, *Worker Ad-*

the agent, lacking knowledge of the principal's true intentions, can only treat the principal as an average partner, she may be unable to determine how much to give the principal for her sunk costs. Furthermore, the payment mechanism, like all of these private devices, may be costly to design and implement.

Because agency contracts are invariably incomplete and private attempts to prevent shirking are costly, the law supplies a fiduciary obligation between principals and agents and in other relationships of special trust or confidence, regardless of whether the parties to those relationships bargain for such an obligation.¹³³ A fiduciary owes "a duty of utmost good faith rather than the standard contractual duty of good faith."¹³⁴ In the corporate setting, for example, managers must "manage the enterprise so as to enhance the wealth of the [equity] investor."¹³⁵ Essentially, "[t]he agent is paid to treat the principal as he would treat himself; to be his alter ego."¹³⁶

b. The Agency Analogy for Precontractual Negotiation

Drawing an analogy from bargaining for agency contracts to other preliminary bargaining situations, we might view one party (a principal) as delegating decisionmaking authority to the other, who then decides whether to make an offer (an agent).¹³⁷ The principal must delegate

verse Selection]. Similarly, bad cars tend to drive good cars out of the market for used automobiles, because consumers treat all cars as being of average quality for lack of information. George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 489 (1970); see *infra* Part III.B.

133. Ronald J. Coffey, *Firm Opportunities: Property Right Assignments, Firm Detriment, and the Agent's Performance Obligation*, 13 CAN.-U.S. L.J. 155, 156 (1988) [hereinafter Coffey, *Firm Opportunities*].

134. POSNER, *supra* note 17, § 4.6, at 113.

135. John A.C. Hetherington, *Defining the Scope of Controlling Shareholders' Fiduciary Responsibilities*, 13 U.S.-CAN. L.J. 103, 109 (1988).

136. POSNER, *supra* note 17, § 4.6, at 113.

137. Coffey, *Firm Opportunities*, *supra* note 133, at 156-57 n.5 (suggesting the usefulness of the agency analogy for legal relationships in which one party's performance obligation includes the "discretionary power to choose among alternatives"). Of course, the relationship between principals and agents as modeled here might apply to different sides of different transactions. Depending on the case, we may view a putative promisor either as the agent or as the principal. For example, consider the relationship between lenders and borrowers of money. Despite the absence of an explicit agency contract, a lender may claim to be a principal to whom the borrower, as an agent, owes a fiduciary duty. Courts have been slow to recognize such a duty in the relationship of bondholder and corporation. See, e.g., *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1524 (S.D.N.Y. 1989) (holding corporation did not owe its bondholder a fiduciary duty to refrain from a leveraged buyout that reduced bond value). Bond issuers are "under a duty to carry out the terms of the contract, but not to make sure that [the bondholders have] made a good investment." *Gardner & Florence Call Cowles Found. v. Empire Inc.*, 589 F. Supp. 669, 674 (S.D.N.Y. 1984), *vacated on other grounds*, 754

some decisionmaking authority so that the agent may obtain enough information to make a rational decision whether and on what terms to go forward with the deal. Natural barriers to complete and explicit contracting arise in preliminary negotiations because the parties lack the information from which to determine whether and on what terms it would make sense to proceed.¹³⁸ Moreover, the problems of uncertainty and moral hazard that characterize the agency situation also affect the preliminary contracting process in general. Uncertainty makes it difficult to specify the price, quantity, quality, and time for any proposed transaction. The risk of moral hazard consists of the threat that putative promisors will "maximiz[e] their own utility to the detriment of others, in situations where they do not bear the full consequences or, equivalently, do not enjoy the full benefits of their actions."¹³⁹

Given that similar problems of uncertainty and moral hazard affect both agency contracting (where they hinder completeness) and precontractual bargaining (where they hinder complete, explicit agreements), the question arises whether the law should rely on private, bargained-for devices to overcome these barriers. More to the point, are there circumstances under which the law should intervene, as it does in the agency

F.2d 478 (2d Cir. 1985); see *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 958 (5th Cir.) (limiting corporation's duty to debenture holders to compliance with obligations under indenture), *cert. denied*, 454 U.S. 965 (1981). *But see* *Fox v. MGM Grand Hotels*, 187 Cal. Rptr. 141, 142 (Ct. App. 1982) (noting in dicta that a debtor corporation has a duty not to intentionally prejudice bondholder's expectation that debt will be paid when due). In lender liability cases, the roles are reversed; the borrower claims that the lender owes the borrower a fiduciary duty. See, e.g., *Stewart v. Phoenix Nat'l Bank*, 64 P.2d 101 (Ariz. 1937) (finding an implicit fiduciary duty when creditor relied on bank's financial advice); Frances E. Freund, Note, *Lender Liability: A Survey of Common-Law Theories*, 42 VAND. L. REV. 855, 867-71 (1989) (reviewing the fiduciary duties that the law imposes on lenders in special relationships of trust or confidence). See generally Daniel R. Fischel, *The Economics of Lender Liability*, 99 YALE L.J. 131 (1989) (exploring economic approaches to resolving the tension between contractual provisions and law-supplied terms in lender liability cases). In each instance the self-proclaimed principal asks the law to create terms making conduct that the contract did not expressly forbid nonetheless a breach of the contract. In preliminary bargaining situations, the identification of principal and agent suggested here (making the putative offeror the agent and the putative offeree the principal) could likewise be reversed in other stages of bargaining.

138. See *supra* Part II.

139. 3 THE NEW PALGRAVE: A DICTIONARY OF ECONOMICS 549 (John Eatwell et al. eds., 1987) [hereinafter THE NEW PALGRAVE]. Without liability during the period of preliminary negotiations, putative promisors need not internalize the costs of their actions. Thus a promisor may make assurances to any point short of a contract in order to gain the promisee's reliance, which then enables the promisor to rationally determine whether to proceed. The promisor maximizes her overall utility by such actions because she can determine the profitability of a potential deal without being liable for the promisee's reliance costs. See 3 *id.* at 549-51.

context, by supplementing the private devices with a default rule imposing something akin to a fiduciary obligation?¹⁴⁰

Private devices might prevent a promisor-agent from shirking, acting opportunistically, or otherwise exploiting a promisee-principal who has invested sunk costs in the process of bargaining, but the uncertainty in such settings is great. For example, incentive alignment schemes link the agent's compensation with objective indicia of her performance. In precontractual negotiations, however, it is especially difficult to determine when nonperformance occurs. To the extent that these devices depend on objective measures of the agent's conduct, they may be difficult or impossible to implement in the preliminary bargaining context. The putative promisor-agent typically faces such an array of potential choices that the promisee-principal cannot specify useful measurements for incentive alignment schemes. Similarly, the principal might incur monitoring costs "to limit the aberrant activities of the agent,"¹⁴¹ but effective monitoring requires understanding the nature of aberrant behavior. Promisees cannot effectively characterize promisors' behavior because of the prevailing uncertainty in precontractual negotiations, thus making monitoring ineffective.¹⁴²

Screening devices also prove unhelpful. Promisees might screen promisors to determine their overall trustworthiness and potential for diverging from promisees' interests. In the preliminary negotiation context, a putative promisee might screen for unexpected changes in the level of interest exhibited by a putative promisor in order to gauge the seriousness of the promisor's intent to proceed toward an ultimate prom-

140. For an excellent treatment of the linkage between law-supplied fiduciary obligations and the barriers to comprehensive contracting, see Coffey, *Firm Opportunities*, *supra* note 133, at 156-57 n.5, 163-64. See also Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1261-62 (1982) (identifying fiduciary obligation as a less costly alternative to entering into many separate contracts).

141. Jensen & Meckling, *supra* note 117, at 308.

142. In the typical agency relationship, the principal can limit divergences of interests by establishing incentives for the agent and monitoring the agent's activities. *Id.* The principal can measure aberrant behavior because he usually can distinguish *ex ante* between actions that favor and disfavor his interests. For example, it is clear *ex ante* that stealing from the principal's cash register is aberrant whereas increasing profitable sales is positive.

Incentive alignment and monitoring schemes are difficult to implement in incremental contracting, however, because it is unclear *ex ante* what is aberrant behavior. For example, agent actions that prevent the parties from forming a contract do not necessarily disfavor the principal's interest, since the potential contract thus forgone might have had a negative value. Alternatively, agent actions that lead to the formation of a contract do not necessarily favor the principal since the deal may not be valuable to the principal. Because it is difficult to establish objective criteria with which to monitor the agent's actions, these private devices have little use for parties in precontractual negotiations.

ise, or to determine whether the putative promisor has any greater obstructive tendency than exhibited in her initial contacts with the promisee.¹⁴³ Attempts to design appropriate screening devices must overcome serious problems of strategic behavior: less trustworthy parties will strategically conceal their true qualities, disguising themselves as trustworthy, high-quality promisors. The transaction costs of designing effective devices to separate out low-quality types from the overall pool of potential promisors are likely to be great.¹⁴⁴

Finally, the promisee might try to implement bonding devices or demand that the promisor cover her sunk costs at the outset of negotiations. Either of these strategies would require some sort of preliminary contract between the bargainers. Before a deal has been struck, however, transaction costs make it hard to explicitly contract to regulate shirking.

In any case, all of these private devices are costly to negotiate or to implement on an individualized basis. The impediments to creating a well-specified array of channeling incentives and disincentives include the costs of learning enough to design directives and the associated inability to cheaply and unequivocally discern conduct that violates such directives. These aspects of precontractual bargaining reveal why the parties would be unable or would not bother to expressly bargain for a private system of incentives and disincentives as a means of overcoming the barriers to fully specified, bargained-for contracts.

(2) *Calibrating Enforcement Rules: Depending on Private Adaptations*

Another possible strategy for overcoming the barriers to fully contingent, explicitly reciprocal contracting relies on adjustments in the legal rules of contract enforcement. We could "calibrate"¹⁴⁵ the enforcement rules either to deny or to grant full enforcement to incomplete and unbargained-for promises on the assumption that the affected parties would be able to respond privately to whatever approach the courts adopted.¹⁴⁶ Thus, it would not matter that informational or trust barriers prevented

143. Discussion with Ronald J. Coffey, *supra* note 5.

144. See Ayres & Gertner, *supra* note 17, at 103; *infra* Part IV.C.

145. Goetz & Scott, *Enforcing Promises*, *supra* note 31, at 1266.

146. One version of the Coase Theorem proposes that "resource allocation is efficient, regardless of the structure of liability law, provided that bargaining is frictionless." Cooter, *supra* note 29, at 4. "If the parties can bargain and cooperate, then their best course is to maximize joint profits and split the surplus from cooperation." *Id.* Thus, "the activities which maximize joint profits are undertaken, regardless of the liability law"; the law only influences "the distribution of the cooperative surplus." *Id.* Put differently, "the initial legal entitlement might not matter if parties could bargain perfectly to a Pareto superior entitlement." Johnston, *supra* note 29, at 293; see R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

the achievement of complete and reciprocal agreements and that transaction costs prevented the negotiation of more generalized performance terms—whatever the cause of the contracting failure, courts would respond either by denying enforcement of the ultimate promise or by enforcing the ultimate promise.¹⁴⁷ The courts' choice would have no consequence because parties would presumably adjust their behavior and take private steps to counter the adverse effects of whatever legal rule prevailed.¹⁴⁸ The arrangement of promissory liability rules chosen would ultimately depend on which produced the most desirable private adaptations to those rules.

To some extent, the calibration approach assumes away some of the real characteristics that the parties are likely to share, including bounded rationality. A nonenforcement strategy, for example, assumes that bargainers will react to the rule of nonenforcement by reaching fully contingent, explicitly reciprocal contracts whenever they desire that the law enforce their promises. The other approach, full enforcement, solves the problem of transaction costs differently: it compensates for the presumed insurmountability of transaction costs by enforcing even promises that were not fully specified or explicitly bargained-for.¹⁴⁹

Because bargaining is not costless, parties might not bargain around the initial legal rule, whether it be enforcement or nonenforcement.¹⁵⁰ Despite their sensitivity to the behavioral effects of different legal approaches, Professors Goetz and Scott were comfortable with the current scheme, allocating reliance losses to promisees in initial bargaining, be-

147. The "ultimate promise" consists of an undertaking that the promisor might be willing to make in the future. The ultimate promise should be distinguished from a preliminary promise that the promisor might be willing to make at any given time on terms that could not then be reached in an explicitly reciprocal form because of the barriers to contracting.

148. The Coase Theorem posits that liability law has no effect upon efficient resource allocation, so long as "bargaining is frictionless." Cooter, *supra* note 29, at 4. In incremental contracting, however, transaction costs may prevent the parties from reaching any agreement. In that event, the surplus from cooperation is lost. *See id.* Therefore, the structure of liability rules is important in incremental contracting because bargaining is *not* frictionless and parties will not necessarily be able to contract around the initial rule. Judge Richard Posner explained the general principle at work here:

Since transactions are never costless in the real world, efficiency is promoted by assigning the legal right to the party who would buy it . . . if it were assigned initially to the other party. Moreover, . . . the cost of transacting is sometimes so high relative to the value of the transaction as to make transacting uneconomical. In such a case the initial assignment of rights is final.

POSNER, *supra* note 17, § 3.6, at 52.

149. Presumably, if the full enforcement rule did not provide the optimal terms or was not the optimal rule for promissory liability, then the parties would bargain to some other result. *See supra* note 146 (describing the Coase Theorem).

150. *See supra* note 148.

cause they concluded that "risk-averse bargainers will prefer to face uncertain risks as promisees rather than as promisors."¹⁵¹ While this issue will be rejoined later,¹⁵² the following discussion explores the possible incentive and behavioral effects of enforcement and nonenforcement approaches on parties in preliminary bargaining.

Calibrating liability rules to grant or deny enforcement of nonreciprocal promises and depending on private responses to reach the optimal solution may in fact prevent "socially optimal interaction between the promising parties."¹⁵³ If courts enforced all ultimate promises as a means of overcoming the barriers to complete and reciprocal contracting, then promisors would "make fewer promises" as a "precautionary adjustment."¹⁵⁴ The discouragement of such promises would in turn limit the interim reliance costs that promisees would otherwise be willing to incur in order to provide the informational foundation for an eventual bargain.¹⁵⁵ On the other hand, a nonenforcement regime would prompt "self-protective" behavior by promisees,¹⁵⁶ which would similarly lessen their interim reliance investments. Calibrating the liability rules in either of these ways would thus probably not solve the basic informational barrier that hinders complete, reciprocal contracting. Moreover, as described below, such approaches might entail undesirable costs and may "powerfully modify the nature and amount of future promising"¹⁵⁷ in undesirable ways.¹⁵⁸

151. Goetz & Scott, *Enforcing Promises*, *supra* note 31, at 1295. Professors Goetz and Scott defended the denial of promissory liability in most preliminary bargaining on the theory that its incentive effects produce the most efficient private adaptations, and assume that "risk-averse parties will choose to forgo uncertain gains rather than incur equally uncertain losses of the same magnitude." *Id.* Although Goetz and Scott's model is useful, it fails to fully account for parties' inability to reach the most efficient adaptations in incremental negotiations. *See infra* notes 234-241 and accompanying text.

