

AN ANALYSIS OF THE DUTY TO NEGOTIATE IN GOOD FAITH:  
PRECONTRACTUAL LIABILITY & PRELIMINARY AGREEMENTS

by

AARTI ARUNACHALAM

(Under the direction of Prof. James Smith)

ABSTRACT

Good faith is one concept that defies a clear definition and courts have struggled to understand and establish its scope and ambit. This paper just seeks to analyze the scope of the duty of good faith as understood at the stage when actually no contract has been formed. Despite considerable support for the existence of a duty of good faith, courts in US have not been very receptive in recognizing the duty of good faith especially in the precontractual stage, especially when parties enter into preliminary agreement. Courts have relied on the a number of factors to determine the enforceability of such preliminary agreement. However it has been argued in this paper that Courts should do away with this fact specific inquiry and adopt a bright line rule. This would help promote uniformity and predictability in judicial decisions and also clarify the scope of duty of good faith.

INDEX TERMS: Good Faith, Precontractual Stage, Preliminary Agreements, Intent To Be Bound, Predictability, and Bright Line Rule.

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## DEDICATION

This is dedicated to my husband and best friend Arun, for his love, encouragement, support and sacrifices. Thank you for being there and tolerating me as I worked on this thesis. I could not have done it without you!

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## **I. Concept of Good Faith – An Introduction**

Blacks Law dictionary defines good faith in the following words: “It is an intangible and abstract quality with no technical meaning or statutory definition and it encompasses a number of concepts; honest belief, the absence of malice, and absence of design to defraud or to seek an unconscionable advantage<sup>1</sup>, reasonableness or fair conduct,<sup>2</sup> reasonable standards of fair dealing,<sup>3</sup> decency as well as fairness and reasonableness,<sup>4</sup> and honesty of intention.”<sup>5</sup> In common usage it is ordinarily used to describe the state of mind denoting honesty of purpose and as requiring fairness and community standards of fairness, decency and reasonableness<sup>6</sup> or in other words being faithful to one’s duty and obligation.<sup>7</sup> However, there is no uniformly recognized definition of the duty of good faith and fair dealing. It remains as the Blacks Law dictionary lays down an “intangible and abstract quality”.

This doctrine is pervasive of all commercial transaction, yet Courts continue to disagree about this duty- its application, its ambit and remedies for failing to fulfill this duty. This doctrine of good faith has been hard to define and there is no precise definition. There are those who stipulate that a vague definition of definition of good

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<sup>1</sup>Doyle v. Gordon, 158 N.Y. S 2d. 248, 259, 260 N.Y. SUP. (1954)

<sup>2</sup> Eric. M Holmes, *A Contextual Study of Commercial Good Faith: Good Faith Disclosures In Contract Formation*, 39 U. PITT. L. REV. 381, 452 (1978).

<sup>3</sup> C FRIED, *CONTRACT AS PROMISE* 83 (1981).

<sup>4</sup>E. Allan Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the UCC*, 30 CHI. L. REV 666,670 (1963).

<sup>5</sup> BRYAN A. GARNIER, *BLACK’S LAW DICTIONARY*, Seventh Edition, 701(1999).

<sup>6</sup> Richard Thigpen, *Good Faith Performance Under Percentage Leases*, 51 MISS. L. J. 315, 320 (1981).

faith helps apply that doctrine on a case-by-case basis. However, this lack of clear-cut definitions has caused a number of problems in the application of this duty especially in the precontractual stage and this is the focus of this paper.

This following paper is an attempt to understand the concept of Good faith with particular reference to contractual negotiations. This paper is divided into 7 parts – I to VII and this is an overview of the paper. Part I will present a brief general introduction to the notion of good faith and the history of this doctrine and its development in various ages starting from its inception in the roman era till the present day. This part will also touch upon good faith obligations as discussed under the Uniform Commercial Code and the RESTATEMENT of Contracts.

Part II will discuss the concept of good faith with specific allusion to contract negotiations. This part will attempt to draw attention to the fact that rules of contract law especially good faith does not encompass the precontractual stage in contract formation and its effect on negotiations. Part III will then elaborate on the concept of wrongful formation of contracts and focus on tracing the traditional law with regard to good faith requirement in contractual negotiations and the significant litigation that has been concerned with the prerequisite of good faith during negotiations before the culmination of the final agreement.

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<sup>7</sup> Universal Underwriters Ins. Co. v. Aetna Ins. Co. of Hartford Conn., 249 Cal.App.2d 144, 57 Cal.Rptr. 240 ,245,251(1967).

Part IV will present the analysis of the different kinds of preliminary agreements and the scope of good faith under each of them. Part V will then attempt to understand the obligation of good faith under the Civil Law systems with specific reference to Germany, which was one of the first countries to recognize this doctrine. Part VI will provide an international perception to this doctrine of good faith and its inclusion under certain international conventions and how the international conventions have failed to accord this doctrine a place in the convention and the consequences of the exclusion. Part VII will be the conclusion that is an attempt to advocate a bright line rule to do away with the uncertainties and inconsistencies.

#### **a) History and Development of Good faith**

In order to understand the concept of good faith, it is imperative to grasp the history of the doctrine of good faith and the development of this doctrine under various legal systems to appreciate and understand its present day application.

**Roman law:** Credit has to be given to Roman law for recognizing the essence of the duty of good faith almost two thousand years ago. The Romans acknowledged that a promise could give rise to a duty. It was understood that a duty involved a mutual right that could be enforced under some circumstances.<sup>8</sup> This understanding of the Romans that promises can create duties, gave rise to what we now term promissory liability.<sup>9</sup>

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<sup>8</sup> Robert H. Jerry, *The Wrong Side Of The Mountain: A Comment On Bad Faith's Unnatural History*, 72 TEX. L. REV. 1317, 1319 (1994).

<sup>9</sup> *Id.* Promissory liability is a liability that arises as a result of a promise.

The whole body of Roman law was concisely and comprehensively condensed in a four-book manual, partly historical and partly theoretical by the Institutes of Justinian and Gaius, and most of the present day understanding of Roman law is derived from this source. All promises, under Roman law, to be enforceable had to fall under a specific narrow criterion to qualify for enforcement.<sup>10</sup> This above-mentioned manual divided the Roman law of promissory liability into four categories, one of which was known as "consensual contracts" (*consensu contrahitur obligatio*).<sup>11</sup> The classical *ius civile*<sup>12</sup> (common law or a body of law not governed by statute) recognized four kinds of consensual contracts: sale (*emptio venditio*), hire (*locatio conductio*), partnership (*societas*), and mandate (*mandatum*).<sup>13</sup> The scopes of consensual contracts were extremely wide and they were the only categories that were recognized and enforced.<sup>14</sup>

The promissory obligation in these contracts was "flexibly defined by reference to good faith,"<sup>15</sup> and this enabled the judges to take into consideration the facts of each case and exercise his discretion to decide the matter. It was during this period that one saw the inclusion of the clause 'ex fide bona', which provided an independent source of obligation on which a judgment for breach of contract could be founded.<sup>16</sup> However, when times changed, the purpose of this clause also changed, nevertheless the clause still

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<sup>10</sup> Robert H. Jerry, *supra* note 7, at 1320 Fn11 citing W.W. BUCKLAND & ARNOLD D. MCNAIR, *Roman Law & Common Law: A Comparison In Outline* 195, 193-96 (2d Ed. 1952).

<sup>11</sup> *Id.* at 1320.

<sup>12</sup> W.W. BUCKLAND, *The MAIN INSTITUTIONS of ROMAN PRIVATE LAW* 14 (1931).

<sup>13</sup> FRITZ SCHULTZ, *CLASSICAL ROMAN LAW* 524-525 (1951).

<sup>14</sup> Robert H. Jerry, *supra* note 7, at 1320.

<sup>15</sup> SCHULTZ, *supra* note 12, at 525.

<sup>16</sup> SCHULTZ *supra* note 12, at 525.

served to provide a standard by which each of the contracting parties' performances would be measured.<sup>17</sup>

After the decline of the Roman Empire the notions of good faith faded and it was not until the twelfth century that interest in Roman law was revived and this interest helped influence the law that was developing in England at that time.<sup>18</sup> “During the intervening centuries, the primitive law of promise contained hints of the moralistic good faith standard that the classical Romans had used to measure performance under consensual contracts.”<sup>19</sup>

**Canon Law:** After the Roman Empire collapsed there was a void and in order to fill up the void left behind by the Roman law, a new body of law began to develop – canon law under the aegis of the Christian church.<sup>20</sup> The Church, in the tenth and eleventh century, recognized some ceremonies whereby the debtor would pledge their faith to fulfill his promise.<sup>21</sup> A person's promise would be treated as being important only because that person had promised to fulfill his promise in good faith and that in case he fails to do so he would be giving up his honor or the possibility of achieving salvation.<sup>22</sup> Under the canon law, the behavior of contracting parties was measured against a number of principles one of which was good faith.<sup>23</sup> In Holdsworth's view, canon law "put into legal form the religious and moral ideas which, at this period, colored the economic thought of

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<sup>17</sup> *Id* at 35.

<sup>18</sup> FREDERICK POLLOCK & FREDERIC W. MAITLAND, THE HISTORY OF ENGLISH LAW BEFORE THE TIME OF EDWARD I at 1 (reprint 1923). Hereinafter POLLOCK & MAITLAND.

<sup>19</sup> POLLOCK & MAITLAND *supra* note 17, at 187-189.

<sup>20</sup> Robert H. Jerry, *supra* note 7, at 1324.

<sup>21</sup> POLLOCK & MAITLAND *supra* note 17, at 190.

