

Illuminating the Development of Precontractual Liability

A Comparative Law and Economics Analysis

Ann-Sophie Vandenberghe

Department of Law, Erasmus University Rotterdam, Rotterdam,
The Netherlands
vandenberghe@law.eur.nl

Mitja Kovac

Faculty of Economics, Department of Law, University of Ljubljana,
Ljubljana, Slovenia
mitja.kovac@ef.uni-lj.si

Abstract

By using the tools of comparative law & economics, this article aims to shed a light on the development of precontractual liability. Precontractual liability *sensu stricto* is about the question to what extent one can be held liable for cost incurred by the other party preliminary to, or during precontractual negotiations, when negotiations fail. Comparative legal analysis has observed that the requirements for establishing a successful claim for precontractual liability are very similar at common law and at civil law despite the very different starting positions from which each legal system's rules have developed. By finding correspondence between what comparative law has found and what is expected under an efficient legal system, this study provides empirical evidence for the efficiency hypothesis of law.

Keywords

precontractual liability *sensu stricto* – functionalism – comparative law & economics – economically optimal doctrine – efficiency hypothesis of law – legal development

1 Introduction*

Can an unsuccessful job applicant recover the costs incurred in attending an interview which he has been asked to attend? This is a real-life example of a case to be addressed by the doctrine of precontractual liability. Precontractual liability is about the question to what extent one party can be held liable for costs incurred by the other party preliminary to, or during negotiations, when negotiations fail. Comparative lawyers sometimes say that precontractual liability is one of the legal issues on which common law and civil law systems differ the most.¹ The common law appears to have no counterpart to the German doctrine of liability for *culpa in contrahendo* ('breach of duty prior to contract'): that the relationship between parties who have entered into contractual negotiations (or who merely prospectively may enter into contractual negotiations) gives rise to comprehensive duties of care and good faith, breach of which duties give rise to liability to compensate for loss incurred by parties to the negotiations. And yet, the difference is more apparent than real. In a 2001 article published in *Legal Studies*, Joachim Dietrich illustrates the essential similarity of outcomes of civil law decisions to those of the common law, despite the seemingly very different starting positions from which each legal system's rules have developed: "The common law is generally said to start from the premise of no duty to negotiate in good faith and a freedom *from* contract,

* We would like to express our sincere gratitude to John Bell, Hugh Beale, James Gordley, Paula Giliker, Robert Hillman, Vernon Palmer, Greta Bosch, Catherine Pédamon, Ron Scalise, Eyal Zamir, Christopher Bradley, Paul MacMahon, Adam Feibelman, Mark Wessman, Hans-Bernd Schaefer, Pierre Garello, Muriel Fabre-Magnan, Thomas Eger, Christina Poncibo, Roger van den Bergh, Ewoud Hondius, Larry Di Matteo, Jonathan Klick, Sven Hoepfner, Ben Depoorter and to other participants and discussants of the 14th annual international conference on contracts 2019, Tulane Law School, March 2019 (KCON XIV); of the 109th Society of Legal Scholars (SLS) annual conference, London, September 2019, Queen Mary University of London; and of the 32nd annual conference of the European Association of Law and Economics (EALE), Vienna, September 2015, for their precious comments, suggestions and instrumental insights. *JEL classification*: C23, C26, C51, K42, O43.

1 "(...) it seems fair to say that we have detected a fundamental difference in approach between the countries which are usually considered to be part of the civil law tradition and those which are said to be part of the common law. (...) Unlike English, Irish and Scots law, all the other systems contain some general doctrine of pre-contractual liability, usually based on good faith. English, Irish and Scots law were the systems that most often offered no remedy and never were they the system that provided the most extensive liability. There was therefore both a doctrinal difference between the 'common law' systems and the 'civil law' systems and a corresponding difference in the outcome of cases." J. Cartwright and M. Hesselink (eds), *Precontractual Liability in European Private Law*, The Common core of European private law (Cambridge: Cambridge University Press, 2009) 487.

that is, that one has the right to break off negotiations at any time and without justifying reasons; whereas the civil law commences with duties of good faith and care owed to negotiating parties arising from the precontractual relationship. Yet the detailed rules defining a breach of duty under the civil law have a very similar content as the exceptions to the ‘no duty’ rule at common law.”² In comparing *culpa in contrahendo* with the common law, Kessler and Fine have argued that although the common law cases do not use the term *culpa in contrahendo*, its underlying philosophy of responsibility for “blameworthy” conduct has found expression in numerous ways.³ Comparative lawyers often conclude that legal rules seem different at first sight but that, in spite of differences in the substantive and procedural rules across jurisdictions, different legal systems reach similar outcomes.⁴ This functional comparative method, which starts from the premise that rules have the same function, is very well suited to be employed as a test of the grand efficiency hypothesis of law.⁵ An important premise of law & economics is that judge-made law is the result of an effort, conscious or not, to induce efficient outcomes. According to this hypothesis, first intimated by Ronald Coase⁶ and later systemized and greatly extended Richard Posner, almost all rules made by judges are efficient; it is *as if* they implicitly apply the norm of efficiency.⁷ The efficiency norm is that of minimizing costs to society as a whole.⁸ The serious defense of the efficiency hypothesis depends not on the *a priori* argument, but on the evidence.⁹ In this article we do not use a single legal system, but we use comparative law to test

2 J. Dietrich, ‘Classifying Precontractual Liability: A Comparative Analysis’, *Legal Studies* 21(2) (2001) 153–191, 180.

