Good faith negotiating, irredeemable acts and rent-seeking: towards an optimally legal doctrine

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Mitja Kovac and Qi Zhou

University of Ljubljana, Faculty of Economics, Department of Economic Theory and Policy and University of Leeds, Faculty of Law, UK
e-mail: mitja.kovac@ef.uni-lj.si, qizhou@me.com

Abstract:

Notions of good faith and pre-contractual fair dealing in the formation of contracts have recently received increasing attention from legal scholars and practitioners. Those duties and the related question on who should bear the costs of failed negotiations appear as fundamental concepts in all civil law systems and yet as one whose nature and contents are still ill-understood and controversial. Moreover, recent doctrinal and jurisprudential developments in English, German and Chinese law of contracts call for further systematic assessment of this fascinating topic. This paper seeks to provide a systematic micro-functional, comparative contract law and economics evaluation of the disparate doctrines governing the pre-contractual liability and good faith negotiating in English, French, German and Chinese law of contracts. While employing well-defined normative criteria of wealth-maximization it identifies the double moral hazard problem, offers a legal and economic evaluation of the irredeemable, potentially inefficient and rent seeking negotiating acts and provides legal and economic arguments for an improved regulatory response. The paper is an attempt to find out what new light the economic analysis of law can shed on the issues of pre-contractual good faith and liability to help to clarify it.

JEL classification: C23, C26, C51, K42, O43
Keywords: Good faith, culpa in contrahendo, rent-seeking, irredeemable acts, efficiency, comparative contract law and economics

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1. Introduction

Von Ihering’s introduction of the doctrine of *culpa in contrahendo* in his famous article published back in 1861 into the German law of contracts was definitely a farsighted, efficiency pursuing, enterprise. One might even argue that his ground-breaking introduction of such an efficiency enhancing doctrine features him among the first European law and economics scholars. Its impact has reached well beyond the German law of contracts and have actually pawed the road on the continent towards the more sustainable long-run economic growth. Von Ihering namely advanced the thesis that damages should be recoverable against the party whose blameworthy conduct during negotiations for a contract brought about its invalidity or prevented its perfection. From an economic perspective, as we argue, this is clearly an efficiency enhancing institution that promotes value-maximizing exchanges, decreases transaction costs, enables more efficient allocation of resources, deters opportunism and maximizes social wealth.

When parties have been negotiating a contract or a deal and these negotiations, due to various reasons collapse, the question often arises whether legal rules and courts should ever entitle an individual, rational party to vitiate or unilaterally breach the pre-contractual bargains. Namely, in most European legal systems it is held to be contrary to the pre-contractual good faith to enter into negotiations without having any intention of making a contract. Legal literature actually extensively addresses the question of what kinds of conduct are then at all regarded contrary to such a good faith standard, is this

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2 In addition, in his Law As a Means to an End, 2 vol. (1877–83; originally in German), he argues that the purpose of law is the protection of individual and societal interests by coordinating them and thus minimizing occasions for conflict. Where conflict was unavoidable, he assigned greater weight to societal interests (social wealth maximization principle), thereby inviting the criticism that he subordinated the individual to society.

3 For example, its American counterpart, the “doctrine of promissory estoppel” has been included into the Restatement (First) of Contract in 1930 (which is more than 40 years after the von Ihering’s ground-breaking contribution) and was then followed by reassessment of the importance of protecting reliance interests of the parties (See e.g. Fuller and Perdue, 1937). Moreover, it has also profoundly affected Austrian and Swiss law (Klang, 1951) and has been widely discussed in the French legal literature and influenced the French case law, even if only indirectly (Colin and Capitant, 1959)

4 One may find the roots of such a concept in Justinian’s Institutes under the concept of “Justitia” which is described as the “constant and perpetual disposition to render everyman his due” and that “the precepts of law are, to live honestly, to hurt no one and to give everyone his due; The Institutes of Justinian, Title I., D.1. T.1 paragraph 1 and 3.

negotiating without intending to conclude a contract, conducting parallel negotiations, breaking off negotiations unilaterally, knowingly concluding an invalid contract, not giving adequate information, disclosing confidential information and causing physical harm to the other party in the course of negotiations.\(^6\)

This article offers an elaborated comparative analysis of the pre-contractual duties of good faith and provides a comparative law and economics assessment of related English, French, German and Chinese law of contracts. It seeks to examine just one of the many non-contractual doctrines by which a promise, or manifestation of consent in pre-contractual stage might have (or does have) a legal effect – the *culpa in contrahendo* or *promissory estoppel* as defined/known in common law systems. The comparative law and economics analysis shows that assessed legal doctrines are still very incoherent and that the most difficult problems with the legal doctrines of *promissory estoppel* and *culpa in contrahendo* are actually imbedded in the doctrines of *promissory estoppel/culpa in contrahendo* themselves and that should be actually seen as consisting of at least four distinct principles, none of which is the exclusive domain of those two doctrines.

Namely, provided law and economics investigation suggests that the pre-contractual duty of good faith is a special, unique legal institution that, while pursuing the wealth of nations, addresses multiple set of possible sources of inefficiency (which may retard the efficient allocation of resources) simultaneously. In other words, it is a legal multi-tasking agent that, in order to remedy the sheer problem of positive transaction costs (in an attempt to minimize this transaction costs), simultaneously addresses several different sources of transaction costs in the pre-contractual formation of contracts. Hence, it should be, analytically speaking, actually seen as: a) a transaction costs minimizing institution which boosts, spurs allocative efficiency; b) as a powerful deterrence mechanism that minimizes opportunism and moral hazard (i.e. behaviour which represent a pure waste of resources); c) as a mechanism that fosters efficient generation, utilization and disclosure of information (simultaneously addressing the “prisoner’s dilemma” in pre-contractual negotiations); d) as a mechanism that addresses the problems faced by legal systems in delineating between irredeemable acts and potentially inefficient acts (with all, further on

discussed 3 sub-categories); and e) as a mechanism that after addressing all previous points also induces efficient level of pre-contractual reliance and shifts the risks of failed negotiations upon the superior risk bearer (i.e. incentive to enter and efficiently invest into the value maximizing exchanges).

Furthermore, such a multi-tasking agent actually solves different problems with different variations, emanations of pre-contractual duties of good faith/promissory estoppel and hence corresponds with De Geest’s suggestions that one should use different rules for different problems and that that n problems require n legal rules.\(^7\)

However, although pre-contractual liability is one of the most popular topics among law and economics scholarship, the absence from the major law and economics textbooks might indicate the non-problematic character of that topic and perhaps even the evolutionary nature of law and economics discipline steaming from the American theory of contract law which traditionally refused to attach legal consequences to the formation of contracts and employed the so called “aleatory view” of negotiations.\(^8\) In the early days of law and economics scholarship such negotiating issues have been completely assumed away via a narrowly defined rationality assumption and hence any interference into the freedom of contracting can only be based on paternalism and not on economic grounds.\(^9\) Yet, during the last 30 years, a large number of law and economics scholars addressed problems related to the pre-contractual stage from a broad variety of perspectives.\(^10\) However, a lack of a generally accepted framework of analysis and the ambiguousness of US courts’ attitudes toward pre-contractual liability call for a better understanding of the underlying economic issues. In this respect, a comparative law and economics analysis of the rules developed in the civil law jurisdictions might bring

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\(^9\) In essence the idea was that if we have to assume that parties are rational, we also have to assume that the contracts they sign and how they behave during negotiations for contracts are Pareto improvements and hence any regulation, interference in to the freedom of contracting can only be based on the paternalism (Kronman and Posner, 1979).

additional insights and might help to clarify the structure and the general understanding of the pre-contractual duties.

In addition, a general duty of pre-contractual good faith is in comparative legal literature often employed as an illustration of immediate contrasts between the civil law jurisdiction and the common law jurisdictions (since for example English law imposes no general duty of pre-contractual good faith). By employing legal and economic analysis, this paper overcomes doctrinal inconsistencies and presents an additional explanatory framework for distinguishing unilateral breach/termination of contractual negotiations (which should be allowed) from those which should be deterred.

In this article, the analysis is as positive as it is normative. Moreover, it assumes the “traditional” rational (broadly defined rationality assumption), risk-averse, self-interested and wealth maximizing behaviour and does not employ, due to the space limitation, any recent behavioural law and economics’ insights. Furthermore, the analytical approach employed is novel. It combines a functional micro-comparison12 with the analytical methods and concepts used in the economic analysis of law.13 This new approach reveals that, despite profound differences, the French, German and English laws in action are not as different as is often believed,14 although the doctrinal justifications diverge sharply, whereas Chinese law differs in several specific ways. Since there must be a minimum level of difference between compared systems to make any comparative enquiry worthwhile, and since compared legal systems should at least be at a similar stage of

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development, English law has been chosen to represent common law systems, while German and French law to represent civil law systems. Moreover, those three legal systems are (together with the US legal systems) so-called ‘mature’ or ‘parent’ legal systems which have been extensively adopted or imitated by others, and hence the choice of comparison appeared to be ‘value-maximising’. Further, for reasons of objectivity, scholarly curiosity, the growing importance of Chinese law and its economy, the lack of comparative literature and future challenges in the development of Chinese contract law this paper also provides a comparative analysis of the pre-contractual duties of good faith in Chinese law. Another practical reason was involved, namely the accessibility of legal materials, reports and comments. The research question is structured as a universal concrete problem and, as such, together with the three chosen legal systems forms our tertia comparationis.

However, a caveat should be issued in relation to the scope of this article. Namely, because it is impossible to cover all aspects of the pre-contractual duties to negotiate in good faith, this article merely focuses on questions which relate merely to pre-contractual stage where no contract eventually was concluded and very briefly addresses questions which relate to pre-contractual phase\(^1\) and arise after the completion of the negotiations.

The first part of the paper (Section 2) offers a set of economic criteria for establishing when and in which conditions contractual negotiations should be unilaterally abandoned. The second part (based on a provided set of economic criteria) critically comments on some provisions of French, English, German and Chinese law (Section 3). A conclusion is provided in section 4.