<sup>22</sup> Robert H. Jerry, *supra* note 7, at 1324.

all the nations of Western Europe, and thus contributed to enforce those high standards of good faith and fair dealing which are the very life of trade." <sup>24</sup> However, like the Roman law, even Canon law lost its significance with passage in time. Both these system stressed on the moral component of a promise and this focus on morality had some influence on early English law."<sup>25</sup>

**English Law:** The common law, in England, developed into a very formal system wherein all remedies that were available were governed by a number of writs.<sup>26</sup> However, these writs were found to be inadequate to provide the basis for a general theory of contract law, as we understand it today. Through a number of changes that began in the fourteenth century, the writ of *assumpsit*<sup>27</sup> was extended even to include those promises that did not involve a debt and became the means for the recognition of liability upon a promise under the English law.<sup>28</sup>

Professor Powell, an eminent jurist explained that though the laws provided for some remedies, it was found to be inadequate and the parties often addressed their petitions to the Kings alleging that one of the parties acted against good faith and conscience and sought that their opponents be forced to perform their contracts.<sup>29</sup> Such assertions in the

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<sup>23</sup> *Id.*

<sup>24</sup> 5 W.S HOLDSWORTH, A HISTORY OF ENGLISH LAW 80,81(2d. Ed., 1937).

<sup>25</sup> POLLOCK & MAITLAND *supra* note 17, at 197.

<sup>26</sup> POLLOCK & MAITLAND *supra* note 17, at 558-573. Writs were courts written order, in the name of the Crown or the State or other competent legal authority, commanding the addressee to do something or refrain from doing a specific act.

<sup>27</sup> A writ of *assumpsit* is a form of action in which a plaintiff alleges that the defendant contracted a debt and as a consideration for the same undertook to pay in other words an action for debt.

<sup>28</sup> Robert H. Jerry, *supra* note 7, at 1327 citing J.H BAKER & S.F.C MILSOM, SOURCES OF ENGLISH LEGAL HISTORY: PRIVATE LAW TO 1750, at 482-505 (1986).

<sup>29</sup> RAPHAEL POWELL, *Good Faith in Contracts*, 9 CURRENT LEGAL PROBS.16, 22 (1956).

petitions were used in the hope that it would attract the attentions of the Chancellor and he could then entertain the matter by emphasizing the duties of good faith and conscience-especially conscience.<sup>30</sup> “Most contract litigation took place in Chancery, and in and around 1770 it was ... the established tradition in Chancery that a contract must basically be fair; or perhaps, to be strictly accurate, that a grossly unfair contract was liable to be upset.”<sup>31</sup>

Some English scholars tried to explain the relationship between commercial transactions and morality, and these views were expanded upon by David Hume and Adam Smith who theorized that it was self interest that caused men to honor their promises and also that self interest served as the moral obligation to observe promises.<sup>32</sup> The nineteenth century saw a brief digression in the approach to the notions of good faith and fair dealing, however it did not last and the eighteenth century views of fairness and morality in commercial transaction survived and have been retained even the present day common law in England.<sup>33</sup>

**American Law:** The development of the doctrine of good faith was very sluggish and remained to a large extent fairly unrecognized and little known in America.” However it was the number of treatises written in the late nineteenth century in America help familiarize us with the understanding of this doctrine in America. Some of these treatises

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<sup>30</sup> *Id.*

<sup>31</sup> P.S. ATIYAH, THE RISE AND FALL OF FREEDOM OF CONTRACT 72-73 (1979). Hereinafter ATIYAH .

<sup>32</sup> Robert H. Jerry, *supra* note 7, at 1328 (citing DAVID HUME, A TREATISE ON HUMAN NATURE 479-80, BK III PT II (L.A. Selby-Bigge ed., Clarendon Press 1980); ADAM SMITH, LECTURES ON JURISPRUDENCE 538-39 (R.L Meek et al. eds. 1978).

<sup>33</sup> ATIYAH *Supra* note 30, at 479.

seemed to associate good faith only with unfairness or fraud. Examples: "If the contract was free from any fraud or bad faith, and was otherwise fair and reasonable, except that what the infant paid was in excess of the value of what he received, he can only recover such excess."<sup>34</sup> "Fraud as to material matter will vitiate, or render voidable any contract, for good faith is to this extent, at least, one of the essential elements of an agreement."<sup>35</sup> "In case a contract is susceptible of two constructions, the court will so construe it as to make it just and reasonable as between the parties, if that course can be taken without violating the evident intention of the parties, or infringing upon rules of law."<sup>36</sup> However, these are just some examples of the treatises of the time. Perhaps the most explicit recognition of the duty appears in the 1878 treatise 'Bishop on Contracts':

"When parties enter into a contract in terms, the law presumes each of them to be acting in good faith toward the other; and it binds each to the other, to whatever good faith requires. The implication may be derived from the words employed, from the acts of the parties viewed in connection with the thing contracted about, or from the nature of the transaction."<sup>37</sup>

This suggests that, though some scholars in the late nineteenth century were relegating good faith to the lack of bad faith, there were scholars like Bishop articulated a much more broad based approach to the doctrine of good faith.<sup>38</sup>

This doctrine of good faith helped clarify two kinds of situations. It helped to clear the perplexity if there was some kind of an ambiguity in the contracts in other words when

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<sup>34</sup> CHARLES F. BEACH, A TREATISE ON THE MODERN LAW OF CONTRACTS 1784-85 (Indianapolis & Kansas City, The Bowen-Merrill Co. 1896).

<sup>35</sup> I WILLIAMS F. ELLIOT, COMMENTARIES ON THE LAW OF CONTRACTS §70, at 98 (1913).

<sup>36</sup> LOUIS L. HAMMON, THE GENERAL PRINCIPLES OF THE LAW OF CONTRACT § 397, at 792 (1902).

<sup>37</sup> JOEL P BISHOP, BISHOP ON CONTRACTS § 106 AT 37-38 (St. Louis, F.H Thomas & Co. 1878).

<sup>38</sup>Robert H. Jerry, *supra* note 7, at 1331.



the terms of the contract were such that it seemed to favor one party over another or the terms put one party in a position whereby he could take advantage of the other party. The earliest cases to introduce explicitly a good faith requirement involved contractual conditions that a recipient of goods or services be satisfied with the quality of the other party's performance.<sup>39</sup> In such cases the recipient of the goods could claim dissatisfaction even if that were not the case, thereby gaining unjust advantage over the other party. In such cases, courts read into the contract an implied duty of good faith. These cases helped establish that, in all contracts, there was an inherent covenant of good faith even if the contract did not provide for it in express words.<sup>40</sup> Other early cases involved output or requirement contracts, in which the quantities of the goods to be delivered were left to vary with the output of the seller and the requirement of the buyer.<sup>41</sup> Under certain circumstances, the buyer or the seller felt an economic incentive to manipulate the requirements or the output respectively depending on the market to make a greater profit. The Courts<sup>42</sup> have frequently held such manipulations are examples of bad faith by implying to such contracts a covenant of good faith.<sup>43</sup> "Good faith limits the exercise of discretion in performance conferred on one party by the contract;" therefore, it is bad faith to use discretion "to recapture opportunities foregone on contracting," as determined by the other party's expectations or, in other words, to refuse "to pay the expected cost of performing."<sup>44</sup>

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<sup>39</sup> Doll v Noble 116 N.Y. 230; 22 N.E. 406,406 (1889).

<sup>40</sup> STEVEN J. BURTON & ERIC G. ANDERSON, CONTRACTUAL GOOD FAITH: PERFORMANCE, BREACH AND ENFORCEMENT 30 (1995)(hereinafter BURTON & ANDERSON.)

<sup>41</sup> *Id.*

<sup>42</sup>New York Cent. Ironworks Co v. US Radiator Co., 174 N.Y. 331, 334, 66 N.E. 967, 968 (1903).

<sup>43</sup>BURTON & ANDERSON ,*supra* note 39, 23-27.

<sup>44</sup> BURTON & ANDERSON, *supra* note 39 at 74,

This doctrine helped clarify another kind of situation; it helped salvage a contract that would have otherwise been held invalid. This can be best explained by the two decisions of the New York Court of Appeals, which generated a lot of attention and to a certain degree marked a change from the laissez-faire law<sup>45</sup> of the contracts as was archetypal of that time - *Wood v Lucy, Lady Duff Gordon*<sup>46</sup>, the facts of this case were as follows Lady Duff Gordon the defendant was a famous fashion designer and in an written instrument she promised to give the plaintiff Wood an exclusive agency to market her goods and bearing her endorsement. In exchange for that Wood, promised to pay one-half of the profits from this venture, render monthly accounts and secure intellectual property rights for her designs. The defendant breached this agreement and sold her designs to others. Wood filed an action for breach of contract. The defendant raised the defense that the promise was not supported by consideration and that the plaintiff was not required to do anything under the agreement. She claimed that the plaintiff's promise was illusory. In the famous opinion Judge Cardozo disagreed and explained that Wood impliedly promised to use reasonable efforts to market the defendants' designs and therefore there was consideration for the agreement. Cardozo asserted that when Wood accepted the agreement he assumed all the rights and duties under it. And it was contended by Cardozo that such agreements should be interpreted as having business efficacy.<sup>47</sup> The analysis used in this case was to find a promise from inferences as suggested by the facts of the case. A promise is implied in fact when the conduct of the parties reasonably indicates that promise has been made. In another famous case of *Kirke La Shelle Co. v*

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<sup>45</sup> Laissez faire- whenever possible the Courts would leave the parties free to reach whatever agreements they could. *See generally* Grant Gilmore, THE DEATH OF CONTRACTS (1974) for like discussion.

<sup>46</sup> 222 N.Y. 88, 118 N.E. 214 (1917).

<sup>47</sup> BURTON & ANDERSON, *supra* note 39, at 30.

*Paul Armstrong Co.*,<sup>48</sup> the New York Court of Appeals defined the scope of good faith performance obligation:

“In every contract there exists an implied covenant of good faith and fair dealing, that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract, which means that in every contract there exist an implied covenant of good faith and fair dealing”<sup>49</sup>

The facts of the said case were as follows: The plaintiff acquired a right to use a book written by the defendant as the basis of a play. However, before the play was produced, cinema or talking pictures were invented; the defendant then sold the rights to his book to make a movie without obtaining the approval of the plaintiff. The plaintiff filed an action claiming one-half of the net amount received from the sale. The Court held that the making of the movie would destroy the value of the right granted to the plaintiff to produce a play and the production of the movie would diminish the market for the play and this would reduce the amount of income the plaintiff would make from the play. These two cases, *Wood v Lucy, Lady Duff Gordon*<sup>50</sup> and *Kirke La Shelle Co. v Paul Armstrong Co.*,<sup>51</sup> are good examples of how the doctrine of good faith was used to save the contract, which would have otherwise been held to unenforceable.