3 F. Kessler and E. Fine, ‘Culpa in Contrahendo, Bargaining in Good Faith, and Freedom of Contract: A Comparative Study’, *Harvard Law Review* 77(3) (1964) 401–449.

4 One of the methodological premises of functionalism maintains that legal systems tend to solve practical questions in the same way: “Different legal systems give the same or very similar solutions, even as to detail, to the same problems of life, despite the great difference in their historical development, conceptual structures, and style of operation.” K. Zweigert and H. Kötz, *An Introduction to Comparative Law* (Oxford University Press, 1998) 44.

5 R. Van den Bergh, *The Roundabouts of European Law and Economics* (The Hague: Eleven International Publishing, 2018) 22.

6 R. Coase, ‘The problem of social costs’, *Journal of Law and Economics* 3 (1960) 1–44.

7 “The common law method is to allocate responsibilities between people engaged in interacting activities in such a way as to maximize the joint value, or, what amounts to the same thing, minimize the joint costs of the activities.” R. Posner, *Economic Analysis of Law* (Boston: Little, Brown, 1973) 98.

8 R. Cooter, ‘Unity in Tort, Contract and Property: The Model of Precaution’, *California Law Review* 73 (1) (1985) 1–51.

9 D. Friedman, *Law’s Order* (Princeton: Princeton University Press, 2000) 300.

the efficiency hypothesis of law.¹⁰ After all, when two legal systems which rules develop from different starting points reach a similar outcome and when that outcome corresponds with the rules expected by the efficiency hypothesis of law, the hypothesis is confirmed. Which precontractual liability rules would we expect under an efficient legal system? Over the years, law & economics has developed an impressive framework to determine which rules are efficient and this economic framework has been used by De Geest to develop an economic doctrine of precontractual liability.¹¹ Such an economic doctrine is not a description of positive law, but formulates a set of economically optimal *model* rules.

This article is organized as follows. The first part reproduces in English the Dutch-written investigation of De Geest about which precontractual liability rules would be efficient, leading up to his economic doctrine of precontractual liability (sections 3–7). In the second part we will investigate whether what has been observed by Dietrich in his comparative legal analysis of precontractual liability at common law and at civil law corresponds to the precontractual liability rules expected under an efficient legal system (section 8). In the third part conclusions will be drawn about the efficiency hypothesis of law (section 9). Preliminary to this comparative law & economics analysis of precontractual liability, it has to be made sure that the two bodies of scholarship used (law & economics of precontractual liability and comparative law of precontractual liability) deal with the same legal subject matter (section 2).

2 Precontractual Liability *Sensu Stricto*: Legal Problem Definition

Recognizing that the German *culpa in contrahendo* has been utilized in a range of different situations, Dietrich defines as the subject matter of his comparative analysis, the use of it in the limited context of failed precontractual negotiations.¹² Also De Geest confines his analysis to pre-contractual liability for failed precontractual negotiations, for which he uses the term ‘precontractual liability *sensu stricto*’.¹³ It is important to make this delimitation clear because as Schmidt has said *culpa in contrahendo* applies to a very heterogeneous

10 We do this because we believe that functional comparative law may provide a more reliable test for the efficiency hypothesis of law than a single legal system test, which may suffer from problems of ambiguity and selection bias.

11 G. De Geest, *Economische analyse van het contracten – en quasi-contractenrecht* [*Economic analysis of contract and quasi-contract law*] (Antwerpen: Maklu, 1994) 131–144 [in Dutch].

12 Dietrich (n 2) 154.

13 De Geest (n 11) 131.

group of cases, and it thus deals with “problem areas of considerably varying origins.”¹⁴ The doctrine of *culpa in contrahendo* has been used to address problems which are in essence very different from those arising from costs incurred preliminary to, or during negotiations which are broken off. For example, one stream of cases imposes liability for personal injury and property damage which, at common law, fall within tort law proper. German law, however, has utilized precontractual special duties in these cases in order to remedy perceived defects of tort provisions in the BGB, imposing only a limited vicarious liability upon employers. Other groups of cases of *culpa in contrahendo* arise where a contract is concluded but in unfavourable or burdensome terms due to the fact that one party gave incorrect, inadequate or incomplete information. In such cases, precontractual duties to provide adequate information complement the contractual obligations which may arise. Again such cases are not of relevance to the subject matter of this article. Instead, of particular interest here are cases of liability for *culpa in contrahendo* arising as a result of failed negotiations, for which the term precontractual liability *sensu stricto* is used.