2. Pre-contractual negotiations – a synthesis of law and economics scholarship

In the day-to-day world of mutual transactions, parties continuously negotiate and then make contracts in order to warrant the future provision of goods and services, mutually beneficially reallocate or share risks, or alter the timing of consumption due to

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differences in opinion about subsequent events.\textsuperscript{16} It is well established that, except in the case of a spot-market transaction where parties manage reasonably well without formal contracting,\textsuperscript{17} contracting becomes valuable when there is a temporal element to the exchange or one party is unsure about what their counterparty will do.\textsuperscript{18} In other words, in the modern world a contract enables trust, this trust enables cooperation and thus in end fosters a mutual exchange, an efficient level of relation-specific investment in a contractual enterprise, thereby facilitating the movement of scarce resources to their most valuable uses. However, it is also well established that the hold-up problem in the negotiation stage on performance will result in all manner of underinvestment in the contractual enterprise.\textsuperscript{19} Hence, it is widely accepted that contract enforcement is privately and socially desirable because it spurs production and trade. The ultimate goal of the law in contract situations as well in pre-contractual settings is hence the promotion of wealth-maximizing exchanges.

In daily economic exchanges, parties very often enter into contracts without any negotiations (or with a trivial amount). In more complicated situations, however, a contract typically follows an extended set of communications and pre-contractual exchanges of information. Namely, they would have some degree of informal and formal interaction, they would communicate their respective interests and expectations, and, while testing the feasibility of mutually beneficial transaction, exchange various information regarding their potential exchange. This, sometimes very extensive, exchange of information obviously does not always lead towards the final conclusion of a contract and the freedom of contracting should still be a leading, general principle.

\textsuperscript{17} See e.g. J. K. Arrow and G. Debreu, “Existence of an Equilibrium for a Competitive Economy,” 22 Econometrica 265, 1954.
Namely, a general, efficiency based, possibility to unilaterally terminate negotiations provides a flexible mechanism which enables a response to the emergence of more valuable alternative options, and pursues a change in the market strategy (adapting to ever changing market circumstances) where cancellation of the previous negotiations in the original relationship is efficient. Yet, it should be stressed that such a right to unilaterally terminate negotiations should not be unconditional.

Namely, from economic viewpoint, despite this general principle of freedom of contracting (and terminating negotiations), the rules that govern this pre-contractual stage are significant because they might influence the final outcome of an exchange. By attaching consequences to the various acts and omissions that individual bargainers can choose from in a negotiation, legal rules affect the parties’ incentives to make and to respond to offers, to exchange information, and to communicate with one another at all.20

As Hermalin et al. argue, even before potential contracting parties meet, they make a number of economic decisions that influence the possible gains from future trade.21 Not all of these decisions, however, will necessarily be made optimally. Some decisions create positive or negative externalities, and others entail relational investments that are vulnerable to holdup.

The obvious question in this pre-contractual exchanges of information is then whether negotiations for contracts should be freely terminated at any time and whether such an unrestrained unilateral option would not inflate transaction cost, introduce uncertainty, distort incentives for efficient pre-contractual reliance expenditures (in anticipation of future contract), create incentives for opportunistic behaviour (including the hold-up problem) and eventually destroy the operation of the system of sequential exchanges. In other words, who should actually bear the costs of failed negotiations? According to mainstream French and English doctrinist no one should bear the other’s party costs unless he clearly did not behave as a reasonable person22 or according to German and Chinese doctrinist if he has clearly behave in bad faith. This section identifies four major overlapping principles (searching for contractual partners and disclosing information,

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21 Ibid.
investigating the value of exchange, making pre-contractual investments), which are actually merely different, sub-sources of the costs of transacting and tries to compress them into a single general principle.

2.1. Transaction costs

The welfare of a human society depends on the flow of goods and services, and this in turn depends on the productivity of the economic system (Coase, 1998). The productivity of the economic system depends on specialization which is only possible if there is an exchange of goods and services. Such an exchange, a voluntary transaction is beneficial to both parties, but transaction costs than reduce the value of an exchange and both contracting parties will want to minimize them. In other words, the amount of that exchanges which spur allocative efficiency depends, as Coase (1988) and North (1990) argues, also upon the costs of exchange23 – the lower they are the more specialization there will be and the greater the productivity of the system. In other words, transaction costs analytically speaking slow the movement of scarce resources to their most valuable uses and should hence be minimized in order to spur allocative efficiency. Hence, without the concept of transaction costs it might be impossible to understand the working of the economic system, to analyze many of its problems and to identify the key factors, mechanisms of economic growth. In a world of zero transaction costs parties would always produce economically efficient results without the need of legal intervention. However, since in reality transaction costs are imposed daily, intervention becomes necessary and the legal rules by reducing transaction costs imposed upon an exchange can improve (or worsen in case of increased transaction costs) allocative efficiency and thus maximize social welfare.

Transaction costs, in the original formulation by Coase (1937, 1988, 1998), are defined as ‘the cost of using the price mechanism’ or ‘the cost of carrying out a transaction by means of an exchange on the open market’. As Coase (1961) explains, ‘In order to carry out a market transaction it is necessary to discover who it is that one wishes

23 The costs of exchange actually depend on the institutions of a country: its legal system, its political system, its social system, its educational system its culture and so on (Coase, 1998).
to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up the contract, to undertake the inspection needed to make sure that the terms of the contract are being observed, and so on’. Coase actually sees transaction costs as a crucial factor in shaping the institutions, including law that determines the allocation of resources (Polinsky and Shavell, 2007). Arrow (1969), De Geest (1994), Williamson (1996) and Posner (2011), while closely resembling Coase’s concept, insightfully define transaction costs as the costs of running the economic system of exchanges – costs of exchange. For example, when Robinson Crusoe was alone on the island, there were no transaction costs – as soon as Friday arrived, and they started working together, transaction costs appear. Here, one should note that transaction costs are not costs like the production costs or precaution costs (which Robinson would also have if one would want to have the optimal pollution on his island) but merely costs of economic exchanges. Coase’s (1960) definition of transaction costs actually encompasses ex ante costs (before the exchange) associated with search, negotiation and ex post costs (after exchange) of monitoring and enforcement. In this concept transaction costs are actually an aggregate of ex ante search, negotiation, decision, persuasion and ex post monitoring and enforcement costs. The former ex ante component (i.e. search, negotiating, tipping, advertising, comparing, processing costs) represents also the focus of our attention.

It may be argued that positive transaction costs are actually a crucial reason for emergence (and eventual gradual formation towards more and more efficient substantial rules and doctrines) of the investigated legal doctrines (institutions) of culpa in contrahendo and promissory estoppel. We suggest that these two institutions have actually been generated, designed as mechanisms that shall mitigate the persistent problem of positive ex ante transaction costs which are hindering the optimal functioning of the system of economic exchanges. Since in reality these ex ante transaction costs (negotiating costs; searching costs for contracting partners and for preferable resources; acquiring, generating and disclosing costs on the value of exchange; information processing costs; risk costs; information costs ect.) are imposed daily and are not trivial, intervention becomes necessary and the legal rules by reducing such ex ante transaction costs imposed upon daily exchanges can improve (or worsen in case of increased
transaction costs) allocative efficiency and thus maximize social welfare. The introduction of discussed legal institutions of *culpa in contrahendo* and promisory estoppel in to the legal systems of Germany, England and France might have indeed been, though this is a largely untested hypothesis at this point, from the transaction costs perspective one of the key contributing factors, mechanisms of economic growth. In other words, discussed doctrines should, in order to maximize social wealth, pursue efficiency and minimization of *ex ante* transaction costs. The further on discussed institutions of for example optimal disclosure of information, pre-contractual good faith, deterrence of opportunism and moral hazards should actually be seen as different transaction costs decreasing mechanisms (addressing different sub-sources of transaction costs).

As an illustration, suppose that parties in order to be in position to enter into exchange, they must undertake the expense (transaction costs) of searching for potential trading partners. Such expenses include searching, acquiring information on the possible value of exchange, advertising, correspondence, information processing, travel, and the parties’ time (opportunity costs). Wealth maximization principle calls for parties to undertake such efforts up to the point where the marginal costs of additional search just outweigh its expected marginal value. While search can be modeled in various ways (see, e.g., Diamond, 1987), under plausible assumptions, the value of an additional unit of search lessens as the quality of the bargain in hand increases. This stopping point will depend on the transaction costs (i.e. on the cost of search, the distribution of information). The level of search that is privately profitable for an individual party, however, is not necessarily the same as the level that would be socially optimal. Various legal doctrines are then employed in order to promote the early formation of contractual liability. Such doctrines will thereby affect the level of search, but if such doctrines eventually

24 But which nevertheless follow from the previous observations.
26 As Hermelin et al argue, in markets with bilateral search, each person’s search efforts provide a positive externality that reduces the search costs of others; and secondly, to the extent that there are economic rents associated with trading (i.e., if parties buy or sell at prices that diverge from their reservation prices), some amount of search is motivated by the desire to find a better distributional outcome. These effects work in opposite directions, so it is difficult to generalize about what public policies would be optimal in this regard, but it is possible in principle that enlightened regulation could improve social welfare; Hermelin et al, supra note 24.
unintendedly increase transaction costs\textsuperscript{27}, the direction of the effect might be ambiguous.\textsuperscript{28}

2.2. Pre-contractual information regulation: disclosure duties

The notorious asymmetric information problem is one of the most significant transaction costs generating sources and indeed it may be argued that almost every fundamental legal and economic problem is asymmetric information problem.\textsuperscript{29} Information is the essential ingredient of choice, and choice among scarce resources is also the central question of economics.\textsuperscript{30} Lack of information impairs one's ability to make decisions of the fully rational kind postulated in economic discourse, thus they must be made in the presence of uncertainty.\textsuperscript{31} This uncertainty causes parties to make decisions different from what they would have made under conditions of abundant information. Such decisions may then entail a loss or failure to obtain a gain that could have been avoided with better information.\textsuperscript{32} Uncertainty is thus generally a source of disutility, and information is the antidote to it.\textsuperscript{33} Shaping laws that give parties an incentive to act in a way that leaves everyone better off is a straightforward matter, as long as all the parties and those who craft and enforce legal rules possess enough information.