152. *See infra* notes 234-241 and accompanying text.

153. Goetz & Scott, *Enforcing Promises*, *supra* note 31, at 1266. Professors Goetz and Scott suggested the opposite: "Appropriately calibrated enforcement rules can be used to achieve the optimal number and type of promises based on the degree and form of adaptation by promisor and promisee." *Id.*

154. *Id.* at 1274; *see id.* at 1273-74, 1278-80 (arguing that promisors will react to legal enforcement by making fewer promises and decreasing the value of the promises they do make).

155. For an explanation of this adaptive response, see *infra* Part IV.B.4.

156. Goetz & Scott, *Enforcing Promises*, *supra* note 31, at 1270-71.

157. *Id.* at 1264.

158. From the parties' perspective, enforcement and nonenforcement of ultimate unbargained-for promises are not the only possible results. If transaction costs were sufficiently low, it would not matter what legal rule were the initial entitlement; presumably, parties could bargain for some other rule if that were the optimal result. The parties might negotiate an intermediate rule in which the promisor bargains for the promisee's sunk investments and the promisee bargains for the promisor to cover her sunk costs and apprise her of changes in a

a. Nonenforcement: The Costs of Self-Protective Behavior, Reassurances, and Insistence on the Reciprocal Bargain¹⁵⁹

The nonenforcement view holds that the law should not enforce promises when parties fail to reach an explicitly reciprocal bargain. Implicit in this approach is the expectation that the rule of nonenforcement would produce the most desirable adaptive responses by promisors and promisees.¹⁶⁰

Denying enforcement to unbargained-for, preliminary promises, however, would encourage promisees to adopt a variety of responsive tactics that in turn would tend to frustrate the parties' efforts to consummate a deal. Under this nonenforcement rule, the "promisee bears all risks of breach," since any prebargain reliance is not compensable.¹⁶¹ To minimize these risks, promisees would likely engage in self-protective behavior.¹⁶² Because of the nonenforcement sanction for failure to reach a reciprocal contract, promisees would view any intermediate promises made as having only "imperfect credibility" at best.¹⁶³ As Professors Goetz and Scott explained, "the promisee can protect himself against prospective losses from detrimental reliance by limiting his behavior adjustments."¹⁶⁴ Promisees would rely on promises "only to the extent that the prospective cost of reliance is outweighed by prospective benefits."¹⁶⁵ Weighing their prospective gains from the promise against the risk of losing their reliance investments,¹⁶⁶ promisees would tailor their

willingness to proceed to the projected ultimate promise. Barriers to the parties' adoption of such an intermediate rule are discussed in Part IV.A.

159. See Goetz & Scott, *Enforcing Promises*, *supra* note 31, at 1270-71, 1274.

160. The nonenforcement approach and its underlying assumptions were once dominant. Under classical liberalism, courts almost always denied effect to unbargained-for promises. See *supra* Part I.A.

161. Goetz & Scott, *Enforcing Promises*, *supra* note 31, at 1279. Professors Goetz and Scott, later joined by Professor Douglas Leslie, defended this allocation of risks. As Professor Gergen explained, their "basic point is that people best know their own reliance and can therefore best take appropriate precautions against their own losses." Gergen, *supra* note 57, at 40 (citing ROBERT E. SCOTT & DOUGLAS L. LESLIE, *CONTRACT LAW AND THEORY* 137 (1988)).

162. Goetz & Scott, *Enforcing Promises*, *supra* note 31, at 1270.

163. *Id.*

164. *Id.* A promisee might also adjust to a nonenforcement rule by "discounting the price he is willing to pay for the promise." *Id.* at 1293 (noting this possibility in the context of uncertain enforcement).

165. *Id.* at 1279.

166. In this situation, the promisee's prospective gain consists of the value of the ultimate promise, leavened by the probability that the promisor would gain enough information from the promisee's reliance to be able to make a fully contingent offer and the probability that no intervening events would make the promisor regret having made the promise. See *id.* at 1273 (defining regret contingency). The prospective loss consists of the costs of the reliance to be

behavior according to the perceived "probabilities of performance and nonperformance."¹⁶⁷ In the usual case, in which the parties do not make precontractual investments the subject of an explicit exchange, promisees would presumably limit their reliance on informal promises under a non-enforcement approach—even if the promisor has requested such reliance—or not rely at all.

This likely response to a nonenforcement rule would make preliminary negotiations costly for both parties.¹⁶⁸ To the extent that the promisee's behavioral adjustments to the nonenforcement rule take the form of decreased reliance,¹⁶⁹ the promisor will be deprived of promisee conduct that might otherwise have played a crucial role in the promisor's process of deciding whether to make a fully contingent, explicit offer to the promisee. In incremental contracting, promisee reliance provides the informational foundation on which the parties might eventually base an explicit bargain. By thus discouraging promisees from incurring reliance costs, the nonenforcement rule makes it difficult to negotiate an enforceable contract. Lacking the information necessary for the development of fully contingent, explicitly reciprocal contracts, the parties will suffer "forgone benefits from unmade promises."¹⁷⁰ The nonenforcement rule tends to decrease reliance in this context principally because the reliance

undertaken multiplied by the probability that the promisor would walk away from the deal after negotiating with the promisee, leaving the promisee with no recompense for her reliance investments.

167. *Id.* at 1270 n.26.

168. Both parties will presumably seek to minimize the costs of bargaining, defined as "the resources which must be devoted to the process of allocating goods to their highest-valuing users." Anthony T. Kronman, *Mistake, Disclosure, Information and the Law of Contracts*, 7 J. LEGAL STUD. 1, 3 (1978).

169. Especially when the promisor demands the expenditure of sunk costs in the bargaining process, a promisee might refuse to make even the most preliminary moves toward what the promisor wants. This problem presents itself in a number of other situations that involve sunk costs. In service contracts, for example, payment by installment rather than up front serves to augment the promisor's marginal efforts in the successive stages of the contract relationship. See Tony K. Lee & I.P.L. Png, *The Role of Installment Payments in Contracts for Services*, 21 RAND J. ECON. 83, 84 (1990). Although the dynamics of preliminary bargaining under a nonenforcement rule clearly differ, an analogy suggests that promisees in incremental contracting may need some incentive to make the sunk investments that the promisor wants.

170. Goetz & Scott, *Enforcing Promises*, *supra* note 31, at 1274 (discussing the costs of making fewer promises). Of course, the parties might make an express bargain regarding such interim reliance investments. Even though a putative promisor might not be willing to reach a more completely explicit bargain, she might offer the promisee a generalized commitment—a promise to exert a specified level of diligence in furtherance of the proposed deal, for example, or a promise to compensate the promisee for whatever steps she undertakes prior to receiving a warning of a change in the promisor's willingness to deal—in exchange for the promisee taking certain actions that might be valuable to the promisor. The negotiation of such express contracts, however, still might not be worth the cost. See *infra* Part IV.A.

called for often has no salvage value outside the proposed transaction.¹⁷¹ Because such sunk costs are not compensable under the nonenforcement rule, the promisee's bargaining position vis-à-vis the promisor will worsen as she invests in the bargaining process—she will increasingly be subject to opportunistic behavior by the promisor. Because of that possibility, promisees may be deterred not only from extending interim reliance, but also from entering into "otherwise profitable transactions."¹⁷² Thus, the promisee, reacting to the nonenforcement rule's refusal to enforce unbargained-for promises, would likely engage in such self-protective behavior as to decrease her own interest in the prospective deal and deny the promisor the information needed to proceed toward an ultimate reciprocal bargain, thereby depriving both parties of the gains from trade.

The nonenforcement rule might also prompt promisees to seek explicit reassurances from promisors.¹⁷³ "Reassurance includes such actions as the offer of guarantees, verbal persuasions, and the development of a reliable reputation, designed to convince the promisee that the promise is valuable."¹⁷⁴ If voluntary reassurances are forthcoming, "promisees may regard [them] as substitutes for sanctions."¹⁷⁵ Similarly, a promisee faced with an uncertain promise would probably attempt to determine the promisor's trustworthiness and the relative costs and benefits of performing the actions requested by the promisor. To the extent that promises are legally unenforceable and the promisee is aware of this, the promisee will devote more resources to seeking such substitute reassurances, discerning the promisor's trustworthiness, and calculating the merits of extending reliance prior to relying on promises or acting as the promisor desires.

Of course, all of these efforts by promisees increase transaction costs and may drain the profit from a prospective transaction. Moreover, to the extent that the promisor gives explicit "nonlegal" reassurances in order to foster trust in the promisee, the promisor will suffer the costs associated with furnishing such assurances. These include not only the

171. Lee & Png, *supra* note 169, at 85; see also Stewart Schwab, Shirking, Opportunistic Firings, and Contract-Law Limitations on At-Will Employment (Dec. 1991) (unpublished paper presented at University of Virginia Legal Studies Workshop, on file with author) (linking adoption of limits on "at will" employment termination rules with presence of firm-specific investments by employees at end, and to some extent at beginning, of the employment life cycle).

172. See Lee & Png, *supra* note 169, at 84.

173. See Goetz & Scott, *Enforcing Promises*, *supra* note 31, at 1274.

174. *Id.*

175. *Id.*

actual transaction costs of communicating the reassurances, but also the transaction costs of discovering enough information to decide whether and to what extent reassurances are appropriate—to decide whether the “marginal reassurance costs are exactly balanced by increases in resulting benefits to the promisor.”¹⁷⁶ The difficulty with balancing the costs and benefits of reassurances is that the information necessary to make the calculation may only be obtainable through promisee reliance. Yet that reliance may not be forthcoming without promissory reassurances.

Finally, a nonenforcement rule may prompt the parties to insist on formalized bargains. Promisees in particular might insist on bargained-for contracts prior to undertaking any reliance expenditures. Yet, fully contingent, bargained-for contracts are difficult to achieve. Because the “efficient choice” of a contract’s terms depends on “how the future unfolds,”¹⁷⁷ it is difficult to specify efficient terms *ex ante*. In essence, “entire decision trees cannot be generated,” because “the number of alternative paths in complex decisions is very large.”¹⁷⁸ The promisor may find it difficult or impossible to make an ultimate promise without information gained during the process of preliminary negotiation. Thus, a nonenforcement rule encourages putative promisees to insist on such promises, while simultaneously discouraging them from relying on preliminary promises. To the extent that promisors consequently cannot gather the information necessary to develop complete, reciprocal offers, however, such offers will not be forthcoming.

In sum, a nonenforcement rule would provoke self-protective behavior by promisees and encourage them to demand reassurances and enforceable bargains from promisors before incurring reliance costs. These private responses would ultimately result in the parties making fewer contracts and losing the profits from trade.

b. Enforcement: The Costs of Precautionary Adjustments and Decreased Promissory Activity¹⁷⁹

On the other hand, the law might simply enforce the promisor’s ultimate promise—for example, the promise to give the Red Owl franchise to Hoffman.¹⁸⁰ Although this would initially increase the reliability of

176. *Id.*

177. Williamson et al., *supra* note 66, at 262.

178. *Id.* (citing Julian Feldman & Herschel E. Kanter, *Organizational Decision Making*, in HANDBOOK OF ORGANIZATIONS 614, 615 (James G. Marsh ed., 1965)).

179. See Goetz & Scott, *Enforcing Promises*, *supra* note 31, at 1273-74.

180. See *supra* note 58 and text accompanying note 6. This would be so even when the parties did not bargain for the promise and the promisor did not carefully specify the promisee’s reliance as the price of the promise.

promises made by promisors,¹⁸¹ the enforcement of nonreciprocal promises would likely trigger adaptive behavior by promisors that would be counterproductive to useful bargaining. An enforcement rule might prompt promisors to adjust their behavior in two ways: First, promisors might “alter[] the form” of their promises;¹⁸² second, they might “make fewer promises.”¹⁸³

An enforcement rule encourages costly (and not particularly useful) adaptive behavior,¹⁸⁴ especially in situations of incremental contracting. Before making any promise, the promisor must expend resources to discover the contingencies on which the promise should depend.¹⁸⁵ These conditions, however, often cannot be identified *ex ante*.¹⁸⁶ Indeed, they may not even be susceptible to identification until the incremental contracting process has matured. In this atmosphere of uncertainty, the promisor must qualify her promise to limit her exposure to liability. The enforcement rule forces the promisor to expend more resources to identify qualifying contingencies that will let her escape liability—a process made even more costly by the promisee’s likely refusal to provide relevant information (through reliance investments) until the promise is made. The second response, making fewer promises, would directly cause both parties to lose the prospective benefits of the unmade promises.¹⁸⁷

In incremental contracting, promisee reliance on preliminary promises is often critical to both parties’ enjoyment of the joint benefits

181. See Goetz & Scott, *Enforcing Promises*, *supra* note 31, at 1277.

182. *Id.* at 1273.

183. *Id.* at 1274.

184. See *id.* at 1278-81.

185. See *id.* at 1273 (discussing concept of regret contingencies).

186. Identifying a regret contingency that would cause the promisor to breach entails costs. These include not only the costs of communicating the conditions to the other party, but also the costs of collecting data to identify the condition *ex ante*. For example, in the *Red Owl* case, Red Owl might not have been able to identify *ex ante* all of its own selection criteria for a potential franchisee. Red Owl might have depended on dealing with Hoffman as a means of developing those criteria. Because Red Owl presumably had a normal aversion to uncertain risks, it would be forced to structure any interim promises according to a worst-case analysis—filling them with qualifications—both increasing the cost of formulating the promise and decreasing its value to the promisee. Moreover, if Red Owl were made subject to liability for its interim promises, it might be reluctant to engage in future bargaining that would otherwise lead to fully contingent contracts. As a result, profitable contracts may be lost because promisors will be less likely to engage in activities or make promises that would lead to such deals, owing to their fear of liability.

187. Goetz & Scott, *Enforcing Promises*, *supra* note 31, at 1274. This cost may be great, assuming that some of the unmade promises would have been profitable deals. For example, if Red Owl reacted by making fewer promises, it would probably have fewer profitable franchises.

of contracting. In this context, enforcement of the ultimate promise may not accord with the hypothetical bargain that the individual parties¹⁸⁸ or most parties¹⁸⁹ would have reached if bargaining were costless. Enforcing ultimate promises would probably deter promisors from making promises until the "anticipated benefits from the deal are sufficiently certain."¹⁹⁰ Yet, promisors may be unable to decide whether to make ultimate promises except by securing interim reliance. After a promisee extends such reliance, however, the promisor might decide to back out of the proposed transaction. To the extent that it discourages promises, and therefore interim reliance as well, blanket enforcement of the ultimate promise is inappropriate. Finally, an enforcement rule might entail "reversal costs" by inducing promisors to explicitly signal promisees that any promises made during preliminary negotiations are unreliable, in order to avoid liability.¹⁹¹ Aside from the cost and harm to the parties' relationship that might result from doing so, such a reversal would lead directly back to the equally inefficient nonenforcement rule.