However, precontractual liability *sensu stricto* does not include cases which have to do with an untimely revocation of an offer, although also here a liability issue arises in the context of failed negotiation. These cases concern situations in which a party has made an offer to contract but revokes this offer before the other party has accepted it. For example, a party makes an offer to sell his furniture, he makes arrangements with a potential buyer to inspect the furniture, but upon arrival he tells the other party that the good is no longer for sale at the terms specified in the original offer. Can the disappointed party recover his costs? The underlying question here is to what extent one is bound by the (terms of) the offer made. An ordinary offer is revocable until accepted. This is an implication of the ‘requirement of simultaneity of consent’. However, it may be necessary to set this requirement aside in those cases where its application would make the offeree vulnerable to opportunism on the side of the offeror. This situation may arise when the offeree incurs costs in reliance of the contract offer that was made, as when a potential buyer incurs traveling costs to be able to inspect the goods which the seller has offered to sell. Once the buyer has made these reliance investments, he becomes vulnerable. The seller might change the terms of his original offer such as the price, to his own advantage, whereas the buyer might see no other option than to accept the new offer because otherwise the investments already made would be wasted. Such an action of the seller would be legitimate when the principle that ‘an

14 S. Schmidt, *Der Abbruch von Vertragsverhandlungen im deutsch-schweizerischen Handels- und Wirtschaftsverkehr* (Konstanz: Hartung-Gorre, 1994) 88.

offer is revocable until accepted' applies. To avoid this risk of opportunism, the requirement of 'simultaneity of consent' may have to be set aside by making the terms of the offer binding for a certain period of time. At the same time, it should remain possible for the offeror to withdraw his offer in a timely way, that is, before the offeree has made any reliance investment. While these are interesting cases, they do not fall within the scope of precontractual liability *sensu stricto*. To exemplify the distinction between 'untimely revocation of offer' cases and precontractual liability *sensu stricto* cases, consider the following example, taken from Markesinis, Lorenz and Dannemann:

"Assume the defendant has invited the plaintiff to come, say, from London to Munich for contract negotiations on a certain date, the outcome of these negotiations being open. The plaintiff takes a plane, books a hotel and rents a car. It is only after arrival that the defendant notifies the plaintiff that he changed his mind and gave the contract to a third party two weeks before."¹⁵

This example case falls within the proper scope of pre-contractual liability *sensu stricto*. No offer was made; the defendant merely invited the plaintiff to the negotiation table, the outcome of these negotiations being open. The liability issue arises in a context of failed negotiations. Should the law allow recovery for the plaintiff's wasted outlay?

3 Which Precontractual Liability Rules Would Be Efficient? The General Law & Economics Framework

3.1 Introduction

A important preliminary question for the determination of efficient precontractual liability rules is to ask whether the situations in which cases of precontractual liability arise should be considered as a contract law problem, a tort law problem, or a quasi-contract law problem? What is the nature or basis of any obligation to compensate the other party for the costs incurred when negotiations fail? In the legal literature there is an ongoing debate as to whether principles of contract law, tort law, unjust enrichment or an overlapping area of the existing categories of contract and tort, can better solve problems of

¹⁵ B. Markesinis B, W. Lorenz and G. Dannemann, *The German Law of Obligation (Vol I the Law of Contracts and Restitution: A Comparative Introduction)* (Oxford: Clarendon Press, 1997) 71.

precontractual liability.¹⁶ How should cases of precontractual liability best be classified from an economic point of view? Which classification is efficient? In the following paragraphs it will be shown that from an economic point of view, in which transaction costs play a decisive role, it is best to classify norms and rules which govern precontractual negotiations as contract law default rules. These are rules which supplement the pre-contract in the absence of it. The immediate question following from such categorisation is: Which rules (or clauses) with respect to the allocation of cost incurred preliminary to, or during negotiations are efficient for the majority of parties?

3.2 *Precontractual Liability: Which Classification Is Efficient?*

3.2.1 General Economic Framework

One of the major contributions of the law & economics approach to our understanding of law is that it has highlighted the analogies between contract law, tort law and property law. According to Posner fundamental analogies exist in the following way: “... almost any tort problem can be solved as a contract problem, by asking what the people involved in an accident would have agreed on in advance with regard to safety measures if transaction costs had not been excessive. Equally, almost any contract problem can be solved as a tort problem by asking what sanction is necessary to prevent the performing party or paying party from engaging in wasteful conduct, such as taking advantage of the vulnerability of a party who perform his side of the bargain first. And both tort and contract problems can be framed as problems in the definition of property rights; for example, the law of negligence could be thought to define the right we have in the safety of our persons against accidental injury. The definition of property rights can itself be viewed as a process of figuring out what measures parties would agree to, if transaction costs weren't prohibitive, in order to create incentives to avoid wasting valuable resources.”¹⁷

According to the law & economics literature, *transaction costs* define the boundary between, and the scope of, the different branches of law.¹⁸ The use of contract law is efficient in settings where private transaction costs to specify or modify rules by agreement are low and allocation via litigation costly and inaccurate. The use of tort law is efficient under the opposite circumstances: Where private transaction costs are high, it is efficient for judges or legislators to specify obligations instead of the parties. When is the use of quasi-contract

¹⁶ Dietrich (n 2).

¹⁷ R. Posner, *Economic analysis of law* (Boston: Little Brown, 1986) 21.