Although a number of jurisdictions did not follow the *Kirke La Shelle* decision, the doctrine of good faith became more widely accepted after California Supreme Court elaborated on this doctrine in *Comunale v. Traders & General Insurance Co.*<sup>52</sup> and

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<sup>48</sup> 263 N.Y. 79, 188 N.E. 163 (1933).

<sup>49</sup> *Id* at 87, 167.

<sup>50</sup> 222 N.Y. 88, 118 N.E. 214 (1917).

<sup>51</sup> 263 N.Y. 79 188 N.E. 163 (1933).

<sup>52</sup> 328 P. 2d 198 (Cal. 1958).

*Mattei v. Hopper*.<sup>53</sup> Almost all US courts clearly acknowledge this common law duty in contract performance though it is more in terms of an implied covenant of good faith and fair dealing; at present we find that hardly a complaint is filed stating a claim in contract law without including an allegation of bad faith.<sup>54</sup>

## **b) Good Faith under Uniform Commercial Code and RESTATEMENT of Contracts**

Despite considerable support for the existence of a duty of good faith contract performance in the early twentieth century, the American Law Institute, which undertook to draft the RESTATEMENT (First) of Contracts in the 1920s, did not give explicit recognition to an implied duty of good faith and fair dealing. The RESTATEMENT (First) made no mention of it.<sup>55</sup> But this did not lessen the acceptance of the duty of good faith. This we can conclude, for the famous case of *Kirke La Shelle Co. v Paul Armstrong Co.*<sup>56</sup> was decided in 1933, well after the publication of the RESTATEMENT (First) of Contracts.

In the RESTATEMENT (Second) of Contracts, the drafters did include the doctrine of good faith. The RESTATEMENT (Second) Contracts Section 205 states: "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement." Section 205 of the RESTATEMENT (Second) Contracts, quoted above, has been held to impose an objective standard of good faith. The comments to this section

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<sup>53</sup> 330 P. 2d 625 (Cal. 1958).

<sup>54</sup> BURTON & ANDERSON, *supra* note 39, at 20.

<sup>55</sup> Robert H. Jerry, *supra* note 7, at 1334-35.

<sup>56</sup> 263 N.Y. 79, 188 N.E. 163 (1933).

include a meaning of good faith, although it provides no precise definition or meaning for the concept. Comment d to Section 205 of the RESTATEMENT states that good faith is violated "even though the actor believes his conduct to be justified. But the obligation goes further: bad faith may be overt or may consist of inaction, and fair dealing may require more than honesty." Comment d also provides examples of bad faith, which include "evasion of the spirit of the bargain" and "abuse of a power to specify terms."<sup>57</sup> The standard applied by the Courts for the standard of good faith has varied. "It is not enough for a contracting party to believe that he or she is acting in good faith. Rather, the contracting party's conduct must be objectively reasonable. The Common law standard of good faith is an objective one that considers the reasonable expectations of the parties"<sup>58</sup>

The Commissioners of Uniform State Laws and the American Law institute in 1951 promulgated the Uniform Commercial Code ("UCC") and this to a large extent has influenced the law of contracts in the United States.<sup>59</sup> The UCC imposes a duty of good faith in the performance of all contracts. The UCC specifically imposes two distinctive duties of good faith depending on the type of parties differentiating between 'merchants'<sup>60</sup> and 'nonmerchants'. UCC § 2-103(1)(b) sets forth the definition of good faith for merchants: "Good faith" in the case of a merchant means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade. Thus

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<sup>57</sup> RESTATEMENT (Second) Contracts § 205 Comments.

<sup>58</sup> U.S. Nat. Bank of Oregon v. Boge, 814 P2d 1082, 1091(1990).

<sup>59</sup> BURTON & ANDERSON *supra* note 39, at 34.

<sup>60</sup> UCC § 2-104(1):

Merchant" means a person who deals in goods of the kind of otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction or to whom such knowledge or skill may be attributed by his employment of an agent or broker or other intermediary who by his occupation holds himself out as having such knowledge or skill.

merchants must not only be honest, they must be reasonable. They must observe reasonable commercial standards of fair dealing in the trade. Similarly, merchants are bound by applicable "usages of trade" in agreements between merchants, under § 1-205(2), (4), unless they are abrogated expressly by agreement. Since the status of the parties often govern the standards of the good faith to which they are held upto, the status becomes determinative of the holding. For example, in one case the court held that a bank was not a merchant with respect to the transaction at issue, and therefore it was not negligent in not inspecting a check for forgery; the bank did not violate its good faith duty because it had no duty to be commercial reasonable--only honest.<sup>61</sup>

Contracting parties may choose to limit or specifically define the scope of good faith. But this duty cannot be waived away. UCC § 1-102(3) provides: "The effect of provisions of this Act may be varied by agreement, except as otherwise provided in this Act and except that the obligations of good faith, diligence, reasonableness and care prescribed by this Act may not be disclaimed by agreement but the parties may by agreement determine the standards by which the performance of such obligations is to be measured if such standards are not manifestly unreasonable".

Some courts have required more than simply refraining from dishonest behavior. For example, the U.S. Court of Appeals for the Ninth Circuit explained: "This covenant not only requires each contracting party to refrain from doing anything to injure the right of

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<sup>61</sup> MCarthy Kennedy Reidy, PC v. First Nat'l Bank of Boston, 402 Mass 630, 524 NE 2d 390, 393 (1988).

the other to receive the benefits of the agreement, but also imposes the duty to do everything that the contract presupposes that he will do to accomplish its purpose.”<sup>62</sup>

In an article written by Professor Summers, he maintained that good faith in contract referred to a minimal standard rather than a high ideal.<sup>63</sup> His thesis was that “Court decisions that apply general contract law reveal the term “good faith as a phrase which has no general meaning or meaning of its’ own, but which serves to exclude many heterogeneous forms of bad faith and that the duties judges have imposed in the name of contractual good faith are more varied and numerous than the scope of UCC application.”<sup>64</sup>

There has been a constant tussle by the Courts in the United States to arrive at a clear definition of the ambit and nature of the duty of good faith. Some courts have argued that the duty is simply contractual in nature and arises only with a contract, while others have

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<sup>62</sup> Los Angeles Mem’l Coliseum Com’n v. National Football League 791 F2d 1356, 1361 (9th Cir 1986). In the said case, Defendants professional football league and member teams refused to give cross-claimant football team consent to move from Oakland to Los Angeles, so plaintiff, a Los Angeles stadium authority, and cross-claimant sued for the breach of a covenant of good faith and fair dealing which was implied under California law.

<sup>63</sup> Summers, “*Good Faith*” in *General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 195 (1968).

<sup>64</sup> *Id.* at 196-97.

asserted that the duty is imposed by law.<sup>65</sup> It has been posited by some that it would be incorrect to limit the duty of good faith only to express contracts, as this duty exists even before a contract is entered into, as it is duty imposed by law and reflects the views about the people and what constitutes fairness.<sup>66</sup>

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<sup>65</sup> Nicola W. Palmieri, *Good Faith Disclosures Required During Precontractual Negotiations*, 24 SETON HALL L. REV. 70, 91 (1993).

<sup>66</sup> *Id* at 91.



## II. Good Faith in Contract Negotiations

From our analysis of the provision of the good faith under the UCC and the RESTATEMENT (Second) Contracts, we can infer that this concept is widely recognized and accepted. While a cursory reading of the both the UCC and the RESTATEMENT (Second) Contracts will seem to indicate that the duty of good faith only exist only in contract performance, this is not completely correct. The UCC and the RESTATEMENT did not intend to exclude this duty of good faith from the precontractual stage by any negative inference.<sup>67</sup>

Professor Summer's contribution in recognizing that courts have, even prior to the drafting of the RESTATEMENT, directly or indirectly, imposed some standards of good faith during negotiations, is particularly informative.<sup>68</sup> He cited examples of situations where Courts have favored imposing a standard of good faith like for instances: negotiating without any serious intent, abusing the privilege by withdrawing an offer or

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<sup>67</sup> *Id* at 93.

“In any event, the general recognition in the UCC and the RESTATEMENT (Second) that parties must perform their contracts in good faith evidences the continuing evolution of business ethics towards recognizing that standards of good faith and fair dealing should measure all dealings, even those between businessmen, and even those of a pre-contractual nature.”

<sup>68</sup> Summers, *supra* note 60, at 98, 99. Professor. Summer again attempts to articulate that though UCC attempted to define ‘good faith as a positive concept, Courts have often defined the scope of good faith by listing out acts that would amount to bad faith as an ‘excluder’.

proposal, entering a deal without intending to perform or recklessly disregarding the inability to perform.<sup>69</sup>

Comprehending contract law requires an understanding of the different stages of a contract. There is the formation stage and the performance stage and the enforcement stage. Attempting to provide an examination of duty of good faith in each of these contexts of contract law would be impossible. The topic is wide and varied and would be more appropriate as a subject for a book and there have been several books written on the topic.

This paper however just seeks to analyze the scope of the duty of good faith as understood in the stage of formation, in other words at the stage when actually no contract has been formed. Most of us understand the different stages of contract formation through the conventional rules of offer and acceptance.<sup>70</sup> These simple rules of offer and acceptance and counter-offer and revocation and the like, have limited application and could be made to fit into smaller contracts or contracts for a simple matter not involving a lot of technical details or a lot of money. Another reason for such limited application is because in many contracts, especially the contracts that one enters into on a routine basis, there is just a single written document not a separate offer and

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<sup>69</sup> *Id.* Heyer Products Co. V. United States, 140 F Supp. 409 (Ct Cl. 1959); Sokoloff V National City Bank, 239 N.Y. 158, 239 N.Y. (N.Y.S.) 158, 145 N.E. 917, 1924; Clark & White Inc v. Fitzgerald, 322 Mass. 603, 127 N.E.2d 172, 1955.