However, complication arises when the necessary information is not known, or is known, but not to all parties, or not to the court.\textsuperscript{34}

\textsuperscript{27} Instead off persistently decreasing them.
\textsuperscript{28} From the ex post perspective of parties who have already found each other, such rules should reduce the incentive for additional search, because a party who holds a binding commitment has less need to search; and a party who is bound faces reduced value from search because even if she finds a better bargain, she will still be liable for the first one. But from an ex ante perspective, parties may be more willing to undertake the cost of search if they are assured that any trading partners they find will stick with their deal. Which effect is more important depends on the details of the situation; ibid.
\textsuperscript{29} Term information is used here in a very broad, general sense, encompassing ‘data,’ ‘knowledge’ and ‘information.’
\textsuperscript{32} Ibid, p. 108.
\textsuperscript{33} In most instances efficiency will be enhanced by moves that improve the flow of information in society.
At the pre-contractual stage, when parties are still in the negotiation process, parties have an opportunity to exchange and general contract law offers many rules that generate incentives to disclose information (mistake, fraud, misrepresentation, warranties etc.). In this respect, doctrines of *culpa in contrahendo* and promissory estoppel may be, analytically speaking, regarded as mechanisms for addressing the asymmetric information problem (by providing incentives for information disclosure) and via this info-disclosure channel also the over-all transaction costs. In order to solve this asymmetric information problem Wills actually developed a simple doctrine: you are liable only if you misled the other party with respect to his chances or to amount at stake.\(^\text{35}\)

Suppose, for instance, that you asked a free offer from 100 competing construction while you told each of them that you have asked an offer only from 4 constructors. All competing constructors spend substantial amount of time preparing the offer, believing they have 50% chance to get the contract. In reality they have only a 2% chance. If they would have known their real chances, they would never have spent so much time in preparing the offer. The incentives to misrepresent comes from the fact that the reliance expenditures that one party incurs increase surplus of the deal and since this misrepresentation provoked inefficient reliance investments, the party with superior information should be deterred by the prospect of liability. Hence, the fundamental problem is, according to Wills, asymmetric information (the buyer knows the chances better) resulting in wasted costs.\(^\text{36}\) The solutions suggested by Wills is a legal duty to be honest, sanctioned by the duty to compensate.\(^\text{37}\) Wills also suggests that such liability should not be conditional on whether the liable party has broken off the negotiations, because otherwise the parties would have incentive to wastefully drag out negotiations to avoid liability (so called “you quit first game”).\(^\text{38}\)

Moreover, consider the instance in which one party makes a costly but efficient investment in anticipation of the deal, from which the other party retains a benefit after the failure of negotiations. In the absence of liability, the party would not incur such


\(^{36}\) Since more preparation costs are made than would have been if the buyer had to pay them; ibid.

\(^{37}\) Ibid.

\(^{38}\) Ibid.
costs, because, although the investment increase the final surplus from the deal, they are too expensive for the party to take at her own risk. For example, suppose that you enter a mobile-phone shop, falsely pretending that you plan to buy 400 phones for a non-existing firm. The seller will for sure spend a lot of your personal use. The waste of pre-contractual information costs is caused by the buyer misleading the seller with respect to the amount of stake. Hence, the contracting parties should disclose information. The same holds for a party that starts negotiations with the sole goal of stealing know-how or trade secrets should be held liable. Hence, lying should be sanctioned, since asymmetric information hinders markets.

However, this does not imply that only lying should be sanctioned. Economic theory has shown that the distinction between explicitly lying and just concealing information is less relevant than lawyers tend to believe. Hence, the issues should be analysed in terms of duties to produce and reveal information, rather than in terms of lying, dishonesty or bad faith.

In addition, in order to conduct exchange, the parties not only must find each other, but they must also determine whether trade is worthwhile. Both the acquisition and disclosure of such information can be costly, and the parties’ willingness to incur these costs will depend on whether they can be recouped in subsequent contract bargaining and performance. As with informational investment more generally, imposing a duty to share information tends to undercut the incentive to acquire it, so there is a potential tradeoff between efficient production of information ex ante and efficient use of information ex post.

Whether information should be produced, of course, depends upon whether it is socially valuable, as opposed to simply having private redistributive value. For that reason, if information acquisition is, on balance, socially wasteful, it is best to impose a

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39 Ibid.
40 There should hence a rule imposing restitution of the benefits obtained out of the failed negotiations (in order to provide incentives for efficient but costly investments). However, such a restitution liability should not be linked to the fact of breaking off negotiations. It should be attached to whatever party received benefits from the other’s party action; ibid.
41 In addition, if parties were allowed to lie, the other party would be induced to incur verification costs and other defensive expenditures, which are also a wasteful activity – it is a production of information that have already been produced by someone else.
42 Hermalin et al., supra note 24.
43 Ibid.
disclosure requirement in order to deter rent-seeking (or a tax on acquisition efforts or windfall profits if that is administratively cheaper). The central rule is that in principle, the least cost information gatherer should produce and communicate information. The least cost information gatherer (a concept introduced by Kronman) is the party that can obtain information at fewer costs than the other party.\textsuperscript{44}

However, the least cost information gatherer rule should according to De Geest and Kovac\textsuperscript{45} be subject to number of exceptions:

a) Information should not be communicated if the other party has it or should already have it, since transmitting information has a cost.

b) Information should not be communicated if the communication costs exceed the value of the information - a simple economic rule of thumb should be introduced: information should only be produced and communicated if the information production costs plus the communication costs are lower than the value of the information to the buyer.

c) There should be no duty to reveal entrepreneurial information. Entrepreneurial information is information that is costly to produce, impossible to protect via intellectual property rights, and valuable to other market players, so that without a right to keep that information secret, free rider problems would discourage the production of the information. There should be a right-to-lie-and-conceal with respect to such information.

d) There should be no duty to be honest with respect to mere opinions or other non-falsifiable statements. Examples of non-falsifiable statements are: ‘Pepsi-Cola tastes better then Coca-Cola’, ‘My Toyota is fantastic’, or ‘John is a great lawyer’. These statements cannot be falsified by directly observing the empirical reality, due to the absence of a generally accepted definition (When is a car fantastic? When is a lawyer great?), or due to the subjective nature of the statement (‘It tastes better’). Of course people do not always say the truth here (to sell more cars, they may say that they believe a type of car is fantastic, while their true beliefs are different), but evidence problems would be enormous here. Very often, the only way to prove a party misrepresented its


own opinions will be by that party’s confession. Sanctioning parties, who had a moment of honesty, may not sanction lying but rather sanction being honest afterwards. In addition, sellers with a critical and open-minded attitude towards their own products would have a comparative disadvantage because they would be sanctioned more often.

e) The difference between intentionally and negligently giving wrong information is irrelevant, except for the fact that extra-compensatory sanctions may be needed for deterring intentional misinforming. This conclusion can be derived by analogy from the conclusions of the economic literature on tort law, where the rules for intentional wrongdoing and negligence do not differ, except for in the sense that criminal law (or other forms of extra compensatory sanctions) may be required to deter intentional torts.

f) There is no need for separate doctrines on promissory estoppel, culpa in contrahendo, mistake, fraud/misrepresentation or latent defects besides a duty-to-inform doctrine. While law and economics scholars have hardly made any statements on the optimal formulation of legal doctrines, the literature suggests that all asymmetric information problems can be solved by a duty-to-inform doctrine (which is a more refined fraud doctrine). The only other doctrine that is needed is a risk allocation doctrine for informational shortcomings that are symmetrical. If party A is imperfectly informed, there are indeed three possibilities. First, A was the least cost producer of information. In this case, A should be sanctioned for not having produced this information. The simplest sanction is not to intervene in the negotiations. This does not require a separate doctrine. Second, B was the least cost producer of information. This can be solved by a duty-to-inform doctrine. Third, neither party was able to produce the information at a reasonable cost. In this case we have – from an analytical perspective – a pure risk problem. The question then is which party is in the best position to bear this risk – which may be answered by doctrines such as ‘impossibility.’

g) ‘Consent theories’ or ‘will theories’ can never provide precise criteria for when the negotiations phase ends and when the contract has been concluded. According to these theories, a contract is valid if, and only if, it is based on the real will/consent of both parties. The contract is void (or there is no contract at all) when the consent of one or both parties is absent. Parties, however, never have perfect information at the time of contracting. Ex post, they have more information than ex ante. In this sense, they are
always mistaken. The fact that they had imperfect information should be no reason to avoid a contract because otherwise contracts would never be binding. The question is how to ensure that an optimal amount of information is produced in society (which generally requires that the party who can produce valuable information at least costs gets an incentive to do so). Since the optimal amount will generally be higher than zero information and less than complete information, all-or-nothing concepts like ‘will’ or ‘consent’ are intrinsically inapt to providing clear answers.

h) The signing-without-reading problem (asymmetric information on the content of exchange itself) leads to similar problems as asymmetric information on the characteristics of the transferred object. A special form of information asymmetry consists in the drafter of the contract, while negotiating, possessing more information on the future contract than the party that simply signs it. Analytically, this specific type of information problem is similar to the general type. Hence, it should be possible to integrate rules that deal with transparency (on the negotiations itself) and those that deal with information (on the goods or services), except for when it comes to remedies.

2.3. Irredeemable acts and the duty of good faith

Law and economics considers the obligation of good faith as an implied contractual term that prohibits opportunistic behaviour and enables trust between parties. The more productive such trust is, the more valuable it becomes for the members of a society and therefore the more frequently it is made use of and for this reason trust must be protected both in contracts and pre-contractual relationships. The legal protection of good faith can be hence explained as facilitating legal transactions that maximizes wealth of nations. In pre-contractual setting a duty to negotiate in good faith actually implies that the contracting partners are acting in an honest way and can therefore be said to have reasonable expectations that relevant facts will be revealed (information disclosure) to

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them in order that they can make their decision. Hence, it may be argued that a duty of pre-contractual good faith is essentially an information disclosure mechanism – a duty to disclose information, which we have addressed in previous sub-section. Our analysis of good faith could hence be concluded with this observation and the only policy implication/suggestion would be – introduce the previously developed duty-to-inform-doctrine.