¹⁸ G. Calabresi and A. Melamed, 'Property Rules, Liability Rules and Inalienability: One View of the Cathedral', *Harvard Law Review* 85 (1972) 1089–1128.

law principles efficient? Whereas contracts are voluntary transfers between private parties, quasi-contracts are economically defined as ‘forced transfers’ between two private parties. One party, the initiative-taker, gives his consent to a particular transfer, whereas the other party, the forced one, does not give his consent, but is forced to cooperate. Doctors, for example, can be forced to provide care to unconscious patients whereas these patients can be forced to compensate the doctor for the costs he incurred to save their lives, even when there is no contractual, voluntary basis for such transfers. The economic doctrine of quasi-contracts specifies that they should be used if, but only if, two conditions are fulfilled: (1) the transaction costs to agree on a voluntary transfer are too high; (2) the transfer provides benefits to both parties.¹⁹

3.2.2 Application: the Efficient Classification of Precontractual Liability *Sensu Stricto*

When applying the general economic framework to decide which doctrine is best suited to resolve questions of precontractual liability, one needs to take into consideration the transaction costs characteristics of the relationship between parties who engage in precontractual interactions. It is safe to say that this relationship is characterized by low transaction costs, hence contract law should apply. Parties who interact with each other preliminary to the conclusion of an actual contract have the possibility to agree in advance in a *pre-contract* how costs incurred during their precontractual interactions will be allocated.²⁰ However, the problem of precontractual liability arises in cases in which parties have neglected to write such a pre-contract. Nothing has been agreed between parties about how costs incurred preliminary to, or during negotiations will be allocated. Parties did not agree that one or both will have to pay for the costs incurred by other party, but they also did not agree that one or both of them will not have to pay for the costs incurred by the other. For that reason, precontractual liability rules should be classified as contract law *default rules*. Default rules apply when parties have not specified their own rules by contractual agreement, yet parties are allowed to modify the default rule by prior agreement. What should be the content of the default norms and rules?

3.3 *Precontractual Default Law: Which Rules Are Efficient?*

The question immediately following from classifying precontractual liability rules as contract law default rules (rules which supplement the pre-contract in the absence of it) is which rules would the majority of negotiating parties have

¹⁹ De Geest (n 11) 329–331.

²⁰ A pre-contract may also be called a ‘process contract’ governing negotiation processes.

selected if they would have dealt with the cost allocation issue in a pre-contract? According to law & economics, this means that courts should try to find the efficient terms, the ones that minimize total costs in the majority of cases.²¹ There are two arguments for doing this. The first is that rational parties want efficient clauses. Such clauses maximize the summed gains to the parties. So efficiency is a good thing. The second is that such policy reduces the costs of drawing up pre-contracts. The parties can leave out unlikely contingencies, knowing that if they arise the court will try to fill in the terms they would have agreed to. Efficient majoritarian default rules reduce transaction costs.

After having set out the broad norm of efficiency of precontractual default law, we now have to derive specific precontractual liability rules. In particular, it will be investigated whether efficiency requires (i) a general duty to compensate the costs which the other party has incurred preliminary to, or during negotiations; (ii) that one can be held liable for costs incurred by the other party due to the fact that this party has been misled about the chances of a successful completion of the contract; (iii) that one can be forced to pay for extraordinary benefits kept when the contract does not materialize.

4 Should There Be a General Duty to Compensate the Costs Which the Other Party Has Incurred Preliminary to, or During Negotiations?

4.1 Introduction

In this section law & economics methodology is used to answer the question whether there should be a general duty to compensate ordinary costs incurred by the other party when negotiations fail. To make our analysis more illustrative, we use precontractual interactions for the purchase of a bridal dress as an example. Sellers at bridal stores usually spend a lot of time and effort in helping their customers to find their dream wedding dress. Customers, on the other hand, incur expenses to visit the bridal shop (travel and parking costs) and spend time trying out different wedding dresses. When the customer leaves the shop without buying (or any intention thereto in the future), who should bear the costs incurred? In theory, there are four possible cost allocation regimes: (1) each party bears his own costs; (2) each party bears the costs incurred by the other party; (3) the buyer bears all costs (4) the seller bears all costs.²²

²¹ On the design of the optimal default rules see H.B. Schäfer and C. Ott, *The Economic Analysis of Civil Law* (Cheltenham: Edward Elgar Publishing, 2004) 299–301.

²² De Geest (n 11) 136–140.

As was explained in the previous section, we have to investigate which regime would be efficient for the majority of parties and adopt that regime as the majoritarian precontractual default rule. Which regime is efficient? Which regime minimizes total costs in the majority of cases? To compare the four regimes in economic terms, we have to look at the incentive effects and the transaction costs of each alternative. An incentive analysis is a forward looking, *ex ante* approach: one has to assume that parties know in advance which regime will be applicable in case negotiations fail, and reason how this knowledge will affect general behaviour during precontractual interactions. Such a comparison touches upon the core of the economic analysis of law which holds that “*legal rules are to be judged by the structure of incentives they establish and the consequences of people altering their behavior in response to those incentives.*”²³

4.2 *Economic Analysis*

4.2.1 Each Party Bears His Own Costs (the buyer and the seller each bear their own costs)

A bride-to-be is looking to buy the perfect dress for her wedding day and enters a bridal store asking for help. The seller takes a lot of time and effort in showing the customer different models and helping her in trying out different dresses. But after a long trial period, the bride-to-be comes to the conclusion that none of the models satisfies her expectations. She leaves the store without buying and with no intention to come back. The buyer leaves the store without compensating the seller for his lost time; The buyer, in turn, does not obtain a compensation for the time she has lost.