<sup>70</sup> E Allan Farnsworth, *Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations*, 87 COLUM. L. REV. 217 (1987)

“They are seductive rules that proceed on a simple premise: two parties exchange proposals until an "offer" by one party is "accepted" by the other forming a contract. But however suited these rules may have been to the measured cadence of contracting in the nineteenth century, they have little to say about the complex processes that lead to major deals today.”

acceptance documents. Most major contractual obligations are undertaken only after complex processes of negotiations and bargaining between the parties.<sup>71</sup> In such complex processes it is very hard to distinguish between an offer or a counteroffer, as the entire agreement is entered into on an issue by issue basis and a number of draft agreements are entered into by the parties during the course of the negotiations, where each draft would be an attempt to polish the previous draft and lay down the terms agreed upon by the parties. Professor Farnsworth in his pre-eminent work explained this process eloquently:

“There may first be an exchange of information and an identification of the parties' interests and differences, then a series of compromises with tentative agreement on major points, and finally a refining of contract terms. The negotiations may begin with managers, who refrain from making offers because they want the terms of any binding commitment to be worked out by their lawyers. Once these original negotiators decide that they have settled those matters that they regard as important, they turn things over to their lawyers. The drafts prepared by the lawyers are not offers because the lawyers lack authority to make offers. When the ultimate agreement is reached, it is often expected that it will be embodied in a document or documents that will be exchanged by the parties at a closing.”<sup>72</sup>

If the negotiations succeed then the parties enter into a final agreement, and it is held to be binding between the parties. However, such protracted and sometimes expensive negotiations sometimes fail to culminate into an agreement and then a number of question crops up. There may be questions about the potential liability from a party's failure to negotiate in good faith and scope of the duty depending on the circumstances and if damages are available appropriate method of assessing damages.<sup>73</sup>

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<sup>71</sup>Farnsworth, *supra* note, 67, at 220 explaining that “the negotiations are a far cry from the simple bargaining envisioned by the classic rules of offer and acceptance, which evoke an image of single- issue, adversarial, zero-sum bargaining as opposed to multi-issue, problem- solving, gain-maximizing negotiation.”

<sup>72</sup> Farnsworth, *supra* note 67, at 219.

<sup>73</sup> John Klein & Carla Bachechi, *Precontractual Liability and the Duty to Negotiate in Good Faith in International Transactions*, 17 HOUS. J INT'L L 1, 4 (1994) (See also Farnsworth *supra* note 67, at 219-220)

It would be useful to get an idea as to the kinds of duties that govern a party's conduct during negotiations. They can be classified as i) a general duty to negotiate in good faith ii) the duty, recognized by tort law and the principles of restitution to avoid inflicting harm on another; and iii) duties created by a preliminary agreement.<sup>74</sup> These duties touch upon both contractual and non-contractual duties.

In view of the fact that the negotiations failed to result in an agreement, there is no agreement and therefore principles of tort and unjust enrichment comes into play. These principles are a part of public policy, that require that one person would have to compensate another for harm caused or to return to another some benefit that has been obtained from him in an unjust manner. These would be non-contractual duties. However, there are some parties that do not rely on these general principles to protect themselves, and often such parties enter into preliminary agreements and these agreements provide another source of duties to be assumed by the parties.<sup>75</sup> These would qualify as contractual duties. Although such agreements take many forms, most of them include one or more of three kinds of obligations. The first consists of special duties, which govern the conduct of the negotiations (procedural in nature).<sup>76</sup> The second is the promise to make efforts to agree.<sup>77</sup> The third is a commitment to some terms of the final

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wherein he explains that classic rules of offer and acceptance do not answer all the issues about the failure to conform to the standard of fair dealing and definition of fair dealing and questions about seek restitution or out of pocket expenses or lost profits.)

<sup>74</sup> BURTON & ANDERSON, *supra* note 39, at 329-30.

<sup>75</sup> *Id.* at 334.

<sup>76</sup> *Id.*

<sup>77</sup> *Id.*

agreement made only for the purposes of negotiations.<sup>78</sup> Failure of the negotiations to bring about an agreement could lead to two kinds of situations. There could be a) Wrongful Prevention of Contracts or b) Wrongful Formations of Contracts.

### **a) Wrongful Prevention of Contracts**

All parties that enter into negotiations understand that they might not be able to agree on all terms and as a result no contract may be formed between the parties. The law does not really recognize a general duty to negotiate in good faith. Many courts believe that negotiations are essentially “aleatory in nature- that any losses incurred on account of their failure are foreseeable and non compensable.”<sup>79</sup>

This is just a brief introduction and Chapter C will deal with this topic in detail.

### **b) Wrongful Formation of Contracts**

Sometime the negotiations will result in an agreement but the resultant agreement is different or inferior from what one of the parties expected. This is due some misconduct (like coercive or misleading behavior or fraud or misrepresentations) during the negotiation process. The parties may opt, under such circumstances to avoid the contract, in other words, to undo the contract and return any benefits one side has received from the other.<sup>80</sup> This wrongful formation of contracts is generally a result of failure of one party to disclose some relevant fact or information to the other party. Though American

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<sup>78</sup> *Id.*

<sup>79</sup> Farnsworth, *supra* note 67, 221.

<sup>80</sup> Eric G Anderson, *The Restoration Interest and Damages for Breach of Contract*, 53 MD. L. REV. 1, 20 (1994).

law has always recognized the doctrine of caveat emptor,<sup>81</sup> this doctrine has been diluted with that passage of time and courts are now willing to overlook this doctrine in favor of fairness.<sup>82</sup>

However this topic is beyond the scope of this paper.

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<sup>81</sup> It means 'let the buyer beware' and requires the purchaser of anything to examine and judge the value of the thing himself.

<sup>82</sup>Nicola W. Palmieri, *supra* note 62 at 120. "However, there has been a slow but steady trend away from caveat emptor towards an application of higher standards of good faith, fair dealing, and morality to all contracts and transactions. The doctrine of caveat emptor is being abandoned and the rule that negotiations must be conducted with openness and in good faith is being affirmed."

### **III. Wrongful Prevention of Contracts**

#### **a) Traditional Law**

In order to understand the traditional law with regard to the wrongful prevention of contract, a brief contemplation of some rules that govern the process of negotiations would be particularly useful. “A court cannot enforce a contract unless it can determine what it is. Vagueness of expression, indefiniteness and uncertainty as to any of the essential terms of an agreement, may prevent the creation of an enforceable contract”<sup>83</sup> This rule gives the impression that if the terms of the agreement are unspecified or open ended there can be no contract. The same would be the case if any of the essential terms were omitted. However, another rule, UCC § 2-204 (3)<sup>84</sup> conflicts with the above rule because it lays down that if the intent of the parties to a contract can be determined then the courts may supply the missing terms. The comments also reiterate this by alluding to the later sections, which would help courts supply terms. So here we have two rules, one that lays down that a contract would fail if it is too indefinite and another that specifies that the courts may supply missing terms if the intent of the parties can be established. Though contradictory in terms, a careful study of both these sections seems to suggest that despite lack of essential terms and indefiniteness, if the

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<sup>83</sup> ARTHUR L CORBIN, CORBIN ON CONTRACTS 1952) §95.

<sup>84</sup> “Even though one or more terms are left open a contract for sale does not fail for indefiniteness if the parties have intended to make a contract and a reasonably certain basis for giving appropriate remedy.”

'intent to be bound' can be established between parties then the ambiguity can be resolved by Courts.

Another section that throws light on rule regarding the Precontractual agreements is Section 27 RESTATEMENT (Second) of Contracts: "Manifestations of assent that are in themselves sufficient to conclude a contract will not be prevented from so operating by the fact that the parties also manifest an intention to prepare and adopt a written memorial thereof; but the circumstances may show that the agreements are preliminary negotiations.... "

Comments a and b to Section 27 of the RESTATEMENT elucidates the factors which help determine whether a binding contract exists: "Parties who plan to make a final written instrument as the expression of their contract necessarily discuss the proposed terms of the contract before they enter into it and often, before the final writing is made, agree upon all terms which they plan to incorporate therein. This they may do orally or by exchange of several writings. It is possible thus to make a contract the terms of which include an obligation to execute subsequently a final writing which shall contain certain provisions. If parties have definitely agreed that they will do so, and that the final writing shall contain these provisions and no others, they have then fulfilled all the requisites for the formation of a contract. On the other hand, if either party knows or has reason to know that the other party regards the agreement as incomplete and intends that no obligation shall exist until



other terms are assented to or until the whole has been reduced to another written form, the preliminary negotiations and agreements do not constitute a contract."<sup>85</sup>

All parties that enter into a contract do so with an awareness that despite best efforts no contract may result. <sup>86</sup> "American Law imposes not general duty to negotiate a contract in good faith. Despite scholarly suggestions that the American courts embrace this concept and continued to view contract negotiation as, at bottom, an undertaking in which self-interest is the accepted norm."<sup>87</sup> In fact one Court quoted:

" In a business transaction both sides presumably try to get the best of the deal. That is the essence of bargaining and the free market. So one cannot characterize self-interest as bad faith. No particular demand in negotiations could be termed as dishonest, even if it seems outrageous to the other party. The proper recourse is to walk away from the bargaining table not to sue for "bad faith " in negotiations."<sup>88</sup>

In a conventional single-step merger there is a period of preliminary negotiations during which the parties attempt to agree on a mutually satisfactory price.<sup>89</sup> During these preliminary negotiations, the parties normally do not deal in terms of final binding agreements; they just concentrate on some essential issues and try to reach an agreement in principle. At this stage of the negotiations, the

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<sup>85</sup> RESTATEMENT (SECOND) OF CONTRACTS § 27 Comments a and b.

<sup>86</sup> BURTON & ANDERSON, *supra* note 39, at 328.