However, if one anyhow employs a good faith standard, the next question which immediately is what kind of socially undesirable behaviour should be regarded as bad-faith behaviour and what should be the optimal amount of such behaviour (zero or non-zero)?

In a recent ground-breaking article Raskolnikov introduced a significant distinction between two types of socially undesirable behaviour: irredeemably inefficient acts and contingently inefficient acts.48 Irredeemable acts are according to Raskolnikov acts that are always socially undesirable, whereas contingently efficient acts are acts that are sometimes undesirable but sometimes desirable.49 Irredeemable acts always reduce welfare, they reduce social welfare no matter what the legislator does in any form and at any level, because they are inefficient at their core. They are private, intentional, non-consensual transfer of wealth (money). They are socially undesirable in any form and at any level because though the money transfer is generally welfare neutral, transferors and transferees waste real resources to make sure that this transfer does occur.50 Such acts produces no net social benefit, yet they are giving rise to a variety of social costs.51 They must also be intentional and non-consensual.52 All of the provoked actions are unproductive, no value is created and such activities give rise to social (and private) costs.

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49 Ibid.
50 Ibid.
51 The social benefit is non-existent because the only private benefit of for example theft is the thief’s gain from the stolen money and that gain is then inevitably and fully offset by the victim’s loss; ibid.
52 People resist when others intentionally take what does not belong to them without obtaining the owner’s consent. By being aware of provoked resistance (due to intention and non-consensual character of act) thieves will try to overcome that resistance by concealing their actions – all actions are completely unproductive; ibid.
These costs are actually transaction costs because they inevitably accompany mere transfers of wealth. Given the sheer absence of any net social benefit the transaction costs (transactional costs) make actually such behaviour (e.g. theft) irredeemably inefficient. The same holds also for all other private, intentional, non-consensensual transfers of money, that is, of all other irredeemably inefficient acts. Hence, in the world of zero transaction costs such acts would represent a zero-sum game and hence would not be irredeemable, would not reduce social welfare. Transaction costs are hence also a source of socially undesirable behaviour and opportunism. With such acts there is no trade-off between the marginal costs and benefits central to the optimal deterrence, actor’s intent is central factor and this intent is also the only factor that distinguishes socially desirable and undesirable conduct.

Hence, irredeemable acts should be strictly deterred, forbidden, legislated as unlawful (the law should simply forbid them). Moreover, although the standard view in law and economics is that such an inefficient behaviour might be converted into efficient behaviour by forcing parties to internalize the external harm of their decisions, for such irredeemable acts such conversion is impossible or may even lead to over deterrence.\textsuperscript{53}

Contingently inefficient acts, on the other hand, may or may not be socially undesirable depending on the magnitude of costs that need to be balanced. They represent all kind of socially harmful acts (speeding, issuing misleading forecasts) that are inefficient in some form or at some level, but are socially desirable in a different form or at different level.\textsuperscript{54} They may be inefficient, even highly inefficient, but they are only contingently inefficient. The optimal regulation of contingently inefficient acts should depend upon finding the efficiency-maximizing trade-off between costs and benefits.\textsuperscript{55} In addition De Geest, introduces a further distinction with three sub-types of contingently inefficient acts: a) those that can be cured by telling parties what to do (through duty to disclose information); b) those that can be cured by letting the party internalize harm (through reliance damages); and (c) those that are too hard/costly to cure and therefore

\textsuperscript{53} Irredeemable acts might be over deterred: a) if enforcement increases the costs of irredeemable acts that remain undeterred, or b) enforcement burdens efficient conduct that yields outcomes indistinguishable from those produced by irredeemable acts.

\textsuperscript{54} The appropriate response is surely not to eliminate all speeding and forecasts issuing since driving and corporate disclosure are productive activities that give rise to costs as well as benefits; ibid.

\textsuperscript{55} In many case, efficiency is maximized if private actors are forced to take accounts of the external harms (and benefits) of their acts; ibid.
given up on by the legal system (for instances by simply permitting some types of breaking off negotiations’ acts).\textsuperscript{56}

The irredeemable acts, as for example purely opportunistic negotiations (entering into negotiations with sole purpose if stealing others person trade secrecy, know-how ect.), must be simply forbidden. In instances of negotiating acts (contingently inefficient acts) for which the legal system can identify the inefficient cases (for example when one party in negotiations misled the other party with respect to his chances or to amount at stake) a system of liability for negligence should be established (duty to inform). In the second subcategory where legal system cannot identify the inefficient cases of braking off negotiations, since the legal system does not know which termination is good or bad, it can induce the party to choose only good terminations by letting the party to internalize the harm (reliance damages) and such party will opt for only good terminations. In the third example where the legal system cannot identify the inefficient braking offs from efficient breaking offs of negotiations and for which the harm internalization is not feasible, legal system may simply either ban all negotiation’s termination or simply permit it. This four categories also explain very well the seemingly different legal rules, tools and regulations employed simultaneously under the over-all heading of \textit{culpa in contrahendo}/promissory estoppel.

Furthermore, Raskolnikov makes another insightful observation, that actually irredeemable acts are a subset of rent-seeking and directly unproductive profit-seeking activities.\textsuperscript{57} Negotiating parties can hence dissipate resources through various types of rent-seeking behaviour. From an economic viewpoint we define rent as a profit that would not have been made in a perfect market. Because prices in a perfect market reflect only the true costs, a rent is then part of the price that exceeds the true costs.\textsuperscript{58} Hence, purely opportunistic renegotiations are irredeemable acts, since they generate profit for the wrongdoer that could not have been earned in a perfect market.

For example rent-seeking behaviour could be done by excessive communications, by haggling and stalling, by introducing “chicken game” negotiating techniques

\textsuperscript{57} Ibid.
(brinkmanship, playing tuff guy, intimating, going for broke ect.),\textsuperscript{59} and by hard bidding that risks losing, distorting the bargain entirely. One way to deter such behaviour is through substantive legal doctrines that limit the kinds of bargains that can be enforced, and thus lessen the temptation for overreaching. Contract law may indeed via pre-contractual duties of good faith actually create incentives to deter such behaviour and impose the cost of lost bargains on parties who cause them through excessive rent-seeking.\textsuperscript{60}

An unrestrained right to terminate negotiations might, as already noted, induce cheating, retaliation and instances of opportunistic behaviour where one party may due to socially harmful reasons terminate negotiations. Such opportunistic behaviour should be deterred as it directly wastes scarce resources (destroys wealth – minus-sum game). In other words, opportunism and the other’s party prevention of opportunism waste resources that represent a deadweight social loss which should be avoided.\textsuperscript{61} In legal terms, such opportunism is usually labelled ‘pre-contractual bad faith behaviour’. Thus, one should indeed introduce a necessary precondition that such a termination can only be allowed when it does not represent purely irredeemable acts, cheating or opportunistic behaviour – i.e. when it is in good faith.

This pre-contractual good faith standard for cancellation may thus be interpreted as a mechanism for policing cheating, retaliation, opportunism and other instances of socially harmful behaviour which in economic terms would redistribute the risk already allocated by the agreement.\textsuperscript{62}

\textsuperscript{59} The “chicken game” and related strategies themselves should actually be in pre-contractual stage avoided completely, since they induces irrational behaviour, provides incentives for inefficient investments and actually destroys wealth (minus-sum game).

\textsuperscript{60} Hermalin et al, supra note 24. See also Cooter, 1982

\textsuperscript{61} Limitations on such an opportunism are always optimal when enforcement costs are negligible; E. W. Kitch, “The Law and Economics of Rights in Valuable Information,” 9 Journal of Legal Studies 683, 1980.

\textsuperscript{62} Klein, Crawford and Alchian argue that such strategic behaviour which should be deterred has no socially optimising effects; rather, it only distributes portions of an already allocated contractual pie; Klein, Crawford and Alchian, supra note 7, at 300. Goetz and Scott therefore define bad faith behaviour as intentional efforts to use contractually created discretion or other strategic opportunities to secure a larger share of the anticipated gains from the existing contract; Goetz and Scott, supra note 13, at 1139.
2.4. Protection of pre-contractual reliance

According to the traditional “aleatory view” of negotiations, the parties are free to retreat from the initiated negotiations at any time, for any reason and without any consequences, so that each party bears the risk that her investment (reliance) will be wasted. The previous discussion however emphasized that pre-contractual investigation of exchange value can operate as a sunk investment that is vulnerable to rent-seeking and opportunistic behaviour. Although much of the modern laws of contracts are protecting investment incentives, they merely regulate relationships after the contract was concluded. Some pre-contractual investments, however, must be undertaken before it is practical for contractual liability to attach. Reliance may indeed be beneficial (for one party or for both) because it can increase the size of a pie. Such reliance and investments are usually relation-specific and may be wasted if the negotiations fail. Law and economics scholars point out that the risk of losing the investment might lead to an incentive to underinvest and hence foregoing the opportunities to maximize the surplus obtainable from transactions. By altering the costs and benefits of reliance, argues Katz, pre-contractual doctrines actually influences parties’ decisions to make offers and to rely on them at the proper time and a proper amount. He argues further, that other investments can be delayed until negotiations are completed, but their value is reduced in doing so. Suppliers of goods, for instance, can typically reduce their production costs by

63 Farnsworth, supra note.
64 For example, search efforts inherently must precede contractual negotiation (else who would one negotiate with?), and negotiation must precede the formation of a contract. But both search and negotiation are costly, and their costs are at least in part relation-specific; Hermalin et al, supra note 24.
65 Parties investments that increase the net private surplus of the transaction in the event of a negotiations successfully leading to a binding contract; Craswell, Richard, “Offer, Acceptance, and Efficient reliance,” 48 Stanford Law Review 481, 1996.
66 Thus, contract law should encourage relation-specific investments by awarding verifiable reliance costs to a party if a counter party has strategically delayed investment; Schwartz, Alan and Robert E. Scott, “Precontractual Liability and Preliminary Agreements,” 120 Harvard Law Review 120, 2007. Plaintiffs also ten to win claims in US cases when a positive result would enhance an efficient outcome and to lose cases in which enforcement would have negative welfare effects; Kostrisky, P. Juliet, “The Rise and Fall of Promisory Estoppel or is Promisory Estoppel Really as Unsuccessful as Scholars say it is: A new Look at the Data,” 37 Wake Forest Law Review 101, 2002.
buying materials when prices are low or by doing advance work when business is slow; and buyers can increase their value from exchange by investing in complementary inputs.