Life experience teaches us that this is the most common arrangement in our economic system, especially for ordinary consumer sales transactions. Is it an efficient regime? According to De Geest it is not a perfectly efficient solution.²⁴ The reason is that buyers have an incentive to ‘cause’ too many information costs on the side of sellers under this regime. The information is ‘free’ for buyers. Therefore they have an incentive to ask for too much information, i.e. more information than they would ask if they would have to pay themselves for it. For example, the bride-to-be goes to 10 different bridal shops and asks each time for an elaborate advice. However, there is no such thing as a free lunch. The information costs must ultimately be borne by someone and in a competitive market the costs are accounted for in the price of the product. Consequently, those buyers who effectively buy the product pay for those costs. Also on the

²³ Friedman (n 9) 11.

²⁴ De Geest (n 11) 137.

side of sellers, the incentives are suboptimal. Sellers may benefit from giving incorrect information under this regime. After all, sellers only get paid for their information costs when they effectively sell something. Prices no longer equal marginal costs (making sellers indifferent between selling and not selling) but also include a compensation for wasted transaction costs.

4.2 *Each Party Bears the Costs Incurred by the Other Party (the buyer bears the costs of the seller and the seller bears the costs of the buyer)*

The pre-contractual talks and tryouts at the bridal shop take two hours but do not lead to an effective sale. The buyer asks: how much do I owe you for your time and advice? The seller responds: 100 Euro. The buyer pays a compensation of 100 Euro to the seller. The seller in turn asks the buyer: How much do I owe you? The buyer responds: 200 Euro, because I am a lawyer and those are the opportunity costs of my time. The seller pays a compensation of 200 Euro to the buyer.

This regime is very uncommon. Compared to the first regime, this regime entails more transaction costs, since reciprocal payments have to be made each time negotiations are broken off. Moreover, compared to the first regime, this regime will cause higher incentive costs. Parties are less careful (or more reckless) because it is the other party who will pay for their costs.²⁵ It also generates perverse incentives to over-state real expenditures and costs. Moreover, this regime entails a cross-subsidization of the richer consumers (those with high opportunity costs) by poorer consumers (those with lower opportunity costs).²⁶ After all, the compensations paid by the seller are accounted for in the price of the product. Because poorer consumers anticipate this, a problem of *adverse selection* exists: poorer consumers stay away from stores that apply this regime.

4.3 *The Buyer Bears All Costs (the buyer bears his own costs and pays a compensation for the costs of the seller)*

When the bride-to-be leaves the bridal shop without buying, she pays a sum for the advice received to the seller, but does not get a compensation from the seller for her own lost time.

This regime is sometimes applied. For example, information brochures are not always for free and sometimes a simple advice is charged for (e.g. lawyers or business consultants sometimes charge for a simple advice). Also this regime has certain disadvantages.²⁷ Now, the problem is that sellers may try

²⁵ De Geest (n 11) 138.

²⁶ De Geest (n 11) 138.

²⁷ De Geest (n 11) 138.

to 'sell' too much advice, since buyers pay for the costs of the advice. There is a classical information paradox. One can only assess the value of information once one has obtained the information. In order to know whether the information (advice) is valuable, one first has to buy the information. This information asymmetry in selling information may lead to *averse selection*: bad advisors (those who do not invest in training) stay on the market while good advisors (those who invest in training) leave the market. Nevertheless, this regime can be useful in solving *free-rider problems* between different suppliers: a consumer goes to a brick and mortar store to get free advice, but then decides to buy the item on internet where prices are lower because less advice is given. The regime in which the buyer pays a compensation for a simple advice, solves this problem.

4.4 *The Seller Bears All Costs (the seller bears his own costs and pays compensation for the costs of the buyer)*

When the bride-to-be leaves the bridal shop without buying, she gets a compensation from the seller for her lost time, her traveling and parking costs but does not pay a compensation to the seller for the advice she got.

This regime is sometimes applied. Sellers may distribute free sample products or provide free trials for their products or services. This regime has advantages but also disadvantages.²⁸ There are *principal-agent* problems (consumers ask more products on trial than optimal) and *adverse selection* problems: 'Good' consumers (those with a high chance of buying) subsidize 'bad' consumers (those with a low chance of buying). As a consequence, the 'good' consumers may stay away from the market.

4.5 *Conclusion*

Should there be a general duty to compensate the costs which the other party has incurred preliminary to, or during negotiations? The answer is no.²⁹ A general precontractual liability rule which imposes upon parties a duty to compensate the costs of the counterparty when negotiations fail, would boil down to imposing upon parties the second regime: 'each party bears the costs incurred by the other party'. Is this the regime that most parties would choose if they would explicitly deal with the cost allocation issue in a pre-contract? The fact that we do not observe that type of arrangement in practice is a serious contra-indication. Moreover, economic analysis shows that this type of arrangement causes many incentive problems compared to the alternative regimes.

²⁸ De Geest (n 11) 139.

²⁹ De Geest (n 11) 139.