B. Private Responses to Informational Asymmetries in the Product Quality Context as Applied to Precontractual Negotiation

Informational asymmetries are another barrier to the negotiation of fully contingent, explicitly reciprocal contracts. When these asymmetries concern legal requirements, a less-informed promisee may rely without insisting on an enforceable bargain at all. When the promisee lacks information about the promisor's overall trustworthiness or the quality of the promise, however, she will discount the value of the promise and be more likely to protect herself by withholding interim reliance. Deprived of the information that such reliance would impart, the promisor

188. The law might satisfy the bargaining goals of any given hypothetical party by supplying a tailored default rule to govern the particular situation. "A 'tailored default [rule]' attempts to provide a contract's parties with precisely 'what they would have contracted for.'" Ayres & Gertner, *supra* note 17, at 91. This type of rule, like privately provided express terms, "attempts to reduce the definitional errors resulting from inappropriate formulations." Goetz & Scott, *The Limits of Expanded Choice*, *supra* note 2, at 263.

189. "An 'untailored default [rule]' . . . provides the parties to all contracts with a single, off-the-rack standard that in some sense represents what the majority of contracting parties would want." Ayres & Gertner, *supra* note 17, at 91. Untailored or generalized rules are based on two standard assumptions: First, "it is more important for the law to be certain than to be right"; second, parties are "quite capable of bargaining for customized alternatives." Scott, *A Relational Theory*, *supra* note 12, at 598.

190. Scott, *An Economic Perspective*, *supra* note 16, at 60-61.

191. Discussion with Ronald J. Coffey, *supra* note 5. Reversal costs are those that parties would incur to reverse a default rule that was inappropriate because it did not accord with the "preferred allocation of risks." Goetz & Scott, *Enforcing Promises*, *supra* note 31, at 1295 n.73.

may be unable to rationally decide whether and on what terms to formulate a fully contingent, explicitly reciprocal contract. In this way, the initial informational asymmetry as to the quality of the promise or its maker impedes the achievement of complete bargains.

Informational asymmetries may inhibit efficient contracting in a variety of other contexts, including those involving product quality. In product sales, often "the seller has a more accurate perception of true product quality than the buyer."¹⁹² In the used car market, for example, the buyer may be unable to distinguish good cars from bad cars.¹⁹³ Because car buyers are rational, "no one will pay more for a car that appears to be identical with all others."¹⁹⁴ Eventually, sellers of high-quality cars will withdraw from the market, because they will not be able to garner an appropriately high price for a better car, and "only 'lemons' will be offered for sale."¹⁹⁵ Thus, "[b]ecause the marginal seller cannot be recognized as the 'best,' he cannot receive his full contribution to social welfare. This wedge between social and private benefits results in too low quality and economic inefficiency."¹⁹⁶

Although the problem of product quality differs from the problem of incremental contracting, it raises similar issues. Because of informational deficiencies, the promisee may discount the promisor's promise and engage in self-protective behavior by reducing what she is willing to pay for it—she will reduce the amount of "beneficial reliance"¹⁹⁷ in incremental contracting and reduce the amount of money paid for a product. In this context, as in incremental contracting, the fundamental question is whether the defects in the market or in the bargaining process justify judicial intervention.

The law could take a hands-off approach to the problems created by information asymmetries, relying on private strategies to overcome them. Alternatively, courts might create "[a] number of possible institutional frameworks" to combat these problems.¹⁹⁸ In his study of markets characterized by information asymmetries, Professor Hayne Leland examined the efficacy of seller guarantees in distinguishing products of different quality.¹⁹⁹ Consumers might also rely on a secondary market

192. Leland, *Minimum-Quality Standards*, *supra* note 33, at 266.

193. *Id.*

194. *Id.*

195. *Id.* at 267.

196. *Id.*

197. Goetz & Scott, *Enforcing Promises*, *supra* note 31, at 1267.

198. Leland, *Minimum-Quality Standards*, *supra* note 33, at 267.

199. *Id.*

for information about product quality.²⁰⁰ Because these private strategies generally fail to remedy the market failures caused by asymmetric information in this context, however, legal intervention via minimum quality regulations may be appropriate to correct the market failure.²⁰¹

First, to the extent that sellers offer guarantees or other "signals"²⁰² to the buyers of their products to give insights into product quality,

sellers of lower quality would find it too expensive to offer as complete a guarantee; they would then face a lower price reflecting the lower average quality after the departure of the best-quality products. Then, the next-best sellers might offer a slightly less complete guarantee to separate themselves from the remaining masses. The market would then ravel down until all but sellers of the worst quality offered some form of guarantee.²⁰³

Leland concluded, however, that guarantees regarding product quality would not correct information asymmetries because of a moral hazard problem: sellers will not voluntarily offer guarantees because buyers of the product may misuse it and claim a defect; meanwhile, sellers will be unable to monitor the possible misuse.²⁰⁴

Sellers, or promisors, might offer promisees express reassurances or guarantees of trustworthiness in the incremental contracting process. While such guarantees would combat promisees' informational deficiencies and would help to induce reliance, which in turn could provide promisors with the information needed to develop complete bargains, they would also present significant problems of transaction costs. For example, although a promisor could offer a guarantee of her promise, she would probably find it costly to negotiate the terms of the guarantee.

200. See Easterbrook & Fischel, *supra* note 5, at 1435.

201. See Leland, *Minimum-Quality Standards*, *supra* note 33, at 267-69.

202. For a discussion of signalling, see 4 THE NEW PALGRAVE, *supra* note 139, at 330-33.

203. Leland, *Minimum-Quality Standards*, *supra* note 33, at 268. In markets characterized by asymmetric information, buyers usually have difficulty distinguishing between high- and low-quality products. Such buyers will accordingly assume that all products have average characteristics and refuse to pay more for those of exceptional quality. *Id.* at 266-67. Professor George Akerlof suggested that this problem causes high-quality sellers to withdraw from the market because they will

not find it advantageous to sell at the market price, which reflects the lower average quality. When these sellers withdraw, average quality and price fall further, inducing owners of the next best quality [products] to withdraw from the market. Price and quality spiral downward; in equilibrium, Akerlof suggests, only "lemons" will be offered for sale.

Leland, *Minimum-Quality Standards*, *supra* note 33, at 267 (summarizing Akerlof, *supra* note 132, at 489-90). Professor Leland posited that sellers might use guarantees to signal ill-informed buyers of the higher quality of their products, but concluded that problems of moral hazard render such guarantees risky to sellers, and therefore an ineffective solution to the problem of asymmetric information. *Id.*

204. Leland, *Minimum-Quality Standards*, *supra* note 33, at 268.

Moreover, the promisor might be reluctant to offer security for an ultimate promise because she needs further information to decide whether to make the ultimate promise. Thus, she may want to offer the promisee some added security, but not in the form of a guarantee of the ultimate promise. The promisor might prefer to offer an explicit promise to negotiate in good faith towards finalizing the transaction, to apprise the promisee of any subsequent changes in her willingness to reach an explicit bargain, and to compensate the promisee for reliance expenditures that she values, although some barriers remain to hinder the negotiation of such a generalized commitment.²⁰⁵

Second, parties might solve the problems of informational asymmetries by creating a market to set prices for the risks associated with promises. Such a market would reflect the true value of each promise. Even if individual investors lacked knowledge as to the true worth of any given promise, prices would "respond to the knowledge of professional investors."²⁰⁶ In the corporate arena, for example, "knowledge about corporate transactions does not depend on the wisdom of individual investors. What is not understood through professional advice is priced, so the investor gets what he pays for"²⁰⁷

Unfortunately, there is no organized market that could alert putative promisees to the true value of interim promises. Moreover, it would be especially difficult to price promises or assurances made in preliminary bargaining because, owing to the law's inconsistency on the enforceability of such promises, investors generally could not know under what circumstances or to what extent the courts would enforce such preliminary assurances. Finally, because many promisees are not repeat players, they may miscalculate the risks that they face and thus be unable to price promises accurately.²⁰⁸

Even if all these private devices were available to bargainers and would succeed in eliminating the problems of information asymmetries, parties still would not use them insofar as their costs exceed the benefits that they might secure. When private strategies for overcoming the barriers to contracting are too costly to implement, the law should intervene through a default rule. The judicially supplied default rule should provide the parties with incentives and disincentives in terms approximately

205. See *infra* Part IV.

206. Easterbrook & Fischel, *supra* note 5, at 1435 (asserting that the risks of corporate transactions "are priced through the stock market and respond to the knowledge of professional investors").

207. *Id.*

208. *Id.*

the same as those that average persons (whom we may model based on reasonable assumptions about human behavior)²⁰⁹ would express were they not deterred by inhibiting circumstances. The default liability rule would impose a highly generalized obligation on the promisor to exert reasonable efforts and reasonable competence in acting to maximize the promisee's welfare. The default rule proposed here would save the parties the costs of expressly contracting for such a generalized commitment,²¹⁰ as well as the costs of implementing such private strategies as screening devices, guarantees, or bonding devices.

IV. Justifying a Judicially Supplied Default Rule

Because of transaction costs, moral hazard, informational asymmetries, and the costs and other inadequacies of private devices to overcome these barriers to contracting, parties often fail to reach explicitly reciprocal, fully contingent bargains. Similarly, most parties either cannot or will not expressly contract for a private system of incentives and disincentives to indirectly channel each other's behavior toward their commonly desired goals. There is a further question, however, as to why the parties would not or could not expressly bargain for an exchange of some highly generalized performance commitment. Despite this theoretical possibility, this Article posits that the law should impose a generalized performance commitment on the part of the promisor to keep the promisee apprised of material changes in the promisor's willingness to deal. The terms of the implicit bargain would be as follows:

In exchange for your taking steps toward making it possible for me to finalize our subsequent relations, which steps will be valuable to me, I promise to keep you informed of any change in my willingness to reach a more complete and explicit bargain.²¹¹

The implied performance obligation might take other forms. For example, the law might impute the following to the promisor:

I promise to compensate you for the reasonable value of whatever actions you take in furtherance of our proposed transaction prior to my warning you that my willingness to make the projected promise has changed.²¹²

Or the law might impose a more general commitment:

209. See *supra* Part II.

210. Goetz & Scott, *The Limits of Expanded Choice*, *supra* note 2, at 262.

211. Discussion with Ronald J. Coffey, *supra* note 5.

212. *Id.* Professor Farnsworth identified a similar implied promise in bargaining:

Implicit in the act of negotiating is a representation of a serious intent to reach agreement with the other party. The rationale of [liability for intentional misrepresentation] therefore generally applies, even in the absence of any explicit representation, if a party enters into negotiations without serious intent to reach agreement. It

Though you still bear some risk that our bargaining for the projected promise will not crystallize, I, the promisor, will henceforth be more solicitous of your exposure to costs in exchange for your immediate steps to confer value on me.²¹³

A. Possible Objections

Perhaps the most obvious argument against imposing a generalized performance commitment by judicial default is that the parties can bargain for such a commitment themselves.²¹⁴ Parties may fail to contract for a generalized commitment, however, for reasons consistent with those behind an a priori assumption favoring the judicial imposition of such a commitment. Specifically, the terms of generalized performance commitments apply to so many different contexts that the parties may not think to expressly convey them. The commonplace quality of such terms may account for transactors not bothering to explicate their implicit bargain.²¹⁵

In addition, negotiating generalized performance commitments can be costly. Bargaining for such commitments, as a way to avoid either the difficulties of reaching highly specified, explicitly reciprocal contracts or the difficulties of using fully contingent channeling devices, may still require the parties to advert to all of the mental processes needed to identify the costs of reaching express arrangements or using channeling devices. A default rule would save the parties those costs.²¹⁶

Moreover, even when the costs of negotiating a generalized performance commitment are low, it may still be appropriate for courts to create a default rule imposing that commitment. This is so if one believes

also applies if a party, having lost that intent, continues in negotiations or fails to give prompt notice of its change of mind.

Farnsworth, *Precontractual Liability*, *supra* note 5, at 234 (discussing *Markov v. ABC Transfer & Storage Co.*, 457 P.2d 535 (Wash. 1969)). By contrast, I seek to justify the recognition of an implicit commitment not in terms of a duty to avoid misrepresentations, but in terms of economic assumptions, efficiency rationales, and incentives toward information disclosure.

213. Discussion with Ronald J. Coffey, *supra* note 5. In choosing between these formulations, a court should be sensitive to the costs of uncertainty created by the more generalized third formulation suggested here. I leave specific comparisons as to the relative efficacy of these formulations to a future article.

214. Scott, *A Relational Theory*, *supra* note 12, at 598 (positing that "the principal task of . . . contracts is to set default rules for commercial actors and other repeat players who, presumably, are quite capable of bargaining for customized alternatives"). It may be difficult to justify the imposition of an implied commitment in terms of what hypothetical bargainers would have wanted when the real parties themselves have not expressly consented to a generalized obligation. Coleman et al., *supra* note 17, at 645.

215. Discussion with Ronald J. Coffey, *supra* note 5.

216. *Id.*

- (1) that the commitment accords with the objectives likely to be sought, on average, by parties who deal in a less than fully explicit manner;
- (2) that there are implicit social or other costs to not imposing the commitment,²¹⁷ including costly precautionary adjustments or demands for reassurances;²¹⁸ and
- (3) that the alternative private devices are more costly than the benefits they could achieve.²¹⁹

Finally, even though bargained-for performance obligations might be preferable in a legal system that generally predicates promissory liability on the parties' assent to be bound, positive externalities often prevent individual parties from negotiating such obligations.²²⁰ If only one promisor consents to the generalized performance obligation, that party

217. An example of such implicit social costs appears in the employment contract area. Professor Jeffrey Harrison has suggested that judicial intervention in employment contracts is justified because the efficient allocation of job security rights may otherwise be impeded by transaction costs. Jeffrey L. Harrison, *The "New" Terminable-At-Will Employment Contract: An Interest and Cost Incidence Analysis*, 69 IOWA L. REV. 327, 356 (1984); see also David I. Levine, *Just-Cause Employment Policies When Unemployment Is a Worker Discipline Device*, 79 AM. ECON. REV. 902 (1989) (arguing that a just-cause dismissal policy increases overall efficiencies). Like promisors in incremental contracting, employers are faced *ex ante* with uncertainty regarding their employees' true worth to the firm. A long-term employment contract that "stipulat[es] that neither the worker nor the employer can initiate separation" serves to eliminate "nonoptimal separations" and avoids the costs involved in recontracting, but "generates new loss by forbidding each party to respond to the realized values of productivities." Masanori Hashimoto & Ben T. Yu, *Specific Capital, Employment Contracts, and Wage Rigidity*, 11 BELL J. ECON. 536, 544 (1980).