<sup>87</sup> BURTON & ANDERSON, *supra* note 39, at 330-31. This can be contrasted with the Civil Law Countries where Courts have been more open about accepting suggestions and have expanded the scope of this duty to precontractual stage. *See generally* Ralph Lake, Letters of intent: a comparative examination under English, U.S., French, and West German law. 18 GEO. WASH. J. INT'L L. & ECON. 331 (1984)

<sup>88</sup> *Feldman v Allegheny Intl., Inc.* 850 F 2d. 1217 (7<sup>th</sup> Cir. 1988)

parties usually have an oral agreement or a written memorandum of understanding. The parties often make this memorandum or oral agreement subject to further negotiation and execution of a definitive merger agreement. Once this is achieved the parties then announce this publicly through a joint press release announcing that they have reached an agreement in principle subject to the execution of a formal, signed merger agreement. However this was not considered final and parties continued to negotiate and it was generally accepted that until the final agreement was signed no liability would attach to either parties. This was the traditional law. However, one famous case managed to rock this belief or acceptance and created a lot of confusion and insecurity.

**Texaco Analyzed:** On November 19, 1985, a Texas district court jury sent shockwaves throughout the mergers and acquisitions field by awarding Pennzoil Company (Pennzoil) 10.53 billion dollars in its claim against Texaco, Inc. (Texaco) for tortious interference with a contract.<sup>90</sup> Pennzoil brought suit against Texaco for tortious interference with Pennzoil's contract to merge with Getty even though Pennzoil and Getty signed no merger documents or formal contracts. As discussed above the law on this subject of contract law especially pertaining to mergers and acquisitions was well settled. In a nutshell, the contract law provided that often parties enter into negotiations and concur on terms one by one and finally enter into and sign a final contract. Sometimes these negotiations do not culminate into an

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<sup>89</sup> Freund & Easton, *The Three-Piece Suitor: An Alternative Approach to Negotiated Corporate Acquisitions*, 34 BUS. LAW. 1679, 1687(1979) .

agreement, raising the issue about the binding effect of these negotiations and the law prior to the Pennzoil decision has been that the parties are legally bound only after signing of the formal agreement.<sup>91</sup> In order to fully appreciate the ramifications of this case we must delve deeper in to the fact of this case.

**Facts:** Pennzoil on December 28, 1983 made an unilateral cash tender offer for upto some shares of Getty Oil Company at \$100 per share. This amounted to approximately 20% of the outstanding shares of the company. Representatives of both parties met and agreed to a Memorandum of Agreement which outlined the following proposals; “that Pennzoil would increase the purchase price under its offer to \$110 per share, and increase the number of shares sought; Getty Oil would purchase the shares held by the J Paul Getty Museum<sup>92</sup>(Museum) for \$110 per share; Getty Oil and a newly created entity owned by Pennzoil and the Trustee<sup>93</sup> would be merged, pursuant to which all shareholders, other than the Trustee and Pennzoil, would receive \$110 per share in cash and the Trustee and Pennzoil would, as surviving shareholders, maintain an ownership ratio of 4/7 for the Trustee and 3/7 for Pennzoil, and would work together to effect a restructuring of Getty Oil<sup>94</sup>. The memorandum provided for the eventuality that if the proposed restructuring of the Getty Oil could not be achieved then it would be liquidated and the takings would then be distributed among the parties i.e. Trustee and Pennzoil according to

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<sup>90</sup> Pennzoil Co. v. Texaco, Inc 729 S. W.2d 768 (Tex. Ct. App. 1987). The stated fact was taken from the decision of the Texas Court of Appeals in Texaco, Inc v. Pennzoil Co. 729 S. W.2d 768 (Tex. Ct. App. 1987).

<sup>91</sup> Coulter v. Anderson, 144 Colo. 402, 410, 357 P.2d 76, 80 (1960). Here the Courts held that execution of a formal contract to be a condition precedent to the finality of the agreement.

<sup>92</sup> The Museum was major shareholder owning about 12% of the shares.

<sup>93</sup> Gordon P Getty was the sole trustee of the Sarah C Getty Trust that was one of the parties to this transaction that held about 40% of the shares of Getty Oil.

the number of shares held by them. The Getty Board approved the memorandum wherein the price paid for each share was increased to \$110. This was after an extensive round of negotiations wherein both parties made a number of offers and counteroffers, which finally culminated into the above mentioned Memorandum. On January 4, Getty Oil, the Trustee, the Museum and Pennzoil issued a joint press release, announcing that Getty Oil, the Trustee and the Museum had agreed in principle with Pennzoil Company to a merger of Getty Oil and a newly formed entity owned by Pennzoil and the Trustee; the press release also laid down some of the basic terms of the Plan as set forth in the Memorandum. However, the press release also contained a disclaimer that the transaction is subject to execution of a definitive merger agreement and various procedural requirements. But the same disclaimer was not present in the Memorandum that was signed by both parties.<sup>95</sup> Thereafter the lawyers for Pennzoil and Getty began drafting the formal merger agreement.

In the meantime Goldman Sachs, as investment banker to Getty Oil approached Texaco, a company desperately short of oil reserves<sup>96</sup> about the possible acquisition of Getty by Texaco. Texaco after some negotiations offered \$125 per share and this was accepted by Getty. Texaco agreed to a number of terms some of which were to cover the Trustee and the Museum against all claims arising out the various

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<sup>94</sup> Stephen R. Volk Melissa McMahon, *Letters Of Intent--Getty And Beyond*, 464 PLI/CORP 445 (1984)

<sup>95</sup> The Getty Oil Press Release as cited in T PETZINGER, OIL AND HONOR: THE TEXACO-PENNZOIL WARS 400 (1987) (hereinafter PETZINGER).

<sup>96</sup>*Texaco*, 729 S.W. at 801. Wherein the Texas court of appeals noted, "Texaco's own proven [oil] reserves had been declining steadily, and its recent exploration and development costs had been the

agreements arising as a result of the Texaco acquisition of Getty. On hearing about this development the Chairman of Pennzoil immediately sent a letter to the Board of Directors of Getty Oil demanding that Getty Oil comply with the terms of its agreement with Pennzoil, and threatening a lawsuit against Getty Oil and Texaco. Shortly afterwards a formal merger agreement was signed by Texaco and Pennzoil and it was publicly announced that the Getty Oil Board had approved the Texaco acquisition. Pennzoil initially brought suit against the Getty entities and Texaco in Delaware Chancery Court seeking a preliminary injunction alleging breach of contract against the Getty parties<sup>97</sup> and tortious interference with a contract against Texaco.<sup>98</sup> For tactical reasons, Pennzoil dropped its suit against Texaco in Delaware and re-filed in Texas State court. After a four and half month trial the jury in the 151<sup>st</sup> District Court of Harris County, in Houston found the Texaco tortiously induced the breach of Pennzoil contract with Getty and awarded compensatory and punitive damages of over 10 billion dollars.<sup>99</sup> “The jury awarded \$7.53 billion in compensatory damages and \$3 billion in punitive damages “a sum greater than the gross national product of 116 countries of the world (at that time).”<sup>100</sup> The Court of Appeal left this award substantially intact only ordering a remittitur of \$2 billion of

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highest in the industry . . .” The purchase of Getty Oil would and did double Texaco's worldwide oil reserves.

<sup>97</sup> The following were the major parties of the Getty deal were Getty Oil, the Trustee and the Museum.

<sup>98</sup> Pennzoil's Reply Brief in Support of a Motion for a Preliminary Injunction at 34-41, 66-73, Pennzoil Co. v. Getty Oil Co., No. 84- 7425, 34-41, 66-73 (Del. Ch. Jan. 24, 1984).

<sup>99</sup> This amount was calculated on the basis the testimony put forth by Pennzoil's experts and was not objected to by Texaco.

<sup>100</sup>Christopher M. Goffinet, *The \$10.53 Billion Question--When Are The Parties Bound? Pennzoil And The Use Of Agreements in Principle in Mergers and Acquisitions*, 40 VAND L REV 1367,1368(1987).

the punitive damages.<sup>101</sup> The Texas Supreme Court declined to review the decision of the court of appeals; this ultimately led to Texaco's filing for protection under the Bankruptcy Code, thus creating the biggest bankruptcy case in history.<sup>102</sup> However the parties agreed to settle for a payment of \$3 billions dollars and this saved Texaco from filing for bankruptcy.<sup>103</sup>

**Arguments put forth by the Parties:** Both parties had stipulated that the it would be the substantive law of New York that would be applied in this case because of two reasons: a) the alleged agreement was made in New York and b) Texaco alleged interfered with the alleged agreement in New York.

The main contentions of both the parties were based on two issues:

- Whether the parties had any intent to be bound; and
- Whether the preliminary agreement signed by the parties contained all the essential terms to make it a valid agreement.