The crucial question is which type of arrangement leads to a minimization of costs in the majority of cases? It seems optimal to adopt regime 1 (“each party bears his own costs”) because it is the most common arrangement. But because it might be optimal for parties to adopt an alternative regime in particular cases, this rule should be adopted only as a majoritarian default rule: Parties should have the possibility to adopt an alternative regime. For example a seller of bridal dresses who disagrees with the rule that in principle no compensation is given for his time, help and advice when negotiations fail, could indicate in advance that he charges 100 Euro for his time and advice. If the consumer agrees, then parties have explicitly agreed in a pre-contract to modify the default rule. The transaction costs for parties to modify the default rule are not excessively high.

5 Should One Be Liable for Costs Incurred by the Other Party Due to the Fact that this Party Has Been Misled About the Chances of a Successful Completion or the Benefits of the Contract?

5.1 Introduction

Example 1: A company owners wishes to buy 50 computers for the whole company. He invites a supplier to make a bid, saying that he is conducting similar negotiations with one other supplier, whereas in reality he is conducting similar negotiations with ten different suppliers. The seller spends many hours in preparing a detailed plan thinking he has a 50 % chance of winning the bid.

Example 2: A company owner wishes to buy computers and asks a supplier for a commercial plan saying that he needs 50 computers whereas in reality he only intends to buy 5 computers from the supplier. The supplier spends many hours in preparing a detailed plan thinking it is for a contractual deal for the purchase of 50 computers.

These two example cases make clear that in precontractual interactions there is a danger that a party makes excessive and wasteful costs. This waste exists only because the buyer commits a specific kind of fraud: he misled the seller about the chances of a successful completion of the contract (example 1) or about the benefits of the anticipated contract (example 2). A simple way to avoid such waste is by incentivizing negotiating parties to be honest about the real chances of a successful completion of a contract and/or about the benefits of the deal, a role which precontractual liability could fulfill.³⁰

³⁰ De Geest (n 11) 140.

5.2 *Economic Criterion for Precontractual Liability: Misleading Information About the Chances of Success or About Contractual Benefits*

It is a waste of resources when a party incurs costs during precontractual interactions when these costs are based on a mistaken belief that the chances of a successful completion of the contract are high whereas in reality these chances are low or even zero. A simple way to avoid such waste is by incentivizing negotiating parties to be honest about the real chances of a successful completion of a contract or about the real benefits of the contract. How can pre-contractual liability law achieve this? By holding a defendant liable for the costs incurred by the plaintiff when these costs were misleadingly induced: “If, at some time during the negotiations, any party misled the other party as to the likelihood or the benefits of the deal, and so induced this other party to engage in some costly action in anticipation of the deal, the first party should be held liable for the costs of this action, when the negotiations fail.”³¹

5.3 *Should it be Required that it was Reasonable to Rely on the Misleading Information?*

It may happen that a party, who was misled, accidentally obtains information about the true chances of success or the true benefits of the deal. The law should induce a party to make use of that information and to adjust his expenses accordingly.³² This can be done by requiring that it was reasonable to rely on the misleading information. Economically defined, ‘reasonable’ then means that one did not possess information about the fact that one was misled.

5.4 *Should it be Required that a Party Acted in Bad Faith?*

From an economic point of view, it should not be required that the party who gave the misleading information acted in bad faith.³³ Negligent behavior is as harmful as intentional behavior. In both cases a party incurs wasteful expenses which he would not waste in case he was correctly informed.

5.5 *Should it Matter Who Breaks off the Negotiations?*

From an economic perspective, it should not matter who took the initiative for breaking off the negotiations, that is, who walked away from the negotiations.³⁴

³¹ W. Wils, ‘Who Should Bear the Costs of Failed Negotiations? A Functional Inquiry into Precontractual Liability’, *Journal des Economistes et des Etudes Humaines* 4 (1) (1993) 93–134.

³² De Geest (n 11) 140.

³³ De Geest (n 11) 141.

³⁴ De Geest (n 11) 141.

When liability for costs misleadingly induced would depend on who took the initiative to break off negotiations, parties may strategically play a ‘you-quit-first’ game. The ‘guilty’ party – the party who misled the other one about the chances of a successful completion of the contract – may make such unreasonable demands during negotiations that the ‘innocent’ one sees no other option than to quit the negotiation table. And yet, the ‘guilty’ party would escape liability because he was not the one who walked away from the negotiations.

5.6 *What Measure of Damages Should be Used?*

What is the optimal measure of damages? The reliance measure (expenses) or the expectation measure (expected profits)? A pre-contract is a special form of contract, but it is a contract. In principle it is desirable for the damage compensation to comprise expected profits. But there is an important distinction between the expected profits of the pre-contract and those of the actual contract. In the situation of a pre-contract, there is no difference between the expenses made and expected profits. In the pre-contract, parties make agreements about which party will bear which costs in which case. They may also agree not to impose unnecessary injury. Hence, the promisee’s expectation is that no injury will be done and that he will be compensated for certain costs he has made.³⁵ From an economic perspective and to internalize the costs, it is sufficient to compensate the costs which are misleadingly induced. But also costs due to foregone alternative opportunities should be compensated.³⁶

6 **Should One Be Forced to Pay for Extraordinary Benefits Kept When a Contract Does Not Materialize?**

It may happen that one party has performed work in anticipation of a contract which does not materialize. Should the law allow the other party to be forced to pay a compensation for the extraordinary benefits kept? Such a forced transfer would amount to a quasi-contract: by incurring expenses for the work, the initiative-taker generates unsolicited positive externalities which benefit the other party, and then forces the other party to pay a compensation, the amount