Nevertheless, this loss may be outweighed by the benefits of a long-term relationship in some cases. Paul Fenn & Christopher J. Whelan, *Job Security and the Role of Law: An Economic Analysis of Employment-at-Will*, 20 STAN. J. INT'L L. 353, 372-73 (1984). For example, in labor markets characterized by "human-asset specificity," in which an employee has "skills learned on the job that are sufficiently peculiar to the firm that replacement costs would be high," the "employee's job knowledge is considerably more valuable to the firm than to alternative employers, which means that turnover would be costly for either party." Donald W. Griesinger, *The Human Side of Economic Organization*, 15 ACAD. MGMT. REV. 478, 493, 495 (1990). Thus, firms that employ workers with "specific physical capital" would prefer a long-term relationship to avoid "nonoptimal separations" and the "high cost of spot contracting." Hashimoto & Yu, *supra* at 544, 548. The costs involved in drafting long-term employment contracts, however, may be prohibitive. *Id.* at 548. These include the costs of "specifying and respecifying a contingent claim contract," the costs "involved in enforcing the terms of that contract," such as monitoring costs, and the "costs associated with the use of strategic behavior within the contractual period." Fenn & Whelan, *supra* at 375.

Since a long-term employment relationship is the hypothetical bargain that parties in labor markets characterized by "human-asset specificity" would desire, Griesinger, *supra* at 493, "[c]ourts can help reduce transaction costs" and promote efficiency by employing a just-cause standard, thereby creating "job security" rights in what would otherwise be a terminable-at-will contract, Fenn & Whelan, *supra* at 373.

218. Goetz & Scott, *Enforcing Promises*, *supra* note 31, at 1270; *supra* Part III.A.2.

219. Discussion with Ronald J. Coffey, *supra* note 5.

220. As Professor Harold Demsetz explained,

might attract a disproportionate number of potential promisees who wish to be compensated for all risks. An example of this phenomenon is the problem of just-cause dismissal in employment contracting. If only one firm adopts a just-cause standard, that firm will attract more than its share of undesirable "talented shirkers"—workers that exert only enough effort to avoid being dismissed for cause.²²¹ This externality would discourage the individual firm from adopting a just-cause policy. A law-supplied generalized performance obligation, however, would eliminate these externalities and, consequently, increase efficiencies. "If all companies were required to use just cause, the poor workers would be evenly distributed, and the efficiency gains could dominate the loss of productivity from shirkers."²²²

A second, stronger argument against imposing a generalized commitment is that the opportunist would prefer to leave the other party uninformed of changes in her willingness to deal, keeping this "essentially private information" private.²²³ Yet, a major cause of opportunistic behavior is the desire for information, reliance, or some other conduct from the promisee that is valuable to the promisor—conduct that may not be forthcoming unless the promisor projects a distorted picture of her continued willingness to deal. Imposing a generalized commitment may

Externality is an ambiguous concept . . . [and] includes the external costs, external benefits, and pecuniary as well as nonpecuniary externalities. No harmful or beneficial effect is external to the world. Some person or persons always suffer or enjoy these effects. What converts a harmful or beneficial effect into an externality is that the cost of bringing the effect to bear on the decisions of one or more of the interacting persons is too high to make it worthwhile "Internalizing" such effects refers to a process, usually a change in property rights, that enables these effects to bear (in greater degree) on all interacting persons.

Harold Demsetz, *Toward a Theory of Property Rights*, 57 AM. ECON. REV. 345, 347 (1967).

221. See Levine, *Worker Adverse Selection*, *supra* note 132, at 294-95.

222. *Id.* at 295.

223. Cf. WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 7, at 59 n.19 ("Inasmuch as a great deal of relevant information about trustworthiness or its absence that is generated during the course of bilateral trading is essentially private information—in that it cannot be fully communicated with and shared with others—knowledge about behavioral uncertainties is very uneven." (citation omitted)). One might argue that a judicially imposed performance commitment would unduly burden businesses by requiring negotiating agents "to give the other party continual updates on the progress of the company's internal decisionmaking process." Letter from Daniel A. Farber, Professor of Law, University of Minnesota Law School, to Juliet Kostritsky, Professor of Law, Case Western Reserve University School of Law 2 (June 26, 1991) (on file with author). We may assume that businesses are entitled to keep some information regarding internal decisionmaking private. Nevertheless, when businesses seek out promisee conduct that is valuable to them in formulating fully contingent, reciprocal bargains, a rule of disclosure regarding changes in intention to deal is appropriate to avoid self-protective behavior by promisees and to ensure a continued flow of promisee reliance and information to promisors.

therefore accord with the hypothetical bargain that parties with average goals would have reached absent the opportunist's distortions.

Failing to impose a duty upon the promisor to apprise the promisee of changes in willingness to deal may be costly, especially because any alternative strategy that the courts might adopt would probably be less efficient than the proposed default rule. A judicial rule enforcing all unbargained-for promises, for example, would cause the promisor, faced with the prospect of liability for the promises she makes in preliminary negotiations, to alter the form of those promises. She might expend additional resources to ascertain the circumstances on which she should condition her promissory liability.²²⁴ Alternatively, she might simply reduce the quantity of her promissory activity.²²⁵ In either case, there would probably be an added cost, measured by either the lost benefits from unmade promises²²⁶ or the resources expended to condition the scope of promises. If the court in *Red Owl* had enforced the ultimate promise to grant Hoffman the franchise,²²⁷ for example, that result might have led future promisors in *Red Owl*'s position to adjust their behavior *ex ante*. *Red Owl*'s potential adaptations would include curtailing the scope or number of such promises, altering their forms,²²⁸ and conditioning them on certain contingencies not arising. Of course, these attempts at manipulating the promise would require *Red Owl* to expend resources to anticipate what conditions to attach to the promise. A generalized commitment of the kind suggested here would likely be cheaper and more efficient because it would obviate the need for such precautionary adjustments.

The courts might instead adopt a nonenforcement strategy, which entails its own significant costs due to the demands for reassurances, insistence on formal bargains, and other self-protective behavior that it provokes by promisees.²²⁹ A binary approach that either enforces the promise as made or refuses to enforce it at all fails to produce efficient results because the difficulties that the promisor may encounter in discovering enough information to take appropriate precautionary steps might lead her to stop promising altogether.²³⁰ A generalized commitment, on

224. See *supra* notes 180-191 and accompanying text.

225. See *supra* notes 180-191 and accompanying text; Goetz & Scott, *Enforcing Promises*, *supra* note 31, at 1274.

226. Goetz & Scott, *Enforcing Promises*, *supra* note 31, at 1274.

227. See *supra* note 58 and text accompanying note 6.

228. See Goetz & Scott, *Enforcing Promises*, *supra* note 31, at 1273 (suggesting that promisors will mitigate "potential costs . . . by altering the form of the promise").

229. See *supra* notes 160-178 and accompanying text.

230. Of course, a court might opt for a middle way: compensating reliance when it feels

the other hand, would enable the promisor to gather enough information to determine rationally whether it is possible or desirable to reach an explicit bargain in the future.

B. Rationales

The law-supplied obligation proposed here should be adopted because it would achieve efficiency gains that cannot be achieved privately by providing the results that most parties would prefer, encouraging the disclosure of information, and decreasing the opportunistic use of sunk costs. The following discussion outlines the efficiency arguments favoring the proposed default rule and defends it against the contrary efficiency justifications advanced by Professors Goetz and Scott.

(1) *Hypothetical Bargain*

a. Explanation

The costs of *not* imposing a default rule for incremental preliminary bargaining, which include the costs of private strategies to overcome barriers to contracting, suggest that a default rule should be adopted to govern precontractual reliance investments—at least if one is convinced that the rule accords with the objectives sought by most parties.²³¹ Under this assumption, we can justify the proposed default rule under an efficiency theory called the Expanded Choice postulate: “The postulate maintains that implied terms expand contractors’ choices by providing standardized and widely suitable ‘preformulations,’ thus eliminating the cost of negotiating every detail of the proposed arrangement.”²³² Courts

that it is desirable to do so, purporting to apply the current standards of the Restatement or some form of empiricism. These standards create their own severe difficulties of uncertainty, however, and are therefore inadequate to resolve the problems of incremental bargaining. See *supra* Part I.C-D.

231. Imposing a default rule that accords with the objectives of most parties saves the costs associated with express provisions for the various contingencies. See, e.g., UNIF. PROBATE CODE art. II, pt. 1 cmt., 8 U.L.A. 56 (1983) (intestacy law “attempts to reflect the normal desire of the owner of wealth as to disposition of his property at death”). The law of intestate succession resorts to this type of default rule because “the large majority of people dies intestate,” because “most people cannot accept and plan for the fact of their own death,” and because making a will is costly. JESSE DUKEMINIER & STANLEY M. JOHANSON, *WILLS, TRUSTS, AND ESTATES* 75 (4th ed. 1990). Thus, intestacy law imputes “to property owners an intent to prefer family” because that preference is “likely to achieve most property owners’ donative wishes.” Mary Louise Fellows, *In Search of Donative Intent*, 73 IOWA L. REV. 611, 613 (1988). If certain parties desire a “nontraditional plan,” they can “rebut the presumption with objective evidence.” *Id.*

232. Goetz & Scott, *The Limits of Expanded Choice*, *supra* note 2, at 262 (quoting Charles J. Goetz & Robert E. Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligation*, 69 VA. L. REV. 967, 971 (1983)).

should adopt the default rule because it is a broadly suitable preformulation that parties in preliminary negotiation would prefer and at which they would probably have arrived explicitly through bargaining were it not for the high transaction costs of doing so.

Both parties gain if the law supplies a default liability rule for precontractual negotiation. The law-supplied fiduciary obligation in agency relationships is another example of a rule adopted because the parties themselves (principal and agent) are deterred, by palpably inhibiting circumstances, from negotiating an express commitment.²³³ The liability rule accords with a hypothetical bargain because it seems likely to enhance the achievement of the average goals sought by each party. The basic reason that the law supplies a fiduciary duty even though the parties have failed to explicitly contract for it is that natural barriers of unforeseeability inhibit negotiation of the duty, and the private devices for overcoming those barriers are expensive. Similarly, hypothetical average parties are likely to prefer the terms imposed by the default rule proposed here because the private devices for overcoming the barriers to contracting are more expensive than the costs associated with the law-supplied rule.

b. Defending the Hypothetical Bargain's Allocation of Risk to the Promisor: A Response to Professors Goetz and Scott

Professors Goetz and Scott postulated that the law should often impose no precontractual liability, whether through a default rule or otherwise.²³⁴ They argued that optimal risk allocation analysis requires that the risk of breach be allocated to the promisee, reasoning that "risk-averse bargainers will prefer to bear uncertain risks as promisees rather than as promisors."²³⁵ This preference is somewhat persuasive "because a promisee can control reliance costs more easily than can a promisor,"

233. See *supra* notes 117-136 and accompanying text.

234. Goetz and Scott made an exception for reliance incurred "when the essence of the bargain has been established." Goetz & Scott, *Enforcing Promises*, *supra* note 31, at 1314. They explained:

When agreements are unclear, risk-averse bargainers prefer to bear the risks of regret contingencies as promisees, and the nonenforcement rule is optimally retained. When the bargain is less clear but fails technically, however, parties may prefer pursuing gains to avoiding losses. Enforcement under section 90 allocates the risk of regret to promisors and thereby shifts resources to more efficient precautionary conduct.

Id. at 1314-15.

235. *Id.* at 1295.

and therefore "the risk of detrimental reliance is lower if borne by the promisee rather than the promisor."²³⁶

This postulate does not apply, however, in incremental contracting. In this context, the assumption that the promisee can control reliance costs more easily than can the promisor proves too much because the promisee does not have complete control of those costs. Due to the complex nature of transactions and incremental negotiations, the parties (including the promisee) cannot ascertain the likelihood of a prospective gain or identify and evaluate a regret contingency without first interacting and communicating. As a result, the promisee will be forced to rely on the promisor's preliminary assurances so that enough information can be generated to determine whether further reliance is warranted. In other words, the promisee cannot control her overall reliance until her initial reliance generates enough information to do so. Moreover, insofar as the promisor actively shapes the extent and nature of the promisee's sunk costs, the promisor appears equally able to control them.

The other rationale for the rule of nonenforcement put forth by Professors Goetz and Scott is also problematic. They posited that risk-averse bargainers, who prefer to bear uncertain risks as promisees rather than as promisors in preliminary negotiations, shift their risk preferences following a contract. After forming a contract, "bargainers prefer to bear remaining risks as promisors."²³⁷ This shift occurs at the moment of reciprocal agreement, Goetz and Scott reasoned, because only then does "the expected value of gain outweigh[] the risk of liability upon breach."²³⁸ This analysis only applies, however, to the parties' willingness to assume an obligation to perform the *ultimate* promise. A party would prefer to bear the much smaller risk of liability represented by the proposed default rule²³⁹ at a much earlier stage of bargaining—the point at which her expected gains from securing the other party's reliance investments exceed her expected liability for those investments.²⁴⁰

236. *Id.*

237. *Id.* at 1296.

238. *Id.*

239. A promisor's risk of liability under the ultimate promise will almost always exceed her risk under the proposed default rule, because the promisee's damages under the former will be measured by the benefit she expected from the bargain (compensating her lost gains by putting her in a position as good as she would have been in had the contract been performed), while the default rule requires a breaching promisor to only pay for the promisee's out-of-pocket losses (sunk costs) at most. FARNSWORTH, *CONTRACTS*, *supra* note 9, § 12.8 (noting that reliance is a lesser measure of damages than expectation).

240. The default rule would prompt promisors to carefully assess the optimal amount of promisee reliance needed to determine whether to proceed with the proposed transaction.

Goetz and Scott's view of risk allocation cannot be justified in terms of the preferences of hypothetical bargainers. Nonenforcement saddles the parties with costs that could be eliminated by the proposed default liability rule. These include the cost of reassurances that will be extended by putative promisors if preliminary promises are denied legal enforcement and the unavailability of promisee reliance (required for the development of a fully contingent, bargained-for contract). Most significantly, to the extent that promisors cannot formulate complete and explicit contracts without such promisee reliance, the nonenforcement rule lessens economic activity.

In light of these costs and their likely effect on parties' behavior, nonenforcement makes little sense as a preferred risk allocation. When negotiations proceed incrementally, bargainers may prefer to bear increasing risks as promisors as the probability of reaching an agreement increases.²⁴¹ It is appropriate to allocate some risk of liability for an unkept unbargained-for promise during precontract negotiations to the promisor because the promisor receives the benefit of increased knowledge regarding potential regret contingencies through the promisee's transaction-specific investments. It is therefore inefficient to force promisees to bear the risks until an explicit agreement is reached. An interim liability rule allocating some risk to the promisor would be consistent with average bargainers' preference to assume increasing risks as promisors as the possibility of such an agreement increases.

(2) *Other Efficiency Rationales*

By quickly alerting the promisee to changes in the promisor's willingness to deal, or by compensating the promisee for her sunk costs when appropriate, the proposed default rule would foster trust by promisees in promisors. The general rationale for imposing a default rule giving effect to trust is that trust is efficient: it allows the parties to conserve the resources that they would otherwise expend to secure the same level of promisee reliance.²⁴² Because it is cheaper to operate on the basis of trust, and because both parties want to save the "costs of guarding

241. Under the nonenforcement rule, putative promisors lacking information are faced with a stark choice between blindly contracting for unknown risks and not contracting at all. The default rule would depolarize this choice and expand the promisor's options during bargaining—allowing her to stay flexible at a relatively low and certain cost while avoiding the more significant risk of suffering an "irreversible" loss from mistakenly choosing among her ultimate alternatives too early in the process. See HIRSHLEIFER & RILEY, *supra* note 13, at 204-06.