But if they wait until they are finished bargaining to begin preparations, many such opportunities will be lost. It is not desirable to provide complete protection for pre-contractual investments, conversely, because such protection would lead to excessive reliance. As the parties negotiate, they may discover information that reveals that the intended exchange should not be pursued. If this happens, any relation-specific investments will be wasted. Optimally, the parties should take the risk of wasted investment into account before making them.69 The rules governing contract formation, accordingly, should ideally be designed to promote optimal reliance at the optimal time, balancing the benefits of productive investment against the costs of waste.70 Katz proposes a simple rule of thumb: the party with a bargain power that captures the bulk of the gains from reliance should also be made to bear the costs of reliance, including the costs of waste when the exchange cannot be completed – in that way this party will have the proper incentives to weight costs against benefits.71 In general, persons without bargain power will be reluctant to enter relationships (economic exchange) requiring specific investments, for fear that their investments will be expropriated. The proper legal rule that can provide them with necessary reliance protection and hence induce them to enter in to the economic exchanges. Of course, mere protection of reliance interest won’t be satisfactory and must be combined with previously discussed issues.

2.4 Synthesis – towards an optimal unilateral cancellation doctrine

After economically assessing the unilateral cancellation of contracts, several instructive conclusions and insights may be offered and summarised in the following outlines for an optimal default rule on the unilateral cancellation of contracts:

69 Ibid.
70 Ibid.
71 This will actually lead her to choose the timing of the transaction to maximize the potential value of an exchange; Katz, ibid.
(1) In principle, contractual negotiations should be unilaterally terminable (potentially inefficient acts – type c).

(2) However, purely opportunistic termination of negotiations (irredeemable termination acts) are forbidden.

(3) Moreover, this unilateral termination of negotiations must be done in accordance with good faith principle (contingently inefficient acts) and the negotiating party is in such instance liable for failed negotiations (duty to compensate – contingently inefficient acts – type b) only if she misled the other party with respect to his chances, time, costs or to amount at stake. Such a liability should not be conditional on whether the liable party has broken off the negotiations.

(4) There should be a duty for party A to inform party B if all the following conditions are fulfilled (contingently inefficient acts, type a): (a) A is the cheaper cost producer of this information; (b) the information is valuable to B (i.e. the value is higher than the information and communication costs); (c) it is unlikely that B possesses the information already; (d) the information is not entrepreneurial (entrepreneurial information is costly to produce and hard to be compensated for once it is revealed); (e) the information does not consist of mere opinions and other non-falsifiable statements.

3. A comment on French, English, German and Chinese contract law

This section critically comments on parts of certain articles in French, English, German and Chinese contract law, and investigates whether they are in line with the proposed, economically-based recommendations.

3.1. French Law (rectitude et loyaute)

The French Code Civil, while it call for good faith in the performance of contracts, does not have any general provision regarding the contract formation. Article 1134 of Code Civil merely provides that “Contracts…must be performed in good faith” and this article clearly does not relate to pre-contractual negotiations, but only to performance of
contracts.\textsuperscript{72} In contracts to the German developments, pre-contractual duties were an issue mainly in situations where strict adherence to classical will theory and to the meeting of minds was found to lead to undesirable results. The elaborate and detailed expansions (as we will see later on) of pre-contractual duties in Germany appeared to have no French counterpart.\textsuperscript{73} Yet, it should be stated that Code Civil itself already furnishes an illustration of the \textit{culpa in contrahendo} principle in Art. 1599 which provides that while the sale of a thing belonging to another is void, if the purchaser is unaware of the seller’s defective title he may recover damages from him.\textsuperscript{74}

However, in recent years there has been a clear tendency on the part of both jurisprudence and doctrine to import, in reliance on the general principle of delictual liability, a requirement of good faith or honesty and fair dealing into the pre-contractual negotiations.\textsuperscript{75} Today, the courts and most contemporary French authors recognize a general duty of pre-contractual good faith.\textsuperscript{76} This tendency was according to Nicholas, consecrated in a decision of the \textit{chamber commercial} of the \textit{Cour de cassation} in 1972.\textsuperscript{77}

This decision has according to commentators arrogated to the courts a very wide discretion to police the conduct of businessmen and is one of many illustrations of the truth that, because French law thinks in large categories rather than in detailed instances (like his German and English counterparts), the French judge often exercises a much

\textsuperscript{72}Beale, Hugh, Hartkamp, Arthur, Kotz, Hein and Denis Tallon, “Cases, Materials and Text on Contract Law,” Hart publishing, 2002, at p. 239.


\textsuperscript{74}Since French law recognizes a general liability for fault, the implications are noteworthy; ibid at p. 407.


\textsuperscript{77}In this case the defendant was the exclusive distributor in France of machines made by an American firm, X. The plaintiff entered into negotiations with the defendant and eventually, after going to US to see the various types of machines which X could supply, asked the defendant for certain complementary information to enable him to make a choice. The defendant made no reply and (as the plaintiff later discovered) withheld an estimate send by X. Two weeks later the defendant signed a contract to supply a machine to a competitor of the plaintiff’s, with a clause in which the defendant undertook not to supply another machine in the same area for forty-two months. The court found that there had been a wrongful breaking off of negotiations and held the defendant liable in delict. \textit{Cour de cassation} also noted that the defendant had deliberately withheld the estimate and kept the plaintiff in the dark, and had broken off the negotiations when they were in an advanced stage, in a brutal and unilateral way, in the knowledge that the plaintiff had incurred considerable expense. The defendant had therefore in court’s opinion broken the rules of good faith in commercial relations; Cass com 20.3.1972, JCP 1973.II.17543; reported in Nicholas, supra note 61, at p. 69.
wider power than his English counterpart.\textsuperscript{78} However, in an earlier case\textsuperscript{79} court refused to impose liability for breaking off negotiations and recognized that certain obligations of honesty and fair dealing \textit{(rectitude et loyaute)} rest on the parties in the conduct of negotiations, but fault \textit{in contrahendo} must be obvious and beyond dispute.\textsuperscript{80} Malaurie and Stoffel-Muck for example argue that the modern French law provides for the freedom to terminate the negotiations without incurring any liability (freedom of contracting), but at the same time also introduces the obligation of good faith in the negotiations – to carry out the negotiation process in a fair and honest manner.\textsuperscript{81} According to commentators modern French law establishes the following duties in the pre-contractual formation of contracts: a) the duty to inform in an honest manner the other party to the contract; b) the duty to grant other party a reasonable time to think about it; c) the duty to attempt to reach an agreement; and e) the duty not to seek to introduce unacceptable conditions or dilatory measures.\textsuperscript{82} Good faith in French law now governs the execution as well as the formation of contracts and amount to each party not betraying the confidence created by the willingness to enter into a contract.\textsuperscript{83}

In particular, the courts have identified duties of “loyaute” (fairness) and “cooperation,” which require the parties to respect their obligations in the contract and work together towards its performance.\textsuperscript{84} This may well extend to an obligation to keep each other informed of developments which may affect performance of the contract. French case law confirmed that negotiating parties must act fairly, particularly when negotiations reach an advanced stage and if one party then breaks off negotiations without a legitimate reason, the court will awarded the innocent party damages.\textsuperscript{85}

\textsuperscript{79} Pau 14.1.69, D 1969.716.
\textsuperscript{80} Otherwise there would be grave interference with freedom of contract and the security of commercial transactions; reported in Nicholas, supra note 61, at p. 68 et seq.
\textsuperscript{82} Ibid.
\textsuperscript{83} Such expectation is also in the heart of the contract particularly where we deal with long-term contracts; ibid.
\textsuperscript{84} Giliker, Paula,”Pre-contractual Liability in English and French Law, Kluver, 2002, at p. 45.
\textsuperscript{85} See e.g. Cass Com. JCP 1973, 1972; Cass com. 7.1. et, D 1998.45.
In French case law a vendor is free to conduct parallel negotiations with other parties. For example:

“In 1988, the French Company Gallay decided to hive off its renovation division and entered into negotiations with a Belgium firm Alvat. The directors of the companies met a number of times in order to give concrete for that project and various documents were exchanged during the course of negotiations. Sometime afterwards Alvat learned that Gally was conducting parallel negotiations with the British company Blogden. The Belgium Company thereupon broke off negotiations and sued French one, seeking an order for specific performance of the transfer, which it regarded as having already been constituted and claiming damages on a joint and several basis from the French company and the British company. Alvat claim failed. Gallay actually issued a widespread note headed “search for a partner” and hence this establishes the open character of negotiations.”

However, it is contrary to good faith actually to lead the other arty to believe that he is negotiating exclusively. Yet in a very know Italian case Cass it. No. 199, 1972 was for example decided that it is contrary to good faith for a party to conduct pararell negotiations and after you have decided to sign a contract with one party still negotiating with other, with no intention to conclude a contract with him.

In Cass Com JCP 1973.II-17543 (the so called “The Hydrotile machine” case) a delictual liability for pre-contractual bad faith was imposed imposed where a party intentionally keeps another in a state of protracted uncertainty and then breaks off advanced negotiations without legitimate reason, knowing that the other has incurred considerable expense. In Cass. Civ. 3e, III.491. 1972 (the so called Monoprix case) was decided that liability for pre-contractual bad faith does not require negotiations to have been broken off with an intention to cause harm to the other party.

It is evident from the previous, somewhat short legal survey that the French law of obligations regarding the question of the unilateral cancellation of negotiations generally corresponds with the provided efficient institution and imposes liability precisely in those situations where our analysis recommended to do so. However, our discussion on irredeemable acts actually points to the “intention” requirement, which is missing in the last “Monoprix” case. Moreover, the previous economic discussion shows clear path for the efficiency minded legislator towards statutory change/improvement.