**Pennzoil's Arguments:** Pennzoil contended that facts clearly indicated that there was an offer and acceptance that led to the formation of a contract. They claimed that an offer was made by them, which was modified by Getty and when they accepted Getty's counteroffer, a binding contract came into being. On the question of 'intent to be bound' Pennzoil relied on the following to prove the extent of the intent: a) the Memorandum of Agreement signed by Pennzoil and the majority shareholders of Getty Oil and approved by the Getty Oil board with a price increment; b) the sequence of offer, counteroffer, and acceptance reflected by

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<sup>101</sup> *Id.*

<sup>102</sup> *Id.*

documentary evidence and testimony; and c) the January 4 Getty Oil press release announcing the agreement to the world.<sup>104</sup> Further, Pennzoil also counted on the approval of the Getty Board of the Pennzoil's proposal by 15 to 1 vote on January 3<sup>rd</sup>, 1984, to show Getty's intent to be bound by the agreement.<sup>105</sup> Another argument put forth by Pennzoil was fact that the Memorandum of Agreement stipulated that the board approval was required to make to the agreement effective with execution was just a formality and was not meant to act as a condition precedent.<sup>106</sup>

The other issue questioned which was contested by both parties was if the agreement in questions contained all the essential terms. Pennzoil claimed that this was just a just a part of the first issue i.e. if the parties had exhibited an intent to be bound then it can be concluded that there was 'intent to be bound', this could taken to mean two things either that the parties agreed on all essential terms or that the terms that required any kind consensus was not vital.<sup>107</sup> Pennzoil also claimed that the handshake and the celebratory clink of the champagne glass indicated the closure of a valid agreement as indicated objectively by the parties' actions.<sup>108</sup>

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<sup>103</sup> *Id.*

<sup>104</sup> Michael Ansaldi, *TEXACO, PENNZOIL AND THE REVOLT OF THE MASSES: A CONTRACTS POSTMORTEM* 27 HOUS. L. REV. 733(1990) citing Pennzoil's Reply to Texaco's Application for Writ of Error at 18, *Texaco, Inc. v. Pennzoil Co.*, No. C-6432 (Tex. Nov. 2, 1987) [hereinafter *Texaco Application*]

<sup>105</sup> *Texaco Application, supra* note 99, at 175-76)

<sup>106</sup> *Id.*

<sup>107</sup> *Texaco Application, supra* note 99, at 98-99

<sup>108</sup> *Id.*

**Texaco's arguments:** Texaco put up various contentions seeking to counter the arguments of Pennzoil. It argued that the following issues denoted that the parties had not intended to be bound: a) It contended that the enormity of the deal was such that normally a signed writing would be expected. (b) It also relied on the common practice/usage in the particular field of mergers and acquisitions trade that parties would not consider themselves bound unless a formal agreement was signed by the parties; (c) To strengthen its previous contention, Texaco also pointed out that no agreement was ever signed by the parties; only drafts had been exchanged and even the drafts stipulated that the agreement had to be signed to be effective; (d) several significant terms of the agreement were still undecided and were being negotiated.

<sup>109</sup> Further Texaco argued that the press release specifically stated that the agreement was only an 'agreement in principle' and was 'subject to an execution of a definitive merger agreement'.<sup>110</sup> Texaco also drew attention to the fact the agreement had a number of open terms and hence the agreement was too indefinite to qualify as a final agreement. Texaco pointed out that many issues: who would buy the Getty museum's shares, the time and manner of payment of the price, the payment of dividends and whether Pennzoil would honor the Getty Oil's employee benefit plans, which had not been finalized by the parties.<sup>111</sup>

Texaco, unlike Pennzoil tried to delineate between the two issues of 'intent to be bound' and essential terms. They claimed that before a contract comes into existence all the essential terms must be agreed upon. "Even if there is intent to be

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<sup>109</sup>*Id.*

<sup>110</sup> The Getty Oil Press release as quoted in PETZINGER, *supra* note 95.



bound, there can be no contract in the absence of essential terms. An intent to be bound to an agreement with less than the essential terms creates an unenforceable agreement to agree”<sup>112</sup>

**Analysis of the Decision:** The issue of contract law was dealt with by the Court of Appeals. However even in that respect the court did not provide a complete analysis of the subject as it only had the authority to review the jury findings and base their decision on the same.<sup>113</sup> The Courts of Appeals only looked into whether there was sufficient evidence for the jury to determine that there existed a contract between Pennzoil and Getty and they did not look at the merit of the case to conclude that there was a valid contract between Pennzoil and Getty.<sup>114</sup> The Court concluded on that basis that there was sufficient evidence by which the jury could have concluded that the parties intended to be bound by the preliminary agreement.<sup>115</sup>

As discussed above, the parties stipulated that the New York Law would be controlling. New York law provides a list of issues to determine the intent of the parties. They are as follows: a) whether a party expressly reserved the right to be bound only when a written agreement is signed; b) whether there was any partial performance by one party that the party disclaiming the contract accepted; c) whether all essential terms of the alleged contract had been agreed upon; and d) whether the complexity or magnitude of the transaction was such that a formal,

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<sup>111</sup> *Texaco*, 729 S W. 2d at 793-94.

<sup>112</sup> *Texaco Application*, *supra* note 99, at 162-63.

<sup>113</sup> *Texaco*, 729 SW 2d at 795.

<sup>114</sup> *Texaco*, 729 SW 2d at 784-85, 787,795.

executed writing would normally be expected.<sup>116</sup> The Court of Appeals also focused on the issue of the parties ‘intent to be bound’ as being the yardstick to impose contractual liability.

The first criteria about reserving the right to be bound, was satisfied with the issuance of the joint press by both parties. However the Courts refused to accept this line of reasoning. Court concluded that though the language of the press release suggested that that transaction was incomplete and a definitive merger agreement was to be executed, there was evidence to suggest that such an agreement was not really regarded as substantive under the laws of Delaware but just a formality.<sup>117</sup> In other words, “it was mere scrivener's work and not a potential obstacle to contract formation.”<sup>118</sup>

With regard to the issue of partial performance to decide whether an oral agreement could be made enforceable; the courts concluded that the test was whether or not one party had partially performed and whether or not that performance was accepted by the other party now claiming that there is no contract; under such circumstances, courts could infer there was an implied contract and

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<sup>115</sup> *Texaco*, 729 SW 2d 768.

<sup>116</sup> *Id.*

<sup>117</sup> PETZINGER, *supra* note 95, at 392.

<sup>118</sup> Del Code Ann. Tit. 8, § 251(b) (c) (1983 & Supp 1988). This clearly distinguishes between two options, the agreement of merger a detailed document containing, inter alia, the substantive terms and conditions of merger, and the certificate of merger, which does not contain such details and could reasonably be referred to as a standard formal document. The Getty Oil-Pennzoil press release spoke of a definitive merger agreement.

Courts could award restitution interest.<sup>119</sup> In the Pennzoil-Getty negotiations there was neither any performance by a party nor or acceptance of such performance by the other party which could give rise to some type of recovery which might have ensued under the contract.<sup>120</sup> However, the court stated that “the absence of partial performance did not conclusively demonstrate the absence of a contract, but was merely a circumstance that the finder of fact could consider in reaching a decision on whether the parties intended to be bound.”<sup>121</sup> Courts seemed to find the short time span within which this entire episode had taken place not favorable for performance by either party.

Regarding the third factor, about essential terms, as discussed above in the arguments of Texaco, many details had to be sorted out. However, the court found evidence to show that each claimed open term had either been actually been agreed to or was a matter of indifference to the parties, or would be handled in a manner customary to transactions of the kind.<sup>122</sup>

Finally, the size and complexity of the negotiations and the sums of money involved strongly suggested that the parties probably did not intend to be bound prior to the signing of the definitive merger agreement. However the Court found that were circumstances the finder of fact could consider and a factor tending to

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<sup>119</sup> Ronald J. Baron, *The Pennzoil-Texaco Dispute: An Independent Analysis*, 38 BAYLOR L. REV. 253, at 273 (1986).

<sup>120</sup> *Id.*

<sup>121</sup> *Texaco*, 729 S W 2d at 792. However the Pennzoil argued that it had performed partially by arranging finances to the tune of one billion dollars to fulfill the contract. “But the Texaco argued that arranging of finances was only a preparation to perform and not actual performance and Getty did not accept any payment”. 729 S.W.2d. 768.

support Texaco's position, however to the court's mind this was to be considered by the jury and had been so considered.<sup>123</sup>

Some of Texaco's arguments were well grounded, and evidence supporting its contentions was sound. However, it seems the court in Texas and jury failed to accord it proper credence while considering all the evidence in the matter. The Court of Appeals relied on the 'intent of parties' as an index to determine the enforceability of the preliminary agreement. The Court used this 'intent to be bound' as the 'sole diagnostic tool',<sup>124</sup> in its scrutiny. Though there is evidence in the case to suggest that the parties intended to be bound, there is also evidence to suggest that the parties did not intend to be bound. So we can conclude the evidence taken in its totality was unclear. If this was only factor considered, then only two possibilities could result: either that there was intent to be bound or that there was no intent to be bound.<sup>125</sup> However, as ambiguity of the evidence suggest, there can be a third possibility that the intent was unclear.<sup>126</sup> In a nutshell, by considering all the evidence in this case, it would impossible to decide whether there was intent to be bound or no intent to be bound. The Courts should have considered a third alternative that the intent of the parties was unclear. This would have allowed the jury to consider that at times especially during complex transactions sometimes

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<sup>122</sup> *Id* at 795

<sup>123</sup> *Id* at 792.

<sup>124</sup> Michael Ansaldi *supra* note 99, at 793

<sup>125</sup> Michael Ansaldi *supra* note 99, at 782

“ If intent to be bound is the only concept we bring to the scrutiny of a set of facts, we are inclined to see a bipolar reality as presumptively possible: intent to be bound/ no intent to be bound. The existence of only two categories will lead at times to the allocation, with strong misgivings, of more complex, category- straddling situations to one or the other filing cabinet.”

things are not black or white but rather that there is a lot of gray.<sup>127</sup> And under such circumstances, this option of intent being unclear should have perhaps been considered. This case fits aptly under this possibility. If Courts had been willing to consider this as option, maybe we could have avoided opening the Pandora's box with the damaging verdict in the Texaco case.

Another reason to want to champion the arguments of Texaco and seek a different holding in the said case is that such a decision would work in the 'best interests' of the shareholders. In cases of mergers or acquisitions the shareholders should be able to receive the best price for their shares. One could contend that it was a part of the fiduciary duty that directors of a corporation owe to their shareholders. Courts have also acknowledged this duty. The *ConAgra* court explicitly stated that, when a target company's directors received a higher competing bid after signing a purportedly exclusive merger agreement, "they had an obligation at that point to investigate the competing offer, and if, in the exercise of their independent good faith judgment, they found that the higher bidder's offer was better for the target company's shareholders, they were bound to recommend the better offer."<sup>128</sup> The reason why most parties to a merger or acquisition choose to first enter into a preliminary agreement is to seek better offer.<sup>129</sup> Even in the said

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<sup>126</sup> *Id.*

<sup>127</sup> *Id.*

<sup>128</sup> *ConAgra, Inc. v. Cargill, Inc* 222 Neb 136, at 156; 382 N W 2d. 576,at 588.

case, Getty sought better offers when “the investment banks of Getty put out the word that their clients were looking for a ‘white knight’”.<sup>130</sup>

This is not to suggest that Getty’s conduct of going behind Pennzoil’s back should be encouraged or that in case of a higher bid the directors of a company have no duty of good faith to a party that the directors have been negotiating with. The suggestion is that Getty should have let Pennzoil know that Getty was seeking better offers or that they were also negotiating with Texaco and Getty should have been more explicit in their documents and their conducts that they did not intend to be bound by the negotiations. There is no arguing that Getty and to some extent Texaco breached the duty of good faith and were liable to Pennzoil. But what is being recommended is that the recovery in this case should have been limited to the actual amount spent by Pennzoil in reliance of the negotiations.