242. See Gordon, Outline, *supra* note 16, at 57-58.

against predation,"²⁴³ parties that want to minimize costs generally prefer default rules giving effect to trust.²⁴⁴

Moreover, a default rule that assumes cooperation between parties "enhances the expected value of the contract for each,"²⁴⁵ and is thus efficient in that sense. From an *ex ante* perspective on preliminary bargaining, "if either party anticipates bearing excess cost, it will negotiate for more favorable price terms to compensate for these additional costs."²⁴⁶ Because she negotiates in a state of uncertainty, the promisee who perceives a risk of bearing uncompensable reliance cost will insist on more favorable terms to offset those costs and risks. These terms might include express reassurances or the protection of a formal contract—terms that are costly for the promisor.

It would arguably be in each party's self-interest "to promote cooperative risk reduction"²⁴⁷ by adopting a generalized default rule obliging the promisor to notify the promisee of changes in her willingness to deal or to assume some liability for the promisee's interim reliance. The parties would promote their joint interests by affirmatively adopting the default rule themselves; indeed, they would if they thought to do so and were negotiating it not costly. A rule enforcing (and thereby promoting) cooperation between the parties lowers the promisor's overall contracting costs by lessening the cost of securing promisee reliance. Similarly, the promisee would gain greater security from the default rule and thus would make fewer costly adjustments in her behavior. The promisee would also be much more inclined to extend the reliance needed by the promisor.²⁴⁸

243. *Id.*

244. Because the costs of not imposing the duty are greater than the costs resulting from the duty, we may presume that rational parties have implicitly bargained for the law-supplied default rule. *But see* Charny, *Nonlegal Sanctions*, *supra* note 25, at 443-44 (arguing that intervention may be more costly than relying on nonlegal sanctions because "the prospect of intervention may interfere with the development of trust" since "promisees have no way of determining whether promisors' adherence to commitments signals discipline and good character or simply fear of legal sanctions").

245. Scott, *A Relational Theory*, *supra* note 12, at 605.

246. *Id.* at 604.

247. *Id.* at 605.

248. Moreover, the default rule would be more efficient than a rule of full enforcement. A liability rule enforcing the ultimate promise would provoke the promisor to withdraw from negotiations and make other expensive precautionary adjustments in her behavior. *See supra* notes 180-191 and accompanying text. Under the default rule, on the other hand, the promisor would make fewer precautionary adjustments because her maximum liability would be for the promisee's sunk costs. Thus, she could secure promisee reliance at a lower cost than under the enforcement rule.

(3) *Information Disclosure Rationale*

A law-supplied obligation to disclose changes in willingness to deal may also lead to efficiency gains by "encourag[ing] the production of information."²⁴⁹ "By setting the default rule in favor of the uninformed party, the courts induce the informed party to reveal information and, consequently, the efficient contract results."²⁵⁰ Conversely, failure to require disclosure may afford the relatively informed party a private advantage and a cross-subsidized price that would not have been available with full disclosure.²⁵¹ In these situations, the uninformed promisee tends to treat the promisor as of average trustworthiness rather than as untrustworthy.²⁵² Thus, a promisor could profit greatly by hiding her untrustworthiness or other undesirable characteristics from the promisee. Requiring disclosure of changes in the promisor's willingness to deal would eliminate this private advantage while increasing value overall: as promisees become able to weigh the promisor's trustworthiness with accuracy, they may also determine more precisely whether a promise merits reliance or other conduct sought by the promisor.²⁵³

(4) *Mitigating the Problem of Sunk Costs*

When uncertainty and barriers to explicit contracting exist, the proposed default rule may mitigate the problem of sunk costs.²⁵⁴ Sunk costs

249. Ayres & Gertner, *supra* note 17, at 97 (discussing penalty defaults).

250. *Id.* at 99.

251. *Id.* For example, a promisor who knows that a proposed deal would be abnormally risky for the other party may avoid having to share in the added costs by keeping this information secret. Such a promisor would enjoy a "free ride"; her price for the deal would be cross-subsidized by the price in the pool of average transactions to which the promisee assumed the particular transaction belonged. *See id.* at 99, 103.

252. *See supra* Part III.B.

253. As Ayres and Gertner noted,

if revealing information is efficient because it increases the value created by the contract, one might initially expect that the informed party will have a sufficient private incentive to reveal information—the incentive of splitting a bigger pie. This argument ignores the possibility, however, that revealing information might simultaneously increase the total size of the pie and decrease the share of the pie that the relatively informed party receives. If the "share-of-the-pie effect" dominates the "size-of-the-pie effect," informed parties might rationally choose to withhold relevant information.

Ayres & Gertner, *supra* note 17, at 99.

254. Indeed, the presence of transaction-specific, sunk investments provides the essence of the paradigm calling for a liability rule. In the following situation, for example, the absence of such sunk costs specifically requested by the promisor helps to explain why the liability rule proposed here would be inappropriate. Suppose that the average person entering a Marshall Field department store spends \$100 on any given Saturday. The justification for the liability rule suggested here would not support a default rule imposing a \$100-per-day purchase requirement on any customer. In this situation, the promisee-customer's action in entering the

are incurred when the context demands that one party undertake some investment or take preliminary steps before the completion of an enforceable contract.²⁵⁵ Permitting opportunistic behavior in these situations—allowing a party to break off negotiations without fear of liability after gaining valuable information from the other's reliance investments—diminishes "the incentive to invest."²⁵⁶ In order to limit opportunism and prevent inefficiencies, it makes sense to impose a generalized performance commitment during the period of uncertainty and preliminary negotiation. A default rule requiring the promisor to disclose changes in her willingness to deal and to pay for the information developed from the promisee's reliance expenditures before that time would increase the promisee's incentive to invest in the proposed deal. Consequently, such reliance is more likely to be beneficial: because the promisor is discouraged from opportunistically exploiting the promisee's sunk investments, the promisee will make sunk investments more freely, thereby providing an informational foundation for continued negotiation and increasing the likelihood that the parties will reach a complete and reciprocal bargain.

C. Problems with the Hypothetical Bargain Standard

Despite the efficiency justifications for the proposed default rule discussed above, Professors Ayres and Gertner have argued persuasively against exclusive reliance on such majoritarian default rules. They suggested that efficiency may require alternatives to the majoritarian "would-have-wanted" approach to the formulation of default rules in many contexts. For example, Ayres and Gertner justified the Uniform Commercial Code's zero-quantity default, which refuses to enforce a contract for the sale of goods that does not provide a quantity,²⁵⁷ as a "penalty default" set to provide a result that the parties would not want;

store does not constitute a sunk cost that is useful to the promisor store in deciding whether and on what terms it is possible to finalize subsequent relations between the two. Therefore, no need arises to enforce an implicit bargain and impose a generalized performance obligation upon the store. In this example, the store presumably had already decided which items to stock and at what price to offer them before the customer entered the store. The customer's incremental steps did not affect the possibility that the customer and the store would eventually finalize the terms of a fully contingent contract.

255. See 3 THE NEW PALGRAVE, *supra* note 139, at 550.

256. *Id.*; cf. Lloyd Cohen, *Marriage, Divorce, and Quasi Rents; Or, "I Gave Him the Best Years of My Life,"* 16 J. LEGAL STUD. 267, 295 (1987) (noting that women have less incentive to invest in marriage because of the "enormous magnitude of the consequence of breach on the value of the specific assets of marriage"); Johnston, *supra* note 29, at 313-14 (conceding that expanded fiduciary obligations will garner increased firm-specific investments by good managers).

257. See U.C.C. § 2-201(1) (1977) (statute of frauds); *id.* cmt.1 ("The only term which must appear is the quantity"; "recovery is limited to the amount stated.").

the rule governs circumstances in which "it is cheaper for the parties to establish the quantity term beforehand than for the courts to determine after the fact what the parties would have wanted."²⁵⁸ Emphasizing that contractual incompleteness may result from strategic behavior rather than from transaction costs, they proposed the adoption of penalty defaults to counteract strategic behavior in other situations as well.

To illustrate the appropriateness of penalty defaults when strategic behavior prevails, Ayres and Gertner discussed the rule of *Hadley v. Baxendale*²⁵⁹—a low-damage rule under which courts require foreseeability or disclosure of risks before awarding extra damages.²⁶⁰ Courts following a high-damage, non-*Hadley* rule, on the other hand, permit full recovery without regard to foreseeability or disclosure. In choosing between these rules, courts must consider the likely behavioral reaction that the measure of damages will provoke in both millers having a low risk of damages (low-risk millers) and millers having a high risk of damages (high-risk millers). Setting a default rule to give a result that some parties would not want induces them to opt out of that result. The default rule that emerged from *Hadley*, for example, encourages the party with special information regarding her risk of loss to reveal that information. By compensating only for low or reasonably foreseeable damages, the *Hadley* rule gives the high-risk miller an incentive to contract around the default result by revealing information as to the size of her potential losses, thereby increasing the overall efficiency of the transaction. "Informing the carrier creates value because if the carrier foresees the loss, he will be able to prevent it more efficiently."²⁶¹ The miller will have an incentive to disclose whenever the cost of potentially bearing the extra

258. Ayres & Gertner, *supra* note 17, at 96. By contrast, Ayres and Gertner noted, the U.C.C. supplies a "reasonable price" term when the parties reach a contract but fail to provide for the price. *Id.* at 95 (citing U.C.C. § 2-305(1) (1977)). The difference between the relatively majoritarian reasonable price standard and the zero-quantity default, they explained, lies in the fact that "it is systematically harder for courts to figure out the quantity than the price *ex post*." *Id.* at 96.

259. 156 Eng. Rep. 145 (Ex. 1854).

260. See Ayres & Gertner, *supra* note 17, at 101-04, 108-17. The plaintiffs in *Hadley*, who owned a grist mill, contracted with a common carrier to deliver the mill's broken shaft to another city, where a third party was to use it as the model for a new shaft. The shipment was delayed for several days, forcing the mill to remain idle. In reversing the millers' recovery for the profits they had lost as a result of the delay, the court held that consequential damages for breach of contract must be foreseeable at the time of contracting. The carrier was not aware of the "special circumstances" that a delay in sending the shaft would cause the mill to lie idle and the millers to lose profits, the court reasoned, and such damages would not be recoverable as the ordinary and natural consequence of breach unless the millers had communicated to the carrier the information that would make it so. *Hadley*, 156 Eng. Rep. at 151.

261. Ayres & Gertner, *supra* note 17, at 101. Put differently, "the carrier is the least-cost avoider." *Id.* at 102.

damages herself exceeds the added amount that she would have had to pay for the shipment upon disclosure.²⁶² Ayres and Gertner described the *Hadley* rule as a penalty default adopted to induce knowledgeable parties to reveal information.

Although the theory behind a penalty default rule makes sense in the case of the zero-quantity default (to avoid costly ex post determinations of quantity through litigation), other applications reveal its conceptual flaws. Ayres and Gertner conceded that the *Hadley* rule, originally conceptualized as a penalty default, "can be alternatively conceived as an untailed default rule that provides what the majority of parties would want."²⁶³ *Hadley's* rule only incidentally penalizes the minority of parties who, as high-risk millers, would prefer a high-damage rule under which they might secure a cross-subsidized price for shipping and a bigger piece of the pie.²⁶⁴

There are larger problems inherent in the general use of penalty defaults to counter strategic behavior. Parties in preliminary bargaining attempt to glean information from each other. The penalty default model, premised on an assumption that one party will strategically withhold information (such as a car buyer withholding information about his preferences), is ill-suited to a situation in which each party lacks information about the other and has an interest in acquiring such information.²⁶⁵ Ayres and Gertner's theory of strategic behavior fails to justify a penalty default rule of nonenforcement in precontractual bargaining because rational self-interest often operates to lessen the incentive for strategic behavior in this context. Self-interest in fact dictates a cooperative strategy to mitigate the likely effect of a nonenforcement rule in decreasing precontractual promisee reliance.

262. *Id.* at 109. Disclosure leads the carrier to take the "efficient level of precaution and pass[] the cost on in the price." *Id.*

263. *Id.* at 112.

264. *Id.* Of course, such strategic nondisclosure by the high-risk miller would lessen the transaction's aggregate benefit to society. *See id.* at 103.

265. One could argue that Ayres and Gertner's penalty default analysis actually supports the rule proposed here, given their assumptions about rampant opportunism. In other words, the generalized performance obligation might be exactly what crafty promisors would not want—they would rather be able to demand promisee reliance and retain the freedom to walk away because that freedom is more valuable to them than the costs of the promisee's reluctance to rely, reassurance requests, and other adaptations to a nonenforcement rule. This line of reasoning is ultimately untenable, however, because the costs of decreased reliance in the situations in which the proposed rule would apply are such that average promisors would prefer a generalized performance obligation as a way of motivating sunk investments, even when they are reluctant to commit to a projected ultimate promise.

Another efficiency theory, advocated by Professor David Charny as well as Professors Ayres and Gertner, posits that even if promoting efficiency is the law's prime concern, legal decisionmakers should be wary of assuming that the majoritarian "would-have-wanted" standard necessarily serves that purpose.²⁶⁶ Professor Charny analyzed different assumptions about parties' abilities to bargain around a legal rule. Even if courts use purely instrumental efficiency criteria to select a default rule that "minimizes the net costs of transacting," Charny noted, they will not always adopt the rule most bargainers would want.²⁶⁷ When the costs of bargaining for a term significantly outweigh the costs of bargaining around a default rule that supplies the same term, legal decisionmakers should adopt the default rule even if only a minority of parties wants it.²⁶⁸ Professor Charny illustrated this concept in the context of an employment contract: "Suppose, for example, that it is ten times more costly for workers to specify a contractual good cause provision, with a background at will rule, than for workers to specify a contractual at will rule, when the background legal regime specifies good cause."²⁶⁹ In that case, "the adjudicator should choose the good cause rule: it minimizes the net costs of transacting for firms and workers."²⁷⁰ Thus, efficiency requires the adoption of a default rule that "would actually be desired in relatively few transactions if it is much cheaper to bargain around that term than it would be for the few parties who want the term to bargain for it."²⁷¹ Charny's theoretical qualification to the efficiency of majoritarian default rules, however, does not apply to the default rule proposed here. Because most parties would prefer the proposed default rule, and because there is no reason to suppose that parties who wish to bargain around it would find it especially costly to do so, the courts should adopt the proposed rule as the most efficient alternative.

Ayres and Gertner also asserted that setting the default rule to provide what the parties would have wanted fails to account for all the costs associated with any given default rule. Majoritarian rules tend to disregard the costs of opting out of the default rule, as well as the inefficiencies

266. While Professor Charny offered this specific objection, see Charny, *Hypothetical Bargains*, *supra* note 16, at 1842, Ayres and Gertner more generally challenged the necessary efficiency of the majoritarian standard for default rules, see Ayres & Gertner, *supra* note 17, at 91 ("We suggest that efficient defaults would take a variety of forms that at times would diverge from the 'what the parties would have contracted for' principle.").