86 RTD 753, 1992.
3.2. German law

The German origin of the possibility of pre-contractual liability for *culpa in contrahendo* is to be found in famous von Ihering’s article published in 1861\(^{87}\) and it took courts to develop that doctrine into a general ground of liability by establishing liability for negligence during contractual negotiations, even if no contract is ever concluded between the parties.\(^{88}\) Initially the doctrine was concerned to provide a remedy for party’s reliance interest in cases where parties did not conclude a contract or although such a contract was concluded it was afterwards void due to an error for which the other party was responsible.\(^{89}\) Von Ihering saw the German law of his day seriously defective in not paying sufficient attention to the needs of commerce and that the law can ill afford to deny the innocent party recovery altogether and has to provide for the restoration of this “status quo” by giving the injured party his “negative interest” or reliance damages.\(^{90}\) The careless promisor has only himself to blame when he has created for the other party the false appearance of binding obligation and this is also the meaning of *culpa in contrahendo*.\(^{91}\) Although the framers of the German civil code were not ready to adopt this doctrine\(^{92}\) the subsequent case law began to treat the isolated provisions of the code as instances of a general scheme of pre-contractual liability.\(^{93}\) The concept became anchored in the great principle of good faith and fair dealing,\(^{94}\) which permeates the whole law of contracts and once parties enter into negotiations for a contract a relationship of trust and confidence comes into existence, irrespective of whether they succeed or fail. This doctrine today serves as a general doctrine which allows courts to

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\(^{87}\) Von Ihering, “Culpa in contrahendo oder Schadensersatz bei nichtigen oder nicht zur Perfection gelangten Vetragen,” Jher Jb 4, 1-112, 1861.


\(^{90}\) Von Ihering, supra note 85.

\(^{91}\) Ibid.

\(^{92}\) In some parts of the code the impact can be clearly seen, since the civil code drastically modified the will theory of contracts so as to protect injurious reliance; Kessler, Friedrich and Edith Fine, “Culpa in Contrahendo. Bargaining in Good Faith, and Freedom of Contract: A Comparative Study,” 77 Harvard Law Review 3, 1964, pp. 401-449.

\(^{93}\) Ibid.

\(^{94}\) The contractual obligations according to German law are subject to the standard of good faith that has been read by the doctrine and courts into a seemingly marginal provision of Art. 242. BGB; Musy, M. Alberto, “The Good Faith Principle in Contract Law and the Precontractual Duty to Disclose: Comparative Analysis of new Differences in Legal Cultures, 1 Global Jurist Advances 1, 2001.
shift pure economic loss suffered by the plaintiff due to the negligence of the defendant during negotiations for a contract which never came to existence.\textsuperscript{95} Thus, as commentators argue, the mere opening of negotiations intended to lead to a contract creates a special relationship between the parties by virtue of the law rather than by agreement between parties.\textsuperscript{96} According to commentators \textit{culpa in contrahendo} serves three different function in the German law of contracts: a) it overcomes certain flaws in the German law of delictual liability by applying contractual rules on vicarious liability; b) it establishes liability in cases where one party has negligently led another party to incur expenses in the hope of a contract which eventually falls through or is void;\textsuperscript{97} c) introduced the duties of disclosure imposed on negotiating parties in the interest of fair dealing and the security of transactions;\textsuperscript{98} and d) occasionally serves to establish liability for negligence during contractual negotiations in situations where a contract has been actually concluded, but where the usual remedies have been inefficient.\textsuperscript{99}

The first category was historically created in famous Linoleumfall\textsuperscript{100} decision where Reichgericht accepted that “a legal relationship came into existence between parties in preparation for a purchase and that had a character similar to a contract producing legal obligations in so far as both seller and prospective buyer came under a duty to observe the necessary care for the health and property of the other party in displaying and inspecting the goods.\textsuperscript{101}

The second category is to allow a party to recover for reliance loss even if there is no contract in the first place.\textsuperscript{102} The essence of such cases is, according to commentators, not reliance of a party on a future contract, but rather the conviction of at least one of the

\textsuperscript{95} Ibid.
\textsuperscript{96} This relationship then imposes on both parties special duties of care where any violation of such duties can entail liability towards the other party; Ibid. See also Youngs, Raymond, “Source Book on German Law,” 2\textsuperscript{nd} ed., Cavendish Publishing, 2002.
\textsuperscript{97} A party is liable for negligently creating the expectation that a contract would be forthcoming although he knows or should know that the expectation cannot be realized; RGZ 219, 143, 1934.
\textsuperscript{98} Each party is bound to disclose such matters as are clearly of importance for the other party’s decision, provided that the latter is unable to procure the information himself and the non-disclosing party is aware of the fact; J.W. 743, 1912.
\textsuperscript{99} Markesinis et al. supra note 103.
\textsuperscript{100} Where a sales assistant in the defendant’s department store negligently had caused two rolls of linoleum to fall over and knock down a customer and her child; RGZ, 87, 239, 1911.
\textsuperscript{101} And allowing recovery for personal injury; Ibid. See also BGHZ 66, 51, 1976.
\textsuperscript{102} Doctrine developed from situations where both parties intended to enter into a contract, but where by the fault of one of the parties, eventually no valid contract was concluded; Markesinis et al., supra note 103, at p. 66.
parties that a valid contract has come about. Moreover, German courts even reached a point where there is no difference anymore between the amount of reliance damages and the expectation interest.

The third category applies in the cases where for example the owner of a house negotiating for its sale has made arrangements for inspection with a prospective buyer and then he fails to give notice that he has already sold the house to a third party and the prospective buyer makes a trip in vain. Consider also that a seller of a house “negligently” fails to notify the buyer that the housing authority is planning to take over the rental of the house making it impossible for the buyer to move in – the doctrine applies again. A party negligently discharging his duty to inform by giving erroneous information is equally liable. In all these circumstances *culpa in contrahendo* is invoked and the blameworthy party is held liable for the resulting injury. The victim is to be restored to the position he would have occupied had there been no violation of the duty to disclose (reliance interest). The usual remedy is reliance interest and the expectation interest can only be recovered if it can be shown that without *culpa in contrahendo* the contract would have been concluded on the terms anticipated by the innocent party.

Furth, *culpa in contrahendo* is under German law of contracts also employed as a general ground of liability that allows a party to recover for reliance damages suffered when the other party breaks off negotiations, even before parties believe that they have

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103 As an illustration one should consider a case decided in 1920 where the offeror was a person who engaged in private business dealings during his working hours as an employee in the firm of another. The offeree did not succeed in communicating the acceptance in time, because the telephone operator in the firm where the offeror worked could not trace him in time. On these facts the court held that the offer had lapsed. But, it also held that the offeror was liable in reliance damages on the basis of *culpa in contrahendo*. However, since the offeree could have avoided these consequences by exercising ordinary care, the rule governing contributory negligence has been applied. The offeree was therefore entitled to half the amount of damages; RGZ 97, 336, 339, 1920.

104 For example, consider the case where negligent misstatement of the seller of an industrial enterprise had caused the buyer to enter into a contract which he would not have made had he known the decisive facts. Yet, the buyer wanted to maintain this contract and the Court ruled that the seller had to compensate him for his loss which was the amount he had paid in excess of the true value of the enterprise; BGHZ 69, 53, 1977.

105 See e.g. Reichgericht, J.W. 743, 41, 1912.

106 See e.g. Reichgericht, 1377, 1931.

107 RGZ 58, 1918.

108 Kessler and Fine, supra note 90.

109 Ibid.
agreed on the terms. However, as commentators point out, such general statements that once the parties have entered into negotiations, neither can break off unilaterally without compensating the other for his reliance damages must be received with utmost caution. For example, a party who negligently nourishes in the other party the hope that a contract will come about must make compensation for any outlay which the opposite party could have regarded as necessary under circumstances. Hence, negligence in beginning of negotiations might lead to liability.

The position of German law can be hence summarized in the following general terms that the mere opening of negotiations intended to lead to a contract imposes upon duties of care upon the parties and gives rise to a special relationship. The latest reform of BGB in 2002, however, incorporated the doctrine of *culpa in contrahendo* into the text of the BGB and the doctrine itself is now embodied in the Article 311 II BGB.

Moreover, case law shows that once a party has induced or encouraged in another party a confident expectation that a contract will be concluded, the breaking off of negotiations without good reason will give rise to liability to compensate the other for damage suffered as a result of his reliance on the expectation (BGH, BGH 1840, 1970). In the so called “Oolitic stones” case (BGH, NJW 1993.50), a party is entitled to compensation in the measure of the positive interest if he can establish that, had the correct tendering procedure been followed, he would certainly have been awarded the contract.

The analysis of German case law, doctrine and the provisions of the BGB shows that German law corresponds entirely to our recommendation. Moreover, von Ihering’s introduction of his concept of “*culpa in contrahendo*” clearly establishes him as one of the first continental law and economics scholars.

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110 Markesinis et al., supra note 103.
112 Bundesgerichshof decided that there is a duty to bargain in good faith and that the reliance damages must be paid by a party who in the course of negotiations has made the other party believe that a contract will certainly be concluded, but then without good reason or from ulterior motives refuses to go ahead; BGZ, NJW 1970, 1840. See also BGZ, NJW 1975, 1774; BGZ JZ 1991, 199, 202.
113 For example in RGZ 143, 219, 1934 case where a party entered into negotiations while knowing that he would not be able to comply with conditions put by the other party for concluding a new contract and thus provoked unnecessary expense for the other party has been held liable.
3.3. English Law

The legal principle of promissory estoppel is one of the most extensively debated question in the English law of contracts and is essence means preventing or estopping a person from going back on his word or repudiating his previous conduct when someone else has relied upon it. English law, as his French and German counterparts, recognise that someone cannot change his mind unilaterally in commercial dealings whenever he pleases, but here the application of this elementary rule is complicated further by the requirement of consideration.\(^{115}\)

English law on the doctrinal level does not recognize a general principle of pre-contractual liability and there is no general principle in English law that a negotiating party can be made to fulfil or otherwise compensate the other’s party disappointed expectations, even where he has caused those expectations and knows of the other party’s reliance.\(^{116}\) However, there are some other forms of redresses – e.g. misrepresentation. Under the English doctrine of promissory estoppel a person who makes a precise and unambiguous representation of fact may be prevented from denying the truth of the statement if the person to whom it was made was intended to act on it, and did act on it to his detriment.\(^{117}\) The principle of promissory estoppel has been in English law actually conceptualized some 50 years after previously mentioned German, revolutionary von Ihering’s insight on culpa in contrahendo, in the famous Central London Property Trust v. High Trees House\(^ {118}\) case, which, due to the fundamental question on the claimed

\(^{115}\) Concept, ideas and underlying principles may be found in the law of contracts, although under different names and employing different language of description.