#### **b) Effects of Texaco Decision**

The Texaco decision led to a lot of confusion and uncertainty in minds of businessmen and attorney. This decision created a lot of speculation especially in the field of mergers and acquisitions. Mergers and acquisitions are generally complex transactions that involve huge sums of money and elaborate and time consuming negotiations. But after the decision in Texaco, there was uncertainty and this caused anxiety in the minds of the investors who rely on the fact the rules and law would be applied objectively and predictably.<sup>131</sup> Such a fact specific enquiry

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<sup>130</sup> S COLL, THE TAKING OF GETTY OIL (1987) (as cited in Michael Ansaldi *supra* note 99 at 793).

<sup>131</sup> Christopher M. Goffinet, *supra* note 100, at 27 (citing N.Y. Times, July 26, 1986, at 27, col. 5).

could be subject to manipulation and this potential of manipulation, especially when huge sums of money are involved, makes people nervous and this in turn has a deterrent effect on negotiations. Though there are a few skeptics who believe that this decision was an anomaly and that it would not really have long-term effects in the field of mergers and acquisitions, the general view has been to be very cautious about the use of agreements in principle. Courts in this case concluded that parties intended bound by the preliminary agreement and awarded the aggrieved party expectation damages, when in actuality Getty and Texaco were just liable for breaching their duty to negotiate in good faith and hence should have been made to just pay for the expenses incurred by Pennzoil in reliance of the negotiations.

**c) Subsequent Case(s) limiting Texaco:**

The Second Circuit Court of Appeals did a great deal to clear the upheaval and insecurity caused by the award in *Texaco v. Pennzoil*<sup>132</sup> in the case of *Arcadian Phosphates Case Inc. v. Arcadian Corp*<sup>133</sup> especially with regard to the use of preliminary agreements.<sup>134</sup> This case re-established the presumption that preliminary agreements cannot be enforced as legitimate contracts, and at the same time it acknowledged there exists a duty to negotiate in good faith. The breach of that duty could result in an award of out-of-pocket costs to the non-breaching party.

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<sup>132</sup> *Texaco*, 729 S.W. 2d. 768.

<sup>133</sup> 884 F 2d. 69 (2d. Cir. 1989).

<sup>134</sup> Jonathan O. Hafen, *Arcadian Phosphates, Inc. V. Arcadian Corp.--Taming Texaco's Agreement In Principle*, B.Y.U. L. REV. 1045(1990).

The Second Circuit's holding and rationale in *Arcadian* offers the best chance for a solution the question of what is the scope of preliminary agreements.

The Second Circuit relied on a number of cases to base its decisions in the *Arcadian*<sup>135</sup> case. The Court in *Arcadian*<sup>136</sup> relied on the seminal case of *Hoffman V Red Owl*<sup>137</sup>, which extended the application of promissory estoppel to commercial transactions and recognized that promissory estoppel could be also used as a sword to initiate a cause of action.<sup>138</sup> The court used section 90 of the RESTATEMENT (First) of Contracts as the basis for the decision, finding that the plaintiffs reasonably relied on the defendant's promise to grant a franchise, and that injustice could only be avoided by the enforcement of the promise to the extent plaintiffs relied.<sup>139</sup> Another important reason why the Second Circuit relied in this case was that it specifically dealt with the issue of pre contractual negotiations and the duty of good faith.<sup>140</sup> What is most significant about this case is the is the awarding of only 'out of pocket' expenses, which was hailed by many jurists was being most apt.<sup>141</sup> Another famous case, which formed the basis for the reasoning in *Arcadian*<sup>142</sup> case, was *Teachers Ins. and Annuity Ass'n of America v. Tribune Co.*<sup>143</sup>, where again the Courts found preliminary agreements to be of two types: one where

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<sup>135</sup> *Arcadian*, 884 F 2d. 69.

<sup>136</sup> *Id.*

<sup>137</sup> 26 Wis. 2d. 683, 133 N.W 2d. 267 (1965).

<sup>138</sup> WILLISTON, A TREATISE ON THE LAW OF CONTRACT § 139 (1st ed. 1943); Also see Harvey L. Temkin, "When Does the "Fat Lady" Sing? An Analysis of Agreements in Principle in Corporate Acquisitions, 15 FORDHAM L. REV. 125, 145 (1986).

<sup>139</sup> *Id.* 694-699.

<sup>140</sup> Summers, *supra* note 60, at 223.

<sup>141</sup> Summers, *supra* note 127, at 224.

<sup>142</sup> *Arcadian*, 884 F 2d. 69 (2d. Cir. 1989).

<sup>143</sup> 670 F Supp 491 (S.D. N.Y 1987).



all the terms had been agreed upon and the other where the parties have agreed upon a few terms and undertake to negotiate the unresolved terms in good faith.

The cases mentioned above provide us with an understanding of the reasoning adopted Arcadian<sup>144</sup> case. “Arcadian Corporation ("Arcadian") is a New York Corporation involved in the manufacture and sale of fertilizer. Arcadian Phosphates, Inc. ("API") is a Delaware corporation, which was seeking to purchase Arcadian's phosphate fertilizer business.<sup>145</sup> Arcadian, motivated by the deterioration in the productivity of its phosphate fertilizer business began negotiating the sale of its phosphate fertilizer assets with API. In June of 1986, the parties drafted and signed a four-page memorandum, which detailed the assets to be purchased, the price, and an option for Arcadian to purchase and control up to 20% of API.<sup>146</sup> Pursuant to the memorandum, Arcadian allowed API to establish offices on its premises, introduced to others the two principal shareholders of API as the new owners of the phosphate facilities, and obtained lenders' consent to the acquisition.<sup>147</sup> API deposited some amount towards the purchase price and in addition also made some improvements worth \$100,000 to Arcadian's fertilizer facilities.<sup>148</sup> After several months, the market for phosphates changed for the better and Arcadian asserted that it wanted a majority interest in API; API refused and instituted this action.<sup>149</sup> The district court granted summary judgment for Arcadian

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<sup>144</sup> *Acardian*, 884 F 2d. 69 (2d. Cir. 1989).

<sup>145</sup> *Id* at 70-74

<sup>146</sup> *Id.*

<sup>147</sup> *Id.*

<sup>148</sup> *Id.*

<sup>149</sup> *Id.*

on the breach of contract and promissory estoppel claims by finding that the preliminary agreement was non-binding. The Second Circuit affirmed the summary judgment ruling as to the breach of contract claim, but reversed and remanded on the promissory estoppel claim.<sup>150</sup> The Courts in this case applied the Tribune<sup>151</sup> test. In applying the Tribune test to this case, Courts held, “we need look no further than the first factor. The language of the November memorandum--two references to the possibility that negotiations might fail and the reference to a binding sales agreement to be completed at some future date--shows that Arcadian did not intend to be bound. Contrast the language of the November memorandum with the letters in Tribune.” Conversely, parties that wish to be bound can very easily protect themselves by refusing to accept language that shows intent not to be bound.<sup>152</sup>

In order to prevail on the breach of contract claims, Arcadian needed to show only that API should have known that Arcadian did not intend to be bound before the final contract was signed. The language of the memorandum reveals just that: API should not have believed that Arcadian intended to be bound. The Court here went on to discuss its reasons for choosing to assess damages only for out of pocket expenses. The instructions that the Second Circuit passed on the lower courts was especially useful in sorting out the confusion caused by the damages awarded in *Texaco*.<sup>153</sup> The Courts in *Arcadian* recognized the philosophy adopted in *Hoffman v*

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<sup>150</sup> *Id.*

<sup>151</sup> 626 F.Supp. 1229 S.D.N.Y.,(1986).

<sup>152</sup> *Reprosystem, B.V. v. SCM Corp* 727 F 2d 262(1984).

<sup>153</sup> *Texaco*, 729 S.W. 2d. at 768.

*Red Owl*<sup>154</sup> that also awarded reliance damages and out of pocket expenses. Many jurists have commended this approach<sup>155</sup>. “Out-of-pocket damages are particularly appropriate where, as may be the case here, the plaintiff cannot rationally calculate the benefit of the bargain. It is difficult to make this calculation rationally unless one can say that the defendant's failure to follow through on a promise is a ‘but-for’ cause of the loss of profits.”<sup>156</sup> Here, Arcadian's alleged failure to bargain in good faith is not a ‘but-for’ cause of API's lost profits, since even with the best faith on both sides the deal might not have been closed.<sup>157</sup>

In *Texaco*<sup>158</sup> the Courts awarded expectation damages to a party by holding that a preliminary agreement demonstrated intent to be bound and so the breaching party was liable for the profits the other party had expected to make had the deal gone through. This led to a lot of uncertainty and confusion. Then, the ruling in *Arcadian*, while protecting the reliance interest of the parties during the negotiation stage also laid down clear strategy instructing parties how to avoid the kind liability as was suffered by *Texaco*.<sup>159</sup> The key distinction drawn by *Arcadian* between contractual liability and promissory estoppel was the measure of damages. Breach of contract could lead to an award for expectations damages however, in cases of promissory estoppel the damages are confined to the extent of detrimental reliance and are limited to reliance damages. “*Arcadian* also recognized *Tribune's* requirement that

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<sup>154</sup> *Hoffman*, 26 Wis. 2d 683.