267. Charny, *Hypothetical Bargains*, *supra* note 16, at 1842.

268. *Id.*

269. *Id.*

270. *Id.*

271. *Id.*

associated with failures to do so.²⁷² Ayres and Gertner illustrated these costs in the context of *Hadley v. Baxendale*. Adopting *Hadley* as the default rule imposes costs on the minority of parties—the high-risk millers who must contract around the rule. These costs include the typical transaction costs of bargaining, such as time spent, negotiation costs, and lawyers' fees. Because these costs will probably never outweigh the costs of self-insuring their higher risks, all high-risk millers will contract around the *Hadley* default.²⁷³ A high-damage, non-*Hadley* default, in contrast, imposes transaction costs on the majority of parties (low-risk millers) who wish to opt out by revealing their low-risk status. Yet, because the inclusion of high-risk millers in the overall pool will not likely cause a significant increase in the overall price, the gains from contracting around the default will probably be outweighed by the transaction costs of doing so.²⁷⁴ At the same time, high-risk millers have a purely strategic motive for failing to separate themselves from the pool: By concealing their potential for high losses, they will secure a subsidized price from the carrier. The carrier will charge them a price commensurate with average millers' potential losses rather than a higher price to insure their higher risk. The low-risk millers must "bear the costs of this inefficiency, but are not hurt enough individually to distinguish themselves contractually."²⁷⁵ A default rule that "minimizes the sum of these two costs"—the costs of contracting around and the costs of failing to contract around—is the efficient default.²⁷⁶

Applying Ayres and Gertner's analysis to the default rule for preliminary bargaining proposed here, nothing suggests that the costs of imposing the background term exceed the sum of the costs of bargaining around it and the costs of the inefficiencies that result from parties' strategic failures to do so. Accordingly, there is no reason to depart from a majoritarian rule. The default rule suggested here operates in a context that may not be as susceptible to the strategic withholding of information

272. Ayres & Gertner, *supra* note 17, at 112-15.

273. *Id.* at 110. The *Hadley* default thus causes "a 'separating' equilibrium in which different types of contracting parties sort themselves into different groups at different prices." *Id.* at 111-12.

274. *Id.* at 110-11.

275. *Id.* at 111. The non-*Hadley* rule thus creates "a 'pooling' equilibrium" in which the different types of contracting parties fail to distinguish themselves in the bargaining process. *Id.* at 112.

276. *Id.* at 114. *Hadley's* low-damage rule is the efficient default, Ayres and Gertner concluded, because its total costs (which consist of the transaction costs imposed on high-risk millers) are less than the total costs of a high-damage rule (which consist of the costs of high-risk millers' strategic failures to contract around the rule—the cost of inefficient carrier precaution that will be spread among all low-risk millers). *Id.* at 112.

that provides the main basis for the penalty default. In incremental bargaining, we may surmise that some promisees will strategically withhold private information regarding the risks a proposed deal creates for the promisor, and that some promisors will have strategic incentives to conceal information about their trustworthiness or the quality of their promises from the promisee. In each instance, the withholding of information could alter the price that either party can secure from the other. Three considerations, however, reduce the costs that such strategic withholding might create in preliminary bargaining. First, the promisee does not necessarily know *ex ante* whether she is a high- or low-risk promisee, and she almost certainly does not know *ex ante* how valuable her interim reliance might be to the promisor. Her status and that value might not be revealed until the bargaining process proceeds. Second, compensating the promisee for sunk costs requested by the promisor under the default rule would not necessarily prompt a high-risk promisee to conceal her true nature (thus leading to inefficiencies) because she does not necessarily know *ex ante* how the promisor would view her attributes. Indeed, the purpose of reliance investments, from the promisor's perspective, is to learn what those attributes are. The promisee has no marked tendency to conceal her type and "free-ride on the lower-cost qualities of others and thereby contract at a subsidized price"²⁷⁷ in preliminary negotiations; thus, a penalty default is not required to force her to disclose her true status in this context. Finally, because the default rule is set to compensate for promisees' sunk costs, no apparent inefficiencies would result from promisors concealing their true high- or low-quality status. Such conduct may adversely affect the efficiency of the ultimate transaction, but it would have no impact on the efficiency of the law-supplied obligation in precontractual bargaining. Furthermore, by enforcing and promoting trust in negotiations, the default rule combats this ultimate inefficiency.

The criticisms of majoritarian default rules make sense in this context only if one agrees that majoritarian defaults must be abandoned in favor of penalty defaults in order to discourage strategic behavior and force parties to disclose information about their relative quality. The model of strategic failure to bargain mistakenly assumes that strategic behavioral incentives will persist and predominate, without regard to the effect of such behavior on the other party. Although the promisor might have a strategic incentive to conceal the untrustworthiness of assurances, her incentive to do so is much less pronounced in incremental con-

277. *Id.* at 103.

tracting because of the likely negative effect of such strategic behavior on promisee reliance investments.

In sum, the default rule suggested here would promote efficiency in precontractual bargaining better than any alternative rule could. The costs of bargaining around the rule would be small because only a small number of transactors would choose to do so. The transaction costs of opting out would be negligible because promisors could do so unilaterally by signalling that they will not accept liability for reliance investments. Opting out entails no other costs, because promisors would only choose to do so when they do not need the promisee's reliance to decide whether to proceed. Moreover, the need for a penalty default approach is lessened by the diminished manner in which strategic nondisclosure operates in the preliminary bargaining context. First, cooperative strategies rather than opportunistic behavior may afford parties in preliminary bargaining the most effective means of ferreting out necessary information and securing interim reliance, the promisor's strategic reasons for concealing her true status diminish, lessening the need for forced disclosure. Second, while strategic incentives to conceal one's true quality may persist under other background rules, the very nature of the default rule suggested here mandates a certain level of quality in the promisor. Finally, the promisee's strategic incentives to conceal information will be lessened by the fact that she often will not know *ex ante* what effect that information would have on the promisor's willingness to reach an agreement on any particular terms, and thus will not know what information to conceal. In essence, the criticisms of majoritarian default rules simply do not hold here. I conclude that the proposed majoritarian default rule is the most efficient legal rule for incremental negotiations that involve transaction-specific investments. The following Part describes the practical advantages of the proposed rule.

V. Applications and Advantages of the Implied Default Rule

The proposed default rule would not only mitigate the problems of sunk costs and promote efficiency in precontractual bargaining; it would also achieve better results than are possible under current approaches in a variety of contexts. Furthermore, it would provide courts with a general framework for deciding whether, why, and to what extent the law should impose contractual duties when the parties themselves theoretically had the opportunity to bargain for them but failed to do so. This Part explains these advantages of the proposed default rule.

A. Subcontracting

The implied default rule and analysis suggested here may promote efficiency in the subcontracting context. The subcontractor's bidding process is complex, involving multiple parties.²⁷⁸ Typically, after the owner or project manager has employed an architect to prepare detailed drawings and specifications for a construction job, she solicits bids to perform the work from a number of general contractors. All general contractors must submit their bids on a particular day. Before that day, subcontractors submit bids to the general contractors on portions of the overall job. Each general contractor relies on the subcontractors' bids in computing its own bid on the entire project. After the general contractor submits its bid, there is a "delay . . . between the subcontractor's offer and its acceptance, during which time the offeree general contractor becomes firmly obligated to an offer of his own, which he has calculated in reliance upon the subcontractor's offer."²⁷⁹ The general contractor would be harmed if the subcontractor were allowed to withdraw her offer at any time. Yet traditional offer and acceptance analysis calls for exactly this result.²⁸⁰ Under bargain theory, the general contractor's mere use of the bid in formulating her own is not an acceptance because there is no express bargain under which the subcontractor promised to provide products or services in exchange for the general contractor's promise to use the subcontractor should it be awarded the overall contract. Accordingly, the subcontractor is free to withdraw her bid at any time before its formal acceptance.²⁸¹ This leaves the general contractor vulnerable.

To protect the general contractor's reliance interest in this situation, most courts now follow the rule announced by the Supreme Court of California in *Drennan v. Star Paving Co.*²⁸² by recognizing a one-sided option contract. This result makes the subcontractor's bid irrevocable once the general contractor relies on it, but allows the latter to retain the freedom to accept or reject the offer.²⁸³ Binding the offeror but not the offeree proceeds on the theory that an implied

278. Dorothy Hemmer Bishop, Comment, *The Subcontractor's Bid: An Option Contract Arising Through Promissory Estoppel*, 34 EMORY L.J. 421, 422 (1985).

279. *Id.* at 421.

280. *Id.*; see, e.g., *James Baird Co. v. Gimbel Bros.*, 64 F.2d 344 (2d Cir. 1933) (Hand, J.) (applying traditional common-law contract rules).

281. See *Baird*, 64 F.2d at 346.

282. 333 P.2d 757 (Cal. 1958).

283. FARNSWORTH, CONTRACTS, *supra* note 9, § 3.25. The bid is only irrevocable, however, if the general contractor accepts it within a reasonable time and does not use it to shop for a lower bid. *Id.* at 200-01.

promise serves to preclude the injustice that would result if the offer could be revoked after the offeree acted in detrimental reliance thereon. Reasonable reliance resulting in a foreseeable prejudicial change in position affords a compelling basis also for implying a subsidiary promise not to revoke an offer for a bilateral contract.²⁸⁴

The *Restatement (Second) of Contracts* has since formalized this rule,²⁸⁵ appearing "not only to follow *Drennan*, but to extend it."²⁸⁶

In the subcontracting context, informational barriers often prevent parties from negotiating an explicitly reciprocal contract. At the time that the subcontractor must submit her bid to the general contractor, she cannot predict whether the general contractor will ultimately secure a contract to perform the overall project. This unforeseeability means that the general contractor in turn cannot unconditionally promise to use the subcontractor. The general contractor can only make conditional promises to use the subcontractor that are based on a probability distribution.²⁸⁷ Such a limited commitment from the general contractor, however, may insufficiently compensate the subcontractor for her unconditional commitment to perform. When the subcontractor makes such an unconditional promise, she must restrict the use of her assets while standing ready to perform.²⁸⁸ The subcontractor's consequent inability to meet intervening demand from other sources may not be offset by the value of the general contractor's conditional consideration.²⁸⁹

The subcontractor would prefer to furnish a different promise that costs her less than an unconditional obligation to perform, allowing her to retain flexibility and reducing the value furnished to the contractor.²⁹⁰ Specifically, the subcontractor might make a commitment to enter into a fully specified bargain later, so long as intervening events create no additional burdens on her ability to perform, a commitment to give prompt notice if such events occur, and a commitment not to interfere with the

284. *Drennan*, 333 P.2d at 760.

285. See RESTATEMENT (SECOND) OF CONTRACTS § 87(2) (1979) ("An offer which the offeror should reasonably expect to induce action or forbearance of a substantial character on the part of the offeree before acceptance and which does induce such action or forbearance is binding as an option contract to the extent necessary to avoid injustice."); cf. *id.* § 90, quoted *supra* note 45.

286. MURPHY & SPEIDEL, *supra* note 2, at 409.

287. Discussion with Ronald J. Coffey, *supra* note 5; see HIRSHLEIFER & RILEY, *supra* note 13, at 9 (assuming that "each person is able to represent his beliefs as to the likelihood of different states of the world . . . by a subjective probability distribution").

288. These restrictions on her assets represent an opportunity cost for the subcontractor—she loses whatever she might have gained by using those assets in other ways. See 3 THE NEW PALGRAVE, *supra* note 139, at 719.

289. Discussion with Ronald J. Coffey, *supra* note 5.

290. *Id.*

contractor's attempts to position itself to make a fully specified, unconditional exchange of considerations with the subcontractor. These commitments by the subcontractor would be sufficient to offset the general contractor's sunk costs.²⁹¹

A default rule imposing a conditional commitment on the general contractor to use the subcontractor (becoming unconditional should it secure the overall contract) and a conditional commitment by the subcontractor to perform according to her bid (becoming unconditional if no intervening events cause additional burdens) would accomplish important goals: The rule would satisfy the parties' rational expectations²⁹² and would save them the costs of explicitly contracting over every change in the value of their respective positions prior to the point at which specification of a complete and explicit bargain is possible. Moreover, the rule may be changed cheaply by promisors who wish to do so.²⁹³

B. Other Forms of Precontractual Negotiation

The proposed default rule would provide perhaps the greatest practical benefit to parties in preliminary bargaining that proceeds incrementally. An excellent example of the informational barriers to achieving a complete and reciprocal contract appears in the preliminary negotiations between a putative manufacturer and distributor in *PDL Vitari Corp. v. Olympus Industries*.²⁹⁴ In that case, the putative promisee-distributor made significant transaction-specific investments during precontractual negotiations that were crucial to the potential promisor-manufacturer's determinations of whether and on what basis to proceed to a fully contingent, bargained-for contract.²⁹⁵ In cases like *PDL Vitari*, the crucial information would probably be unavailable unless the putative promisor made some kind of commitment sufficient to offset the putative promisee's sunk costs. For this reason, and because other mechanisms to reassure the promisee are more costly, courts should enforce a liability rule making the putative promisor responsible for reli-

291. *Id.*

292. The default rule suggested here satisfies the rational expectations of the subcontractor and the general contractor so long as each is interested in maximizing his or her own wealth.

293. Discussion with Ronald J. Coffey, *supra* note 5. The default rule proposed here would be a supplementary, nonmandatory term from which the parties could contract out if they so desired. *Cf.* FARNSWORTH, CONTRACTS, *supra* note 9, § 3.25, at 201 & n.14 (noting that at least one court has refused to permit unilateral opting out of the *Drennan* rule).

294. 718 F. Supp. 197 (S.D.N.Y. 1989).

295. *See id.* at 198-203.

ance undertaken at her behest, at least until the potential promisee receives notice that she acts at her own risk.

The principals of PDL created the company solely to act as the exclusive distributor of Olympus's "Vitari Frozen Fruit Dessert" in New York, New Jersey, and Connecticut.²⁹⁶ The dessert had not yet been marketed in this tri-state area, and the principals of PDL had no previous experience in the "frozen dessert packaging and distribution business."²⁹⁷ Thus, while Olympus "expressed enthusiasm for [PDL's] desire to have the product available to consumers in the tri-state area,"²⁹⁸ it was faced with uncertainty about the demand for its product in that locality, as well as about PDL's ability to competently market the dessert.²⁹⁹ Furthermore, Olympus was apparently uncertain as to whether it could enter into an exclusive regional distribution agreement, since it had "provided another major U.S. corporation with a letter of intent for world-wide distribution" of the dessert during the time that it was negotiating with PDL.³⁰⁰ Therefore, before Olympus could formally grant PDL the exclusive distribution rights for the tri-state area, it needed PDL to take certain actions, from which Olympus hoped to determine whether a sufficient market existed in the region and whether PDL had the ability to effectively distribute the product.³⁰¹

To induce the principals of PDL to provide this information, Olympus "expressed [its] support" for the formation of the new corporation, PDL Vitari Corp.³⁰² Olympus's representative also told PDL's principals, "you have a deal," and indicated that "Olympus's attorneys would prepare a final contract for signing."³⁰³ Finally, Olympus sent a letter to PDL stating that it was the "intent of the current management of Olympus Industries . . . to enter into a retail hard pack licensing arrangement for Vitari with [PDL]," but that a long-term contract was not yet possible since Olympus's major shareholder, Coca-Cola of Australia, was then engaged in negotiations that might affect the deal.³⁰⁴

In reliance on Olympus's representations and assurances, PDL hired a frozen dessert expert, "ordered 15 display freezers," and "began making presentations to various potential customers," which resulted in

296. *Id.* at 198.