\(^{116}\) See for example Lord Ackner’s statement in Walford v. Miles (1992, 2 AC 128 at 138): “the concept of duty to carry on negotiations in good faith is inherently repugnant to the adversarial position of the parties when involved in negotiations. Each party to the negotiations is entitled to pursue his (or her) own interest, so long as he avoids making misrepresentations. To advance that interest he must be entitled, if he thinks it appropriate, to threaten to withdraw in fact in the hope that the opposite party may seek to reopen the negotiations by offering him improved terms.”


\(^{118}\) Facts of the case are as following: landlord leased certain property in London to tenants before the WWII. Before the war some of the tenants left the property and to help to keep it the landlord reduced the rent for the remaining tenants. After the war the landlord wished to restore the rent to its previous level, and also claim arrears of rent (the amount lost by reduction); 1 KB 130 1947.
arrears, became one of the most important cases in English contract law.\footnote{Whincup, H. Michael, “Contract law and Practice: The English system and Continental Comparisons,” 4th ed., Kluwer, 2001.} The landlord in this particular case actually unilaterally reduced the rent and encouraged the tenants to stay and adjust their incomes accordingly, but then he went back on his word and demanded (unilaterally, after the war ended) arrears to cover his previously lost rents. Since tenants gave no consideration for that previous reduction (during WWII) and since there was then no bargain\footnote{“The landlord did not say: “I will reduce the rent if in return you will promise to stay here for the duration of the war.” The tenants then did not give or do and, were not required to give or do, anything in return. They were actually free to stay or go as they pleased, though naturally those who stayed relied on the landlord’s assurance; ibid, at p. 83.} it should have followed (from at that time valid English contract law) that the landlord’s promise to reduce the rent was unenforceable (no contract was ever concluded) and hence tenant’s reliance upon such a promise would be an irrelevant one. The case came before Lord Denning and he then, with all due reference and deference to precedent invented the doctrine of “equitable” or “promissory” estoppel. Lord Denning actually extended the existing common rule on representation of facts to make it cover promises as to future conduct (landlords’ promise to reduce the rent)\footnote{Ibid. See also Markesinis et al., supra note 107.} and stated: “If a person by words or conduct makes a promise or representation which he intends another person to act upon, and that other person does act upon it as intended, then the promisor or representor cannot deny his promise or representation if it would be unfair to do so. The landlord intended the tenants to believe him and to stay in the property; they did believe him and stayed; he could not than renounce his promise – at least as regards the tenant’s past reliance upon it. He might be free to restore or change the terms of their relationship for future.”\footnote{Ibid.} In the following \textit{Combe v. Combe}\footnote{Facts of the case are as following: a husband promised to pay his wife maintenance when they separated, but then broke his promise and, of course, some years later she sued for the arrears; 1951.} case Lord Denning again rejected the claim for breach of contract\footnote{Because she had given no consideration for her husband’s promise and hence no contract has ever been established. It had not been given in return for any action of forbearance on her part. She argued in front of the court that since she has relied upon the promise by not seeking a court order against her husbands, as he must have intended, he was therefore estopped under the previous High Trees principle from denying his promise; ibid.} and reaffirmed the basic rule that a plaintiff could only enforce a

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promise if he or she had given consideration for it. In his words an estoppel is a “shield but not a sword” and hence estoppel by itself cannot give rise to cause an action (a right to sue) but merely a right to defence where promise could not sue on an estoppel, but could stop himself from being sued. Estoppel in English law cannot apply to statements made under duress or deception by the other side. However, the rule that estoppel is only “a shield and not a sword” has already been widely criticized and in court held that if for example A leads B to believe that he has rights in or over A’s land, and B incurs expenditure in reliance on that assurance, B can sue to protect his interest even though he gave no consideration for it.

In court granted tortious relief for damages which plaintiff suffered in reasonable reliance on assertions by the defendants’ branch office that a loan agreement would go through without problems, while it was ultimately rejected by the head office. Such case would in German law, according to commentators, be a classic case of .

English law, hence, allows for recovery in many situations that German law would consider as belonging to . Damages will be awarded only if the defendant led the plaintiff to believe that the contract would certainly go through.

However, there are still some situations in which English law does not allow recovery, while German law will allow such a recovery based on . According to Markesinis for example, “the defendant has invited the plaintiff to come 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

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125 Ibid.
126 Ibid.
127 In , 1983, a bank mistakenly overstated the sum in a customer’s account. Afterwards the bank could not recover the amount overstated once the customer has reasonably supposed that the statement was correct and had spent the money; ibid. See also , 1990.
128 1975.
129 For example in , 1994, a niece who for many years was tenant of her uncle’s run-down property spent large sums of money renovating the property in the belief (reliance), even encouraged by her uncle, that he would bequeath it to her. He left it instead to someone else. The niece successfully claimed ownership of the property on the basis of proprietary estoppel; Whincup, supra note 95. See also , 2000; , 1999 and , 1997.
130 Markesinis et al, supra note 97.
131 See for example BGH MDR 1954, 346, 347; BGH WM 1984, 205.
gave the contract to a third party two weeks before. The doctrine of *culpa in contrahendo* in Germany allows the plaintiff to recover for his wasted outlay, because the defendant negligently failed to notify the plaintiff that he better cancel his trip. It is, however, difficult to see how English law could allow recovery in such a case as there is no misstatement, no contract and no enrichment.“

Moreover, some commentators still argue that the current formulation of the doctrine, especially in the light of recent Court of Appeal’s decision in *Collier v. P&MJ Wright Holdings Ltd.* is incoherent and that the most difficult problems with the doctrine of promissory estoppel actually lie with the doctrine of promissory estoppel itself and that should be actually seen as consisting of at least three distinct principles, none of which is the exclusive preserve of promissory estoppel.

The scope of promissory estoppel can now be according to Beatson et al. summarized in the following scope:

a) A clear promise: in the first place, the promise must be clear an unequivocal, although the need not be express and may be implied from words or conduct. No estoppel can arise if the language of the promise is indefinite or imprecise and silence and inaction for example the absence of protest about the breach will not normally estop a party from relying on the breach. If the language is clear, no questions arises of any particular knowledge.

b) Inequitable to go back on promise: It must be inequitable for the promisor to go back on the promise and insist on the strict legal rights under the contract. This will not be so where the promise has been induced by intimidation by the promise. “In the D&C Builders Ltd. V Rees case Mr. and Mrs. Rees owed 482

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132 Markesinis et al. at p. 71 et seq.
135 McFarlane, for example argues, that things have not improved since 1972, when Lord Hailsham observed that “the whole sequence of cases based upon promissory estoppel since the war…rise problems of coherent exposition which have never been systematically explored; in Woodhouse AC Israel Cocoa Ltd. SA v. Nigerian Produce Marketing Co. Ltd. (1972) AC 741, at p. 757, reported in McFarlane, Ben, “Promissory estoppel and debt,” in Burrows, Andrew and Edwin Peel (eds.), “Contract Formation and Parties – The Oxford-Norton Rose Law Colloquium,” Oxford University Press, 2010, p. 115 et seq.
pounds to D&C a small building company, in respect of work done for him. They
delayed payment for several months, and then offered D&C 300 pounds, stating
in effect that if it did not accept this sum it would get nothing. As D&C was in
desperate financial straits, it accepted the 300 pounds in full settlement of the
debt. It then sued for balance.” Lord Denning saw the case as turning on
promissory estoppel. He took the view that is was not equitable for D&C to go
back on his promise, the settlement was not truly voluntary as MR and Mrs Reeds
had improperly taken advantage of D&C’s weak financial situation. They have
been hence held liable for the balance.

c) Alteration of position: the promise must have altered his position in reliance on
the promise made. The person must act detrimentally in reliance upon the
representation. If the promise is revoked the promisee must be in in a worse
position that if the promise had never been made (for example Hughes v.

d) Suspensive or extinctive: Promissory estoppel only serves to suspend and not to
wholly to extinguish, the existing obligation; the promisor may, on giving due
notice, resume the right which have been vaived and revert to the original terms
of the contract (e.g. Tool Metal Manufacturing Co. Ltd v. Tungsten Electric Co.
Ltd. 1 WLR 761, 1955).

Hence, where one negotiating party gives false information to the other, by words or
conduct, then if he was fraudulent (not holding an honest belief in the truth of the
information) he is liable in the tort of deceit to compensate the other for the loss that he
suffered by relying on it.137 The party who is in a position to know the accuracy (least
cost information provider standard???) of the information may owe a duty to take
reasonable care to the other to whom he provides the information, and therefore be liable
in the tort of negligence if he failed to take care and the other party suffered loss in
reliance on it.138

137 Derry v. Peek, 14 App Cas 337, 1889.
However, other representations (e.g. assurances by one negotiating party that he will in due course go ahead with the contract) do not themselves give rise to liability unless they take a form of contractual promise (or in a quasi-contract).\textsuperscript{139} English law has not adopted the approach of the High Court of Australia, which has extended the doctrine of promissory estoppel to impose liability in damages on the party seeking to withdraw from negotiations.\textsuperscript{140}

In short, although English law does not recognize a general underlying principle of pre-contractual liability, nor a general rule that the one party must fulfil or otherwise compensate the expectations created in the other party during negotiations which do not come to fruition in a contemplated contract, there are a range of circumstances in which English courts have given some legal effect to such expectations through the law of contract (promissory estoppel, misrepresentation), tort and restitution.\textsuperscript{141}

Comparison with our economic recommendations show that on first sight English law deviated substantially, since the doctrine of promissory estoppel is not very useful (it requires that promisor intended his promise to be binding). But the analysis of cases actually shows that English law for the cases of pre-contractual liabilities actually invokes tort of fraudulent or negligent misrepresentation. To sum up, through the doctrine of promissory estoppel, by limiting possible abuses of strict contractual rights, English contract law draw slowly towards its Continental counterparts. However, the English stand of not imposing liability in damages towards parties seeking withdraw from negotiations should be approached with criticism and the decision of the High Court of Australia\textsuperscript{142} should be seen as an efficiency maximizing one. Moreover, the previous economic discussion shows also for English law a clear path for the efficiency minded legislator towards statutory change/improvement.