35 De Geest (n 11) 141.

36 For example. A learns of B’s intention to sell its restaurant. A who has no intention whatsoever of buying the restaurant, nevertheless enters into lengthy negotiations with B for the sole purpose of preventing B from selling the restaurant to C, a competitor of A. A, who breaks off negotiations when C has bought another restaurant, is liable to B, who ultimately succeeds in selling the restaurant at a lower price than offered by C, for the difference in price.

of which is determined by the judge. Would it be efficient to use a quasi-contract for work performed in anticipation of a contract which does not materialize? The answer is no.³⁷ The reason is that the conditions for the efficient use of a quasi-contract are not fulfilled because the transaction costs to reach a voluntary transfer to which both parties consent are not prohibitively high. Parties who engage in precontractual interactions are in a position to write an explicit pre-contract in which they agree in advance which expenses may be incurred and which compensation will be paid for it. In settings where private transaction costs are low and allocation via litigation costly and inaccurate, contracts are efficient. It means that if a party intends to perform work in anticipation of a contract, he should get the other party's consent in advance to do the work and to pay compensation for it. The use of a quasi-contract (whereby the judge determines the amount of compensation which the 'forced' party must pay *ex post*, i.e. after the work has been done with the sole consent of the initiative-taker) would be inefficient because individuals know their own preferences much better than anyone else in the world, including judges.

7 The Economic Doctrine of Precontractual Liability: Economically Optimal Model Rules

De Geest has formulated an economically optimal doctrine of pre-contractual liability *sensu stricto*:³⁸

- (i) A party is liable if, but only if, he has misled the other party with respect to the chances of success or the possible benefits of the contract, provided it was reasonable for the other party to rely on this information. The questions 'who broke off the negotiations' and 'was the information given in bad faith' do not matter in accepting liability.
- (ii) The damage compensation comprises the costs misleadingly induced, including the value of foregone alternative opportunities.

This implies the following requirements.³⁹ A negotiating party has a duty to inform or warn

- (a) that one negotiates with more candidates than is usual (i.e. chance of a successful completion of the contract is lower than usual);
- (b) that one has no real intention to conclude a contract (i.e. chance of a successful completion of the contract is zero);

³⁷ De Geest (n 11) 142–143.

³⁸ De Geest (n 11) 143–144.

³⁹ De Geest (n 11) 144.

- (c) that one no longer will conclude a contract because he has contracted elsewhere (i.e. chance of a successful completion of the contract is zero);
- (d) about the reason for breaking off negotiations in a later stage. The purpose of this requirement is to enable the other party to control whether he has been misled about the chances of a successful completion of a contract. Revealing the reason for breaking-off negotiations allows a party to know whether that reason could have been brought up at an earlier stage.

8 Precontractual Liability: Comparative Law & Economics

8.1 Introduction

In this section, we combine law & economics of precontractual liability with comparative law of precontractual liability. First, the comparative law observations made by Dietrich on precontractual liability at common law and at civil law will be summarized. Next, we will investigate whether there is correspondence between what has been observed in comparative law and what we expect under an efficient legal system.

8.2 *Precontractual Liability at Common Law and at Civil Law: Comparative Law Observations*

According to Dietrich's comparative legal analysis of precontractual liability at common law and at civil law, "the scope of precontractual liability is not significantly different in civil or at common law."⁴⁰ He sets out that "the requirements for establishing a successful claim for *culpa in contrahendo* under civil law do not appear to differ significantly from the requirements for establishing a claim for precontractual liability at common law. (...) the detailed rules defining a breach of duty under the civil law have a very similar content as the exceptions to the 'no duty' rule at common law."⁴¹

With respect to common law, there are elements which are common to all cases imposing precontractual liability, irrespective of whether the courts have utilized contract law, the law of quasi-contract, restitution or unjust enrichment, estoppel, or tort law.⁴² These elements are: (a) a belief (at least in part of the plaintiff) that a contract exists or an expectation of a future contract;⁴³

⁴⁰ Dietrich (n 2) 183.

⁴¹ Dietrich (n 2) 179–180.

⁴² Dietrich (n 2) 164.

⁴³ Dietrich (n 2) 165.

(b) a plaintiff has relied detrimentally on that belief or expectation;⁴⁴ (c) the defendant's conduct.⁴⁵ This latter element encompasses two quite different grounds for imposing liability. The starting premise for both is that the risk of negotiations failing (and of any losses consequential upon such failure) is on both parties to negotiations and that it is thus necessary to identify some reason for shifting such risk.⁴⁶ The first of these grounds of liability is founded upon a defendant's intention as either expressed or (objectively) discernable from his or her conduct, to assume an obligation in relation to the work performed or expenses incurred by the plaintiff.⁴⁷ The second ground of precontractual liability involves a shifting of risk, not because of an intention to assume it, but rather because of the imposition of law of such risk upon the defendant. In effect, the law seems to require the defendant to fulfil a 'positive' duty of care to warn or safeguard the plaintiff against foreseeable pure economic loss.⁴⁸ As a result, the defendant is under a duty to take reasonable steps to apprise the plaintiff of the true facts before any detrimental reliance occurs.⁴⁹