297. *Id.* at 199.

298. *Id.*

299. *See id.*

300. *Id.* at 202.

301. *See id.* at 199-200.

302. *Id.* at 199.

303. *Id.*

304. *Id.* at 202.

orders for 500,000 pints of the dessert.³⁰⁵ Additionally, PDL leased office space, negotiated for a taste-test with a supermarket chain, and sought kosher certification.³⁰⁶

PDL's dessert expert expressed concern about operating without a formal agreement, but Olympus had allegedly "assured [PDL] that the contract would be forthcoming and that they should proceed nonetheless."³⁰⁷ PDL continued to work toward establishing its business and introducing the Vitari dessert to the tri-state area, and "[n]o one from Olympus told . . . [PDL] to hold off on the presentation or to stop efforts at securing distributors."³⁰⁸

Through PDL's actions, Olympus was able to learn that there was significant demand for its dessert in the tri-state area³⁰⁹ and also had a chance to evaluate PDL's ability to market the product. Moreover, Olympus gained time to consider alternative distribution arrangements, such as the more lucrative possibility of securing an established, world-wide distributor, and the opportunity to wait for the results of the negotiations involving Coca-Cola of Australia. Thus, after PDL demonstrated its ability and the significant demand in the regional market, Olympus was in the position to decide which deal made the best business sense.

Olympus eventually told PDL that it would be unable to enter a licensing agreement because "matters involving Coca-Cola of Australia made it impossible to proceed as planned."³¹⁰ It is unclear from the court's opinion why Olympus abandoned the deal. Perhaps after it learned of the significant demand, it decided that a world-wide agreement would be more profitable than a regional agreement. Perhaps it lacked confidence in PDL's marketing capability, or the negotiations conducted by Coca-Cola of Australia resulted in a better opportunity. It is clear, however, that Olympus could not make an informed decision until it had the information provided by PDL's actions.

The court denied PDL's request for injunctive relief because PDL could neither demonstrate irreparable harm nor establish a likelihood of success on the merits (because it lacked an enforceable contract),³¹¹ but the court noted that PDL might be entitled to damages under theories of unjust enrichment or promissory estoppel.³¹²

305. *Id.* at 200.

306. *Id.* at 199, 200-01.

307. *Id.* at 201.

308. *Id.* at 203.

309. *See id.*

310. *Id.*

311. *Id.* at 208.

312. *Id.* at 208 & n.9.

PDL Vitari provides a factual scenario in which a judicially imposed default rule would be beneficial. With such a rule, promisees like PDL would have the incentive to make considerable investments in reliance on preliminary assurances, giving promisors like Olympus the ability to determine whether to proceed to a fully contingent, bargained-for contract. Thus, assuming the parties prefer results that maximize their welfare and minimize transaction costs, the rule accords with the hypothetical bargain that the parties would have reached had transaction costs not prevented the negotiation of a generalized commitment clause.³¹³ Also, such a rule would promote trust and cooperation between the parties, without encouraging the costly behavioral adjustments that would result from enforcing ultimate promises to their full extent.³¹⁴

C. Advantages

(1) *Modifying Current Doctrinal Analyses*

The proposed default rule has several other significant advantages. It is superior to the current doctrinal approach because it provides a better analytical framework by suggesting a transactional pattern that justifies liability. This approach avoids resort to such easily manipulable elements as mutuality of intent and reasonableness of reliance to justify liability. Instead, the proposed rule focuses on the barriers that interfere with the creation of fully contingent contracts and is tailored to account for parties' behavioral adaptations to alternative rules.

Numerous cases demonstrate transactional patterns in which the promisor could not commit to a fully contingent contract because of uncertainty or a lack of information, but through the promisee's reliance was able to make an informed contracting decision. In order to justify liability in such cases, courts usually purport to apply Restatement doctrine, but sometimes either attempt to mold the facts to fit the traditional consideration model by finding an implicit contract or resort to other theories, such as the quasi-tort of negligent misrepresentation. Each of these approaches may be overinclusive and underinclusive in defining the proper scope of and warrant for liability, and none can provide consistent outcomes. As a result, they are not only analytically unsatisfying, but also afford parties in preliminary bargaining only the vaguest guidance as to whether and when precontractual liability might attach.³¹⁵

313. See *supra* Part IV.A-B.

314. See *supra* text accompanying notes 180-191.

315. Cf. Scott, *A Relational Theory*, *supra* note 12, at 598 (justifying generalized default rules on the ground that "it is more important for the law to be certain than to be right").

Many courts have applied the vague guidelines of promissory estoppel to precontractual negotiations. In *Esquire Radio & Electronics v. Montgomery Ward & Co.*,³¹⁶ for example, the Second Circuit held that Montgomery Ward (Ward), a department store, was liable to Esquire, its supplier, under the doctrine of promissory estoppel for terminating an oral "tripartite product buy-back arrangement."³¹⁷ Under the agreement, Ward was to order parts from foreign manufacturers, ship them to Esquire, and later repurchase them from Esquire when its "retailing needs for such parts arose."³¹⁸ The court used the theory of promissory estoppel in this case because it deemed Esquire's reliance "reasonable"³¹⁹ based on the facts: the parties had a "long-standing business relationship"³²⁰ and Ward had repeatedly assured Esquire that it would buy the parts,³²¹ thereby encouraging Esquire "to cease doing work for Ward competitors."³²² The difficulty of assessing the reasonableness of reliance, however, renders this doctrinal approach impossible to apply with consistency.³²³ Moreover, the theory behind promissory estoppel fails to emphasize the fact that Esquire's reliance enabled Ward to evaluate the continued desirability of the arrangement at each successive stage without committing to a complete and reciprocal contract. Focusing on this benefit to Ward enables us to view Esquire's reliance as the subject of an exchange, even if it was not explicitly bargained for.

In *Christensen v. Intelligent Systems Master, Ltd.*,³²⁴ a court awarded Intelligent Systems damages under the doctrine of promissory estoppel when Christensen decided not to purchase Intelligent Systems' subsidiary, Asher Technologies.³²⁵ Acting "in reliance on Christensen's expressed intent [to purchase the subsidiary], Intelligent Systems permitted Christensen to take over the operation of Asher . . . while the purchase agreement was being finalized" and advanced \$600,000 for operating expenses.³²⁶ Through Intelligent Systems' reliance, Christensen was able to operate Asher first hand and thus to decide whether the purchase would be profitable before making a commitment.

316. 804 F.2d 787 (2d Cir. 1986).

317. *Id.* at 790.

318. *Id.* at 791.

319. *Id.* at 794.

320. *Id.* at 790.

321. *Id.* at 792.

322. *Id.* at 791.

323. See Feinman, *supra* note 47, at 689.

324. 399 S.E.2d 495 (Ga. Ct. App. 1990).

325. *Id.* at 496.

326. *Id.*

In *D & G Stout, Inc. v. Bacardi Imports, Inc.*,³²⁷ a federal district court held after a bench trial that a liquor supplier, Bacardi, was liable to its Northern Indiana distributor, General (the plaintiffs' predecessor in interest), for withdrawing its product line, even though the relationship was terminable at will.³²⁸ Because Bacardi had given General assurances of its intention to continue the relationship,³²⁹ and the termination forced General to sell its business at a devalued price, the court reasoned that General had suffered a reliance injury.³³⁰ Basing its holding on promissory estoppel, the court overlooked the significance of the fact that the market in which the parties had been operating "was caught up in a series of acquisitions and mergers that had swept the nation's liquor distillers and wholesale distributors."³³¹ Bacardi could not have rationally entered into a bargained-for distribution contract in this situation until it learned more about the outcome of the consolidation efforts. In the meantime, however, it appears that Bacardi needed a continuing relationship with General to prevent General from selling or liquidating its business (which would have ended the distribution of Bacardi products in Northern Indiana) before Bacardi gained enough information to make an informed contract decision.³³²

In *Werner v. Xerox Corp.*,³³³ the Seventh Circuit affirmed an award of damages to Werner, one of Xerox's suppliers, under the doctrine of promissory estoppel.³³⁴ The court found that Werner had reasonably relied on Xerox's representations, which "painted a rosy picture of Werner's future as an off-load supplier of parts for Xerox."³³⁵ The rubric of reasonable reliance is hard to apply, however, and it denigrates the significance of Werner's transaction-specific investments and their value to Xerox. "Establishing an off-load produce[r] would allow Xerox to meet demands for relatively small quantities of rollers without changing its in-

327. 805 F. Supp. 1434 (N.D. Ind. 1992).

328. *Id.* at 1438.

329. *Id.* at 1439.

330. *Id.* at 1443, 1450. Specifically, Bacardi promised that "if General continued to meet Bacardi's expectations in sales, and if there were no changes in market conditions, General would remain a Bacardi distributor." *Id.* at 1439.

331. *Id.* at 1437.

332. At the time Bacardi made its promise to stay with General, "Bacardi wanted to acquire more information concerning General's viability as a Bacardi distributor." *Id.* at 1438-39. Unknown to Bacardi, General was negotiating to sell its business and, based on Bacardi's assurances, decided to reject the potential buyer's offer. *Id.* at 1440. Just before General told Bacardi that it had rejected a purchase offer, Bacardi decided to withdraw its line and switch to a statewide distributor. *Id.* at 1442.

333. 732 F.2d 580 (7th Cir. 1984).

334. *Id.* at 582.

335. *Id.* (quoting the district court's opinion).

house machines to accommodate the specifications of smaller runs."³³⁶ Yet, Xerox could not be certain *ex ante* that buying the rollers from an outside supplier would be preferable to producing them in-house and, therefore, could not rationally enter into a reciprocal contract. Through Werner's reliance (which consisted of the formation of a new corporation and the rental of manufacturing facilities), however, Xerox was able to determine that it was better suited to manufacture the parts by itself.³³⁷ A liability rule requiring Xerox to compensate Werner for its reliance costs incurred at Xerox's request more precisely identifies the conduct that the law should try to regulate in this context.³³⁸

The case of *Chedd-Angier Production Co. v. Omni Publications International, Ltd.*³³⁹ further demonstrates the inherent subjectivity of promissory estoppel. Chedd-Angier, the producer of a one-hour pilot television program on which it hoped to base a "successful and long running TV series," sued for damages when Omni terminated the parties' arrangement and formed its own production company.³⁴⁰ The First Circuit affirmed an award of full contract damages even though a signed document "'explicitly [gave] either party the right to terminate the arrangement at any time.'"³⁴¹ The court held that the negotiations between the parties constituted sufficient evidence for the jury to find that the parties had agreed on the essential terms of an oral contract, and that the district court had the discretion to award full contract damages under promissory estoppel.³⁴² Yet, finding liability under this doctrine disregards the importance of sharing information. Omni apparently wanted Chedd-Angier to produce a "promotional tape" to enable Omni to resolve certain format issues, such as whether reporters would be utilized and who was best suited to produce the show.³⁴³ Thus, the resources Chedd-Angier spent to produce the tape enabled Omni to decide that the format without reporters was best and that the program should be produced in-house.³⁴⁴ In this case, limited liability under the default rule would have better reflected the parties' hypothetical bargain than did an award of full contract damages. Moreover, full damages might

336. *Id.*

337. *See id.*

338. *Cf. Gergen, supra* note 57, at 42 (advocating the adoption of a contractual negligent misrepresentation cause of action to properly describe the conduct to be regulated).

339. 756 F.2d 930 (1st Cir. 1985).

340. *Id.* at 932.

341. *Id.* at 933.

342. *Id.* at 936-37.

343. *Id.* at 932.

344. *Id.* at 933.

prompt potential promisors to decrease their promissory activity, adversely affecting the give-and-take during negotiations.³⁴⁵

Other courts have found reciprocal, implied-in-fact contracts in similar contexts. In *OAO Corp. v. United States*,³⁴⁶ for example, the United States Claims Court held that negotiations between OAO and the U.S. Air Force had resulted in an "implied-in-fact contract for some start-up costs" related to the proposed procurement of a computer system to ease data burdens associated with the "early warning system against missile or air attacks."³⁴⁷ Because the program was "'crucial to the national defense'" and "time was of the essence to the Air Force,"³⁴⁸ OAO began work on the project, with the apparent approval of the Air Force's agents, before a formal contract was completed.³⁴⁹ The Air Force later determined, however, that the project was unnecessary.³⁵⁰ The Claims Court held that the negotiations did not lead to a contract regarding the proposed computer system because "both parties recognized that consummation of the contract was contingent upon future reviews and approvals."³⁵¹ Nevertheless, because "OAO could only meet the deadline by starting performance immediately,"³⁵² and because "no Air Force official counselled against pre-contract performance," the parties' conduct demonstrated "a mutuality of intent for an implied contract for start-up costs."³⁵³

The Claims Court's reliance on the implied-in-fact doctrine focused on the inherently amorphous concept of "mutuality of intent," while ignoring the basic facts of the transaction. The Air Force needed OAO to begin work immediately because of time constraints, and also needed more time to determine whether the program was even necessary. Consideration of the transactional realities of incremental contracting shows that a finding of liability is better justified in terms of the proposed default rule, with its economic model of average human behavior, than in terms of an implied-in-fact mutual agreement, because it helps to explain why parties would have preferred the liability rule over alternative approaches. The court correctly imposed liability for precontract reliance on the United States, not because there was a mutuality of intent, but

345. See *supra* notes 180-191 and accompanying text.

346. 17 Cl. Ct. 91 (1989).

347. *Id.* at 92.

348. *Id.* at 94.

349. *Id.* at 96.

350. *Id.* at 97.

351. *Id.* at 100.

352. *Id.* at 101.

353. *Id.* at 102.

because failing to impose liability when the putative promisee has made transaction-specific investments that the putative promisor needed in order to decide whether and how to formulate a fully contingent contract would diminish promisee investments and lead to other costly behavioral adaptations that the law could easily avoid with a default liability rule.