3.4. Chinese law

\textsuperscript{139} In William Lacey Ltd. V. Davis (2 All ER 712, 1957) Justice Barry J held that a builder could recover for work done after he had been told that his tender was the lowest and that he could expect to receive the contract (yet, the claim was not in contract but implied or quasi-contract).

\textsuperscript{140} Waltons Stores Ltd. V Maher, 164 CLR 387, 1988.


\textsuperscript{142} 1988, 164 CLR 387.
A general principle under Chinese contract law is that parties are free to negotiate a contract and to decide whether to enter/exit negotiations. It is also accepted that good faith and fair dealing are governing in the contractual landscape and in effect limit the individual freedom. Pre-contractual liability under Chinese contract law hence requires the parties to negotiate in accordance with standards of good faith and fair dealing.\textsuperscript{143} Pre-contractual liability in Chinese contract law enables imposing sanctions on the party, which violated principles of good faith and fair dealing and caused the other party to suffer damages during their negotiation process.\textsuperscript{144} Moreover, the old Article 61 of The General Principles of the Civil Law of the People’s Republic of China (GPCL) provided that the party who is at fault shall compensate for the other’s loss if the legal act was null or void. Furthermore, modern Contract Law of People’s Republic of China (CLC) contains four provisions for four different circumstances under which contractual parties can be held liable in the pre-contractual stage. Those for conditions are a) negotiating in bad faith under the pretext of concluding a contract; b) deliberately concealing important fact relating to the conclusion of the contract or deliberately providing false information; c) disclosing or inappropriately exploiting business secrets; and d) other possible activities that might violate the principle of good faith.

First, is governed by Article 42 (1) of CLC which provides that if a party negotiates in bad faith under the pretext of concluding a contract, then it shall be liable for compensation.\textsuperscript{145} Commentators argue that the essence of this provision is the concept of bad faith that should include two elements: a) a party did not have any intention to conclude agreement at all; and b) a party entered into negotiation with a purpose of causing damages to the other party.\textsuperscript{146} However, Chinese scholars distinguish such instances from the situation where one party enters into negotiations lacking knowledge of the market and if this party afterwards becomes more knowledgeable (e.g. about

\textsuperscript{143} Article 6 (Good Faith) of the Contract Law of People’s Republic of China provides: The parties shall abide by the principle of good faith in exercising their rights and performing their obligations.

\textsuperscript{144} As Fu reports, already the Article 11 of the “Law of Economic Contracts Involving Foreign Interest” from 1985 introduced liability for the losses suffered by the other party due to her responsibility for the invalidation of contracts; Fu Junwei, “Modern European and Chinese Contract Law: A Comparative Study of Party Autonomy,” Kluwer, 2011, p.89 et seq.

\textsuperscript{145} Wang, Liming, “He tong fa yan jiu,” Vol. 2., People’s University Publisher, 2002, p. 25 et seq.

\textsuperscript{146} Fu, supra note 109, at p. 90.
market conditions, changes in the company) and consequently decides to break-off negotiations then she is not held liable for negotiating in bad faith.\textsuperscript{147}

Second, is governed by Article 42 (2) CLC which recognizes the duty of disclosure in the negotiation stages, where parties have to disclose adequate information to the others to ascertain their determination of whether to enter into a contract or continue their negotiations.\textsuperscript{148} Commentators argue that under the separate doctrine of fraud, concealing information deliberately or providing false information could make contract void.\textsuperscript{149} However, according to Zhang this liability for fraudulent behaviour is different from the pre-contractual liability in the following three important features: a) time – i.e. the pre-contractual liability is applicable only to the period before the conclusion of a contract where contract is not existing yet, whereas the liability for fraud can only be held after the conclusions of the contract; b) foundation – i.e. the liability for pre-contractual stage is based upon general notion of good faith, whereas fraud is based upon a contract; and finally c) effect – i.e. for contractual liability, the effect is to compensate for the losses whereas fraud results in void or adapted contract.\textsuperscript{150}

Third, is provided in Article 43 CLC which, while recognizing the obligation of keeping business secrets during the negotiation stage states that no matter if the contract was concluded or not, the business secrets received by the party during the negotiations of contracts cannot be disclosed or improperly used.\textsuperscript{151}

Fourth, Article 42 (3) of CLC actually broadens/expands the scope and content of pre-contractual liabilities. Namely, as Fu argues, it provides that any other activity violating the principle of good faith in the course of negotiations can be deemed as violating the pre-contractual duties.\textsuperscript{152} However, Wang narrows that scope and argues that it includes merely the following situations: a) obligation not to withdraw an offer without a due reason; b) obligation to inform; c) obligation to operate and to assist; d)

\textsuperscript{147} Ibid.
\textsuperscript{148} The information that has to be disclosed is any material information that might be relevant for the conclusion of a contract. Non-disclosure represents ground for liability compensation; ibid.
\textsuperscript{149} Ibid.
\textsuperscript{150} Zhang, Mo, “Chinese Contract Law Theory and Practice,” Martinus Nijhoff, 2006, at p. 28. See also Fu, ibid.
\textsuperscript{151} Business secrets are defined as technical information or business information which is unknown to the public, and which could bring economic benefits to the entitled person, have practical utility and owners of such secrets took some steps to keep it secret; ibid.
\textsuperscript{152} Ibid.
obligation to be faithful; e) obligation to keep secret; and f) obligation not to abuse the freedom of the contract.\(^{153}\)

Hence, CLC provides three grounds for the application of pre-contractual liability: a) violation of good faith – negotiations must be in bad faith;\(^{154}\) b) subjective fault;\(^{155}\) and c) loss of reliance interest.\(^{156}\) If then a party is held liable, the other party can under Chinese Contract law opt either to sue upon contractual liability or upon tort liability.\(^{157}\) In this respect CLC also states that the party with failure to comply with pre-contractual obligations should compensate (pay) for the loss.\(^{158}\) Yet, it should be noted that CLC actually does not specify what kind of losses one shall be obligated to reimburse.\(^{159}\) Ling, for example, argues that the injured party may claim damages for the reliance on the contract being concluded – this includes actual expenditures incurred in the negotiation and preparation of performance and lost opportunities of alternative contracts with other potential persons.\(^{160}\)

Obviously also provision of Chinese contract law corresponds fairly with our economic recommendations (this should not come as a surprise since their code is almost a literal translation of German one). However, the more intriguing insights will be revealed with forthcoming case law analysis.

4. Conclusion

This article summarises and synthesises the economic principles concerning the termination of negotiations and compared them with related provisions in English, French and Chinese law. Economic analysis shows that the related provisions of French, German and English contract law regulating the cancelling off negotiations are tolerably close to the efficiency-based recommendations. However, the assessment of available Chinese

\(^{153}\) Wang, supra note 110, at p. 312 et seq.

\(^{154}\) Good faith is defined as a behaviour requirement – a behaviour that is expected from a reasonable person on the basis of moral, social and commercial standards in the society; ibid.

\(^{155}\) In order to claim the pre-contractual liability it has to be presented that party acted either intentionally or negligently in breaching the duty; Ling Bing, “Contract Law in China,” Sweet & Maxwell, 2002, at p. 36.

\(^{156}\) The aggrieved party has to show it suffered losses due to the defaulting parties breach of interest; ibid.


\(^{158}\) Ibid.

\(^{159}\) Ibid.

contract law reveals several deficiencies. This article also offers an elaborated comparative analysis of the pre-contractual duties of good faith and provides a comparative law and economics assessment of related English, French, German and Chinese law of contracts. It seeks to examine just one of the many non-contractual doctrines by which a promise, or manifestation of consent in pre-contractual stage might have (or does have) a legal effect – the culpa in contrahendo or promissory estoppel as defined/known in common law systems. The comparative law and economics analysis shows that assessed legal doctrines are still very incoherent and that the most difficult problems with the legal doctrines of promissory estoppel and culpa in contrahendo are actually imbedded in the doctrines of promissory estoppel/culpa in contrahendo themselves and that should be actually seen as consisting of at least four distinct principles, none of which is the exclusive domain of those two doctrines.

Namely, provided law and economics investigation suggests that the pre-contractual duty of good faith is a special, unique legal institution that, while pursuing the wealth of nations, addresses multiple set of possible sources of inefficiency (which may retard the efficient allocation of resources) simultaneously. It is a legal multi-tasking agent and should be, analytically speaking, actually seen as: a) a transaction costs minimizing institution which boosts, spurs allocative efficiency; b) as a powerful deterrence mechanism that minimizes opportunism and moral hazard (i.e. behaviour which represent a pure waste of resources); c) as a mechanism that fosters efficient generation, utilization and disclosure of information; e) as a mechanism that induces efficient level of pre-contractual reliance and shifts the risks of failed negotiations upon the superior risk bearer (i.e. incentive to enter and efficiently invest into the value maximizing exchanges); and d) as a mechanism that addresses the problems faced by legal systems in delineating between irredeemable acts and potentially inefficient acts (with all 3 sub-categories).

5. Bibliography


Kovac & Zhou – pre-contractual good faith and irredeemable acts


Kovac & Zhou – *pre-contractual good faith and irredeemable acts*