The civil law doctrine of *culpa in contrahendo*, utilized to solve problems of precontractual liability on the premise of duties of care and good faith arising during contractual negotiations, gives rise to similar outcomes in the determination of cases as occur at common law.⁵⁰ With respect to precontractual liability in German law, the requirements of a claim for *culpa in contrahendo* are: (1) Parties have entered into a precontractual relationship, having entered into negotiations or dealings with a view of a legal transaction;⁵¹ (2) One party negligently or intentionally creates the expectation in the other that a contract will be finalized in due course.⁵² Such intention or negligence will be established in circumstances in which that party knows or ought to have known that that expectation could not be realized. This requirement for a claim for *culpa in contrahendo* may also be made out if a party creates merely an expectation in another that potentially worthwhile negotiations will take place and that such party subsequently does not inform the other when the negotiations cannot take place or would be pointless;⁵³ (3) The plaintiff has been induced

44 Dietrich (n 2) 165.

45 Dietrich (n 2) 167.

46 Dietrich (n 2) 168.

47 Dietrich (n 2) 168.

48 Dietrich (n 2) 169.

49 Dietrich (n 2) 169.

50 Dietrich (n 2) 190–191.

51 Dietrich (n 2) 177.

52 Dietrich (n 2) 177.

53 Dietrich (n 2) 178.

to rely on the expectation by incurring expenses or perhaps forgoing opportunities in a way which proves detrimental once no contract is finalized;⁵⁴ and (4) the defendant breaks off negotiations without good cause or justifiable reason, having failed to warn the plaintiff of the possibility of no contract being completed in sufficient time to avoid any detrimental reliance on the plaintiff's part.⁵⁵

8.3 *Is There Correspondence between Comparative Law Observations and the Rules We Expect under an Efficient Legal System?*

In sections 4 till 7 we have set out which precontractual liability rules to expect under an efficient legal system. As it turns out there is a striking correspondence between what is observed in comparative law and what is expected under an efficient legal system.

First, both at common law as well as at civil law, there is no general duty to compensate the costs incurred by the other party when negotiations fail. In both systems the principle applies that in general each party has to carry its own expenses incurred in the course of negotiating a prospective contract. The risk that the contract does not later ensue and that the expenses incurred thus prove to be wasted, lies with each negotiating party. This principle is fully in line with efficient precontractual default rules according to which 'each bears his own costs' applies as a default regime because it is the regime that, compared to alternative regimes, leads to a minimization of costs for the majority of negotiating parties.

Second, both legal systems allow a party to recover wasted outlays when these costs were induced by a mistaken belief about the chances that a contract would be finalized in due course, effectively establishing a duty to warn or safeguard the plaintiff against incurring costs which would be wasted. This rule is fully in line with the economic doctrine according to which a party is liable for the costs incurred by the other party when these costs were due to the fact that the party has been misled about the chances of a successful completion of the contract. In that way precontractual liability law incentives negotiating parties to take actions (i.e. duty to inform or warn when chances of a successful completion of the contract are zero or lower than usual) in order to avoid that resources are wasted.

Finally, both legal systems, do not appear to force a party to pay for extraordinary benefits kept when a contract does not materialize. At common law, the

54 Dietrich (n 2) 178.

55 Dietrich (n 2) 179.

ground of liability is founded upon a defendant's intention as either expressed or (objectively) discernable from his or her conduct, to assume an obligation in relation to the work performed or expenses incurred by the plaintiff. This means that the law requires an explicit (or implicit) pre-contract for imposing (contractual) liability for work performed in anticipation of a contract which does not materialize. This is in line with the efficiency norm because the use of quasi-contracts is not efficient in settings where transaction costs are low, which is the case for parties who engage in precontractual interactions. A party who incurs costs to provide unsolicited benefits to the other party, should not be able to force that party afterwards to pay compensation for the benefits. An explicit or implicit pre-contract to which both parties consent should be required as it is the case under common law.

9 Conclusion: Confirmation of the Efficiency Hypothesis of Law

Each legal system's rules on precontractual liability have developed from seemingly very different starting positions: "The common law is generally said to start from the premise of no duty to negotiate in good faith and a freedom *from* contract, that is, that one has the right to break off negotiations at any time and without justifying reasons; whereas the civil law commences with duties of good faith and care owed to negotiating parties arising from the precontractual relationship."⁵⁶ An yet, despite the despite the seemingly very different starting positions from which each legal system's rules have developed "the civil law doctrine of *culpa in contrahendo*, utilized to solve problems of precontractual liability on the premise of duties of care and good faith arising during contractual negotiations, gives rise to similar outcomes in the determination of cases as occur at common law."⁵⁷ We used this comparative law observation as a test and confirmation of the efficiency hypothesis of law. The rules which were developed under common law and under civil law to establish a successful claim for precontractual liability correspond with the rules expected under an efficient legal system. That common law and civil law have reached similar outcomes is therefore not something which may have happened accidentally, but might be considered as the result of the law's function to enhance efficiency in society by minimizing the joint costs of activities, including the costs of precontractual activities.

⁵⁶ Dietrich (n 2) 180.

⁵⁷ Dietrich (n 2) 190–191.