Finally, the case of *Giant Food, Inc. v. Ice King, Inc.*³⁵⁴ applied a misrepresentation theory in a similar transactional situation. In that case, the court affirmed a jury verdict against Giant Food for negligently misrepresenting its willingness to buy ice from Ice King.³⁵⁵ Believing that it had a firm commitment, Ice King invested heavily to "conform [its business to] Giant's requirements"³⁵⁶ In reality, however, Ice King was merely a "safety valve" to Giant, which had only "sought a new supplier of ice just in case its own plant would not be ready in time for the next heat wave."³⁵⁷ Thus, through Ice King's reliance, Giant was able to prolong Ice King's commitment until it resolved the uncertainty surrounding the demand for ice and its ability to provide its own supply.³⁵⁸

These cases present just a few examples of the many situations in which a putative promisor needs the putative promisee's reliance to make an informed contracting decision.³⁵⁹ Since a hypothetical bargain justi-

354. 536 A.2d 1182 (Md. Ct. Spec. App.), *cert. denied*, 542 A.2d 844 (Md. 1988).

355. *Id.* at 1183. In affirming the award of damages in tort, the court noted that the jury could justifiably have believed that "the relationship of the parties was one in which 'in morals and good conscience' [Ice King] had the right to rely upon Giant, and Giant owed a duty to give the correct information." *Id.* at 1186 (quoting *International Prods. Co. v. Erie R.R.*, 155 N.E. 662, 664 (N.Y. 1927)).

356. *Id.* at 1185.

357. *Id.*

358. *See id.*

359. Informational barriers and unforeseeable contingencies also hinder the success of explicitly reciprocal contracting regarding sales of complex products. By imposing the proposed default rule in these situations, the courts may effectuate the hypothetical bargains that the parties would have achieved were it not for preventive barriers.

The default rule's value is well illustrated by the pending case of *McDonnell Douglas Corp. v. United States*, No. 91-1204C (Cl. Ct. filed June 7, 1991); *see McDonnell Douglas Corp. v. United States*, 25 Cl. Ct. 342 (1992) (denying motion to dismiss for lack of jurisdiction in part); *McDonnell Douglas Corp. v. United States*, 27 Fed. Cl. 204 (1992) (denying certification for interlocutory appeal regarding government's duty to disclose superior knowledge). In this case, the U.S. Navy entered into a "fixed-price type contract," Complaint at 10, *McDonnell Douglas* (No. 91-1204C), with McDonnell Douglas and General Dynamics (the team) for the "full scale engineering development" phase of the Navy A-12 (Advanced Tactical Aircraft) program, *id.* at 2. Three years after the award, the Navy terminated the contract for the team's alleged default in being unable to meet the contract specifications and schedule. *Id.* at 43-44. According to the team's complaint, however, the Navy knew at the time of contracting that the specifications would be "legally impossible to achieve," *id.* at 54-55, and were actually only "goals or objectives" that the Navy intended to modify if the resulting aircraft met its

fies the imposition of liability on promisors in such transactional patterns, applying the proposed default rule in these situations would be superior to relying on the various doctrines currently in use—doctrines

“operational needs,” *id.* at 15. Moreover, according to the complaint, the Navy had “expressly acknowledged” that certain specifications were impossible to achieve, *id.* at 25, and had “elected to continue the program” in spite of the delays since “time was not of the essence,” *id.* at 37-38, and since the aircraft met its operational needs without attaining those specifications, *id.* at 25. The team alleged that it “mistakenly believed that development risks had been reduced sufficiently to permit sensible risk allocation and realistic pricing of a fixed-price [full scale engineering development] contract” because the Navy withheld valuable technical information and underfunded and “unreasonably compressed the normal development cycle for a major weapons system.” *Id.* at 10.

The team claimed that the contract was void or voidable, *id.* at 44-45, because the Navy violated Defense Acquisition Requirements dictating that such fixed-price type contracts are “not appropriate for research and development phases,” *id.* at 4 (quoting Department of Defense Directive 5000.1, para. 9.g (Sept. 1, 1987)), and because Navy officials knew at the time of contracting that the “technical, schedule and price risks had not been reduced sufficiently to permit lawful use of a fixed-price type contract,” *id.* at 19. The team claimed a right to relief under an implied-in-fact contract since the Navy accepted the benefit of technical information intended to be used in future programs. *Id.* at 47. The team also claimed that the doctrines of impossibility of performance, commercial impracticability, mutual mistake of fact, failure to disclose superior knowledge, failure to cooperate, the implied covenant of good faith and fair dealing, and waiver saved it from default on the contract. *Id.* at 54-65, 70-71.

Doctrinal formulations aside, however, from the transactional viewpoint it appears that the Navy entered into a reciprocal contract without adequate information in order to gain the team's performance (a purely transaction-specific investment), which then enabled the Navy to develop other military aircraft programs and reach informed aircraft acquisition and modification decisions. Secretary of Defense Dick Cheney's recommendation that the Air Force defer development of a parallel Advanced Tactical Aircraft program so that the military could benefit from the experience gained from the work on the Navy A-12 supports this view of the Navy's behavior. See *Department of Defense Authorization for Appropriations for Fiscal Year 1991: Hearings on S. 2884 Before the Senate Comm. on Armed Services*, 101st Cong., 2d Sess. 781-82 (1990) (statement of Sec. Cheney). Other remarks by Secretary Cheney confirm that the military had made acquisition decisions and entered into contracts without full knowledge of its requirements and available resources. For example, he reported that changing world events, such as “the declining threat in Europe,” *id.* at 779, and the “kinds of judgments we make about what the threat will be 15 or 20 years from now,” *id.* at 774, would affect the nation's aircraft requirements, and explained that some program changes might be necessary to meet the President's recommended budget cuts, *id.* at 770-71. It is thus clear that the Navy faced tremendous uncertainty when it decided to contract with the team. More significantly, however, Cheney described the Navy's incentive to induce the team's reliance on the contract: to “keep a base out there that is capable of producing these kinds of systems.” *Id.* at 785. He also ascribed great importance to maintaining modern equipment and eliminating the risk of a gap between the introduction of the A-12 and the retirement of its predecessor (the F-14), since “[i]t takes a very long time to implement one of these decisions.” *Id.* at 785, 773.

Consequently, although the Navy required flexibility because of the uncertainty surrounding the program, it also had powerful reasons to induce the team's reliance as a means of gaining information that would enhance the technological development of other aircraft programs. Thus, it is likely that the Navy deliberately imposed impossible standards in the contract in order to secure for itself the option of either modifying the terms as desired or claiming default if the resulting aircraft were entirely unsatisfactory. The deficient contract in *McDonnell Douglas* is therefore analogous to repeated promisor assurances given in incremental con-

that often fail to properly allocate liability, rely on easily manipulable elements, and fail to highlight important factors in assessing liability.

The proposed rule would also provide a sounder method of deciding subcontracting cases than does the current doctrinal approach. That approach prohibits the promisor-subcontractor from withdrawing an offer once the general contractor relies by using the subcontractor's bid in formulating her own bid for the project as a whole.³⁶⁰

As applied, the proposed default rule would recognize the inhibiting effect of the barriers to complete and reciprocal subcontracting contracts. Following an analysis based on the rational expectations of average contracting parties informs the determination of whether and how the law should intervene to rectify the absence of a reciprocal bargain. That analysis suggests that because the general contractor has sunk costs (in positioning herself to make an unconditional promise to purchase the subcontractor's goods or services),³⁶¹ general contractors will be less inclined to invest sunk costs in the future unless subcontractors can furnish some assurance. By imposing a default rule that furnishes that assurance, general contractors will be willing to incur sunk costs in the future in return for the subcontractors curbing other uses of their assets. The

tracting—assurances given by promisors to induce promisee reliance without subjecting themselves to liability.

According to the complaint, the Navy represented to the team that an "equitable and sensible risk allocation" had occurred by entering a fixed-price contract, *see* Complaint at 18, *McDonnell Douglas* (No. 91-1204C), inducing the team to invest its full reliance in the project. Additionally, a fixed-price contract set a "ceiling price" for project expenditures, *id.*, which was important in light of the budget constraints. Furthermore, by admitting to the team that the contract's specifications were impossible to achieve while representing that an acceptable aircraft had been achieved and thus that a formal modification proposal was unnecessary, the Navy induced the team's continued performance. *See id.* at 24-25. Because the contract specifications were not formally modified, however, the Navy maintained its ability to later allege default by the team and thus avoid full liability. *See id.*

By deciding to apply the proposed default rule in this case, the Claims Court would likely be able to achieve the hypothetical bargain that the parties would have wanted had informational and uncertainty barriers not prevented it. Moreover, if the default rule had been in force when the parties began to negotiate, the Navy would have been able to obtain the team's reliance investments without incurring the costs and inflexibility of making a bargained-for contract. In this case, the Navy mistakenly decided to enter a contract and thus faces potential liability in excess of the contract price (if the team prevails in its claim for an implied-in-fact cost reimbursement contract and equitable adjustment). *See id.* at 76-77. With the default rule, however, the Navy would have been required only to apprise the team of changes in its willingness to deal, and would have risked liability only for reliance investments. This result would benefit both parties: the team would have the assurance and incentive to engage in the valuable reliance, which would in turn provide the Navy with information on which to base a decision whether to proceed to a fully contingent, bargained-for contract.

360. *See, e.g., Drennan v. Star Paving Co.*, 333 P.2d 757 (Cal. 1958); *supra* Part V.A.

361. Discussion with Ronald J. Coffey, *supra* note 5.

suggested default rule is preferable to current doctrinal analysis because it would protect both parties in the bargaining process (rather than the general contractor alone) and take account of the informational barriers to fully contingent bargains in this context. These law-supplied promises would overcome the structural barriers to fully contingent, bargained-for subcontracting, while encouraging each party to make transaction-specific investments in the process of negotiation. Without the default implied promises, the current doctrinal model allocates all liability to the promisor-subcontractor—an allocation that discourages the subcontractor from submitting unconditional bids.

(2) *Reaching Better Results*

Apart from providing a sounder theoretical basis for liability, an increased respect for the problems of sunk costs and sensitivity to economic assumptions about the rational expectations of average parties would also lead the courts to reach better results in precontractual negotiation cases. Courts often deny promisees recovery because their transactions do not appear to fit into a doctrinal mold or the pattern of a formal contract. Cases abound in which the promisor gains information through the promisee's reliance yet escapes liability for damages under current approaches. These cases frequently reach improper results when viewed in light of the obstacles to negotiating complete, reciprocal contracts and assumptions about how parties react to judicial insistence on such contracts as the exclusive basis for recovery.

An excellent example appears in *Bender v. Design Store Corp.*,³⁶² in which the parties negotiated over a possible commercial lease. Over a one and one-half year period, the prospective tenant made changes in the proposed lease and disclaimed any "offer to lease."³⁶³ Meanwhile, however, the prospective tenant

had requested, and Northwestern [the prospective lessor] had made, numerous changes in the building's structure, including adding walls, installing new stairways, and relocating the mezzanine. In all, Northwestern made some \$167,049.55 worth of architectural changes over a period of almost 1-1/2 years. During this time, agents of The Design Store, requested changes, reviewed architectural plans, and directed work at the site.³⁶⁴

The court affirmed the trial court's rejection of a promissory estoppel theory and refused to find any "promise here, either real or implied. Indeed, there is uncontradicted evidence that [the lessee] explicitly re-

362. 404 A.2d 194 (D.C. 1979).

363. *Id.* at 195.

364. *Id.*

fused to make such a promise to lease."³⁶⁵ The court followed traditional doctrine in focusing on the promise to lease, embracing a binary approach to contract enforceability while ignoring the obstacles to achieving a fully contingent, bargained-for contract faced by the parties in any negotiation, neglecting the problem of the lessor's sunk costs, and omitting consideration of the effect that the lessor's reliance in making architectural changes had in helping the prospective tenant decide whether and on what basis to proceed toward a formal lease agreement. The court's failure to impose a commitment on the part of the tenant to be solicitous of and responsible for the lessor's costs will decrease future reliance investments by lessors and thereby tend to deprive future promisor-lessees of the information they need to negotiate fully contingent, bargained-for contracts.

Many other cases reach improper results under current approaches. In *Josephs v. Pizza Hut of America, Inc.*,³⁶⁶ for example, the Josephs secured financing and purchased a building in reliance on Pizza Hut's promise to lease the building and representation that "corporate approval was only a mere formality."³⁶⁷ The parties never reached a formal bargain, and Pizza Hut later rejected the lease.³⁶⁸ Describing the Josephs as "experienced business owners who were represented by experienced counsel," the court denied them recovery and ruled their reliance unreasonable as a matter of law.³⁶⁹ The court's analysis ignored the probability that only the Josephs' investments allowed Pizza Hut to evaluate the Josephs and their building and to decide, before committing, that the lease was not in its best interest.³⁷⁰

Finally, in *Tull v. Mister Donut Development Corp.*,³⁷¹ Tull began to convert a building into a site suitable for a Mister Donut franchise, in reliance on a letter stating the "rudiments" of a deal and an assurance from Mister Donut that the lease would be finalized quickly.³⁷² Mister Donut withdrew from the transaction, and Tull sued. The court awarded Tull no damages, holding that the negotiations did not constitute an offer and acceptance and evidenced no reasonable reliance. The court emphasized that "a reasonably informed participant in a commer-

365. *Id.* at 197 (citation omitted).

366. 733 F. Supp. 222 (W.D. Pa. 1989), *aff'd mem.*, 899 F.2d 1217 (3d Cir. 1990).

367. *Id.* at 223.

368. *Id.*

369. *Id.* at 226-27.

370. Indeed, the court did not even consider Pizza Hut's possible reasons for rejecting the lease.

371. 389 N.E.2d 447 (Mass. App. Ct. 1979).

372. *Id.* at 448-49 & n.3.

cial venture would realize that [such informal correspondence] was not adequate to govern the rights and obligations of the parties for a period that might run for forty years."³⁷³ Once again, the court's formalistic approach focused on the existence or nonexistence of a fully contingent, bargained-for lease, overlooking the nature of the incremental bargaining process. Mister Donut needed Tull's reliance to ascertain whether Tull could secure proper mortgage financing and whether Tull could sufficiently meet Mister Donut's specifications.³⁷⁴

These cases demonstrate that relying on contract doctrine often leaves the promisee uncompensated for her reliance, based on indeterminate factors that have little to do with whether liability is justified. This in turn tends to lessen future promisee reliance, thereby preventing promisors from gaining adequate information to make a contracting decision. The denial of relief in such cases necessarily involves neglecting the transaction costs and informational asymmetries of incremental contracting, and prevents the attainment of the hypothetical bargain that both parties would prefer.

Conclusion

This Article proposes that the courts adopt a default rule imposing liability during precontractual negotiations by incorporating the terms of the parties' implicit bargain. Such a rule would protect and encourage transaction-specific investments, thereby promoting the goals that both parties presumably seek. The rule would ameliorate the intrinsic problems of incremental bargaining relationships and encourage optimal interactions between negotiating parties, while deterring more costly private strategies for overcoming the natural barriers to contracting. The proposed default rule would also provide courts with a blueprint for modifying and improving current approaches to such problems as subcontracting and precontractual negotiation—a blueprint that would promote the parties' common goals and take into account how they are likely to react to alternative rules. Finally, the analytical justification for the default rule offered here provides a useful paradigm for application to a variety of other contexts in which the courts must decide whether to impose duties when the parties could have, but failed to, expressly bargain for those protections by contract.

373. *Id.* at 450.

374. *See id.* at 449.