<sup>155</sup> See generally *Summers*, *supra* note 60.

<sup>156</sup> *Arcadian*, 884 F.2d at 72 Fn 2.

<sup>157</sup> *Id.*

<sup>158</sup> *Texaco*, 729 S.W.2d. at 768.

<sup>159</sup> *Arcadian*, 884 F 2d at 73.

the parties must intend to be bound before incurring liability for either out-of-pocket damages for breach of the duty to negotiate in good faith, or expectation damages when the preliminary agreement is found to be a fully enforceable contract.”<sup>160</sup>

The preliminary agreement in *Texaco* contained the general terms of the transaction, but not the details. It could be contended that the parties did not intend to be bound by the terms just that they had undertaken to negotiate the open terms in good faith.<sup>161</sup> There are some who suggest that had the Court taken this view—the result would be beneficial to all parties: Pennzoil would have been awarded its out of pocket expenses and this would have placed Pennzoil in the same position it would have been before it had entered into negotiations with Getty and Texaco would have had to pay more to acquire Getty and this way the Getty shareholders would have received a better price for their shares.<sup>162</sup>

When the parties have agreed on all negotiated terms and a preliminary agreement is entered into, the parties are bound by the terms of the contract. They expect this preliminary agreement to be treated as a contract; in such a case the adequate measure of damages would be expectation damages. Sometimes parties enter into a contract where some of the terms have been settled between the parties while the others terms are still in the process of being negotiated. Here the

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<sup>160</sup> *Id.*

<sup>161</sup> For a similar analysis see generally Harvey L. Temkin, *When Does the "Fat Lady" Sing?: An Analysis of Agreements in Principle in Corporate Acquisitions*, 15 *FORDHAM L. REV.* 125, 145 (1986)

obligation that one party owes to another is just that they would carry on all future negotiations in good faith. Some agree that they cannot renege on the terms already agreed upon. This is not a binding contract and hence the reasonable solution is to award damages on the basis of out of pocket expenses or reliance damages. In other words, expectation damages are generally awarded to a claim for a breach of contract, but here the breach is of an agreement that is not enforceable, and hence reliance damages would be more suitable.

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<sup>162</sup> Jonathan O. Hafen, *supra* note 128, at 1059

#### **IV. Characterizations of Pre-contractual Liability under Different kinds of Preliminary Agreements**

In above chapters we looked at the traditional law with regard to preliminary agreements and cases pertaining to the same. These preliminary agreements are of several types and the rights and liabilities of the parties under each are quite distinct. This was pointed out in the famous law review article by Professor Farnsworth.<sup>163</sup> By analyzing these different types of preliminary agreements we can seek to understand the scope of the duty of good faith, especially in the precontractual stage.

There are many who have called for a change in the application of the doctrine of good faith claiming that existing laws are inadequate to deal with major contractual commitments of today's world.<sup>164</sup> Alan Farnsworth eloquently argued that a creative application of the doctrine of good faith in the existing framework would resolve all disputes. He identified four regimes that parties pass through as they progress from negotiation to a final agreement.<sup>165</sup> A brief discussion of this renowned work will help us grasp the intricacies of the preliminary agreements. Farnsworth divided his theory into polar regimes and intermediate regimes and further divided these into:

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<sup>163</sup> Farnsworth, *supra* note 66.

<sup>164</sup> Juliet P. Kostritsky, *Bargaining With Uncertainty, Moral Hazard, And Sunk Costs: A Default Rule for Precontractual Negotiations*, 44 HASTINGS L.J. 621(1993); Lucian Arye Bebchuk, Omri Ben-Shahar, *Precontractual Reliance* 30 J. LEGAL STUD. 423( 2001).

“Polar regimes:

- Negotiations
- Ultimate Agreements

Intermediate Regimes:

- Agreements with Open terms
- Agreements to negotiate”<sup>166</sup>

### a) Polar Categories

**Negotiations:** Courts traditionally take a view that in the precontractual phase, the parties suffer no risk of any liability, supposing that such a view would correspond to the broad freedom of contracts. It has been generally accepted that a party who is still in the process of negotiating can break off the negotiations for any reason, be it a change in the situation or the fact the parties have changed their minds; in fact parties could break negotiations for no real reason. Farnsworth clarified that this aleatory view of negotiations was based on the premise that if parties could not break off negotiations they would be fearful of entering into any form of negotiations and this would prove to be a deterrent to trade and commerce.<sup>167</sup>

Professor Farnsworth laid down the various grounds under which courts in the US have awarded damages in the precontractual phase: Unjust enrichment resulting from the negotiations, misrepresentations made during negotiations and specific promise made

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<sup>165</sup> *Id* at 220.

<sup>166</sup> *Id.*

<sup>167</sup> *Id* at 221.

during negotiations.<sup>168</sup> We can see from this list that Courts have not made use of the breach of the duty of good faith especially in phase of negotiations as a means to award damages.

Farnsworth explained that, in case liability was based on unjust enrichment, recovery could be adequately measured by the restitution interest.<sup>169</sup> The party in the wrong is required to give back the gain he has received, putting the aggrieved party back in the position in which it would have been had there been no wrong.<sup>170</sup> However if the recovery is based on misrepresentations made during negotiations or specific promise made during negotiations, Farnsworth argued that the proper measure of damages would be reliance damages. He went on to explain how the reliance interest would be measured and the factors that would be considered when assessing reliance damages and that damages would be determined from the date of reliance.<sup>171</sup>

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<sup>168</sup> *Id* at 222.

<sup>169</sup> This measure of damages attempts to put the party in the position he would have been has the contract never been entered into.

<sup>170</sup> Farnsworth, *supra* note 66, at 223

<sup>171</sup> *Id* at 224-25.

“Recovery measured by the reliance interest may, however, differ depending on the ground on which it is based. Suppose that on Day One the parties begin negotiating, each implicitly representing that its intentions are serious. On Day Ten one party makes a specific promise, intending to keep it. On Day Twenty that party ceases to have any further interest in the negotiations, but fails to disclose this and allows the negotiations to continue. On Day Thirty the negotiations break down. Liability based on misrepresentation would be limited to reliance during the last ten days, from Day Twenty to Day Thirty, because before that there was no misrepresentation to rely on. Liability based on a specific promise would be limited to reliance during the last twenty days, from Day Ten to Day Thirty, because before that there was no specific promise to rely on. But if liability is imposed on the ground of a general obligation, it would include reliance during the entire thirty days, from Day One to Day Thirty, because the general obligation could have been relied on from the outset.”



Farnsworth asserted that since the idea of according reliance damages to parties is to place them in a position before the contract was formed- it should include lost opportunities.<sup>172</sup> However as a practical matter this interest is very difficult to be assessed. The reliance interest is generally awarded when expectation damages cannot be claimed because the expectation damages it cannot be proved with any degree of certainty. However this very reason for not being able to claim expectation interest that is lack of certainty, will make claiming lost opportunities virtually impossible. Opportunities missed and the profits that would have been earned under that transaction would probably be considered as speculative.<sup>173</sup> So as a result the aggrieved party would be able to claim only reliance expenditure<sup>174</sup> and the to that extent of lost opportunities the party would be under- compensated.

**Ultimate Agreements:** All parties to negotiations seek culmination through an ultimate agreement. This agreement is a memorial of the all the terms agreed by and between the parties. It defines the rights and liabilities of both parties. Under this regime courts have accepted that the duty good faith is inherent in every contract and breach of this duty could lead to damages. Once the agreement has been entered into, there may be a need to modify the agreement, in such a case the parties are bound to negotiate in good faith and this duty is imposed by the agreement between them.<sup>175</sup> Here the parties do not enjoy the right to withdraw from the agreement or to call off the negotiations as under

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<sup>172</sup> *Id.*

<sup>173</sup> For a similar argument see generally Gregory S. Crespi, *Recovering Pre-Contractual Expenditures as an Element of Reliance Damages*, 49 SMU L. REV. 43(1995).

<sup>174</sup> "In practice, courts employing the reliance measure generally restrict themselves to out-of-pocket losses (disregarding the concept of lost opportunity)." Mark Pettit, *Private Advantage and Public Power: Reexamining the Expectation and Reliance Interests in Contract Damages*, 38 HAST. L.J. 417, 425 (1987) .

<sup>175</sup> Farnsworth *supra* note 66 at 243, 268.

they are under the regime of negotiations.<sup>176</sup> Under an ultimate agreement, the duty of fair dealing extends only to modifications that both parties have chosen to negotiate.

Though an ultimate agreement is the goal of all negotiations, the move by itself is not as straightforward as it sounds. In fact, the parties may face a number of obstacles for example, the time required for negotiations and bargaining, which to some extent depends on the parties involved and the type of transaction.<sup>177</sup> In addition they face a number of hurdles when the transactions depends on some external event over which the parties can exert no influence and there is no way of predicting the time that would be required or the outcome of that external event.<sup>178</sup> The judicial treatment of the polar regimes has been relatively consistent. It is the intermediate regimes that have led to a lot of uncertainty and have been dealt by Courts in diverse manners.

#### **b) Intermediate Regimes**

Often parties find themselves in the intermediate regime -- where negotiations are still going on and the parties are apprehensive about the aleatory view of such negotiations. The regime of negotiations can be uncertain and most parties wish to sidestep this regime and at the same time due to lengthy negotiations it is difficult to enter into an ultimate agreement expeditiously, in such situations parties enter into preliminary agreement. These preliminary agreements have different names, including letters of intent,

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<sup>176</sup> *Id.*

<sup>177</sup> *Id* at 244-45.

<sup>178</sup> *Id.*

commitment letters, binders, agreements in principle, memoranda of understanding, and heads of agreement.<sup>179</sup>

Farnsworth divided these intermediate regimes of preliminary agreements into two groups: agreements with open terms and agreements to negotiate. Both matters shall be the discussed in this chapter.

### **(i) Agreements with Open Terms**

Professor Farnsworth described the preliminary agreement with open terms as an agreement that lays down most of the terms of the deal.<sup>180</sup> This kind of preliminary agreement may be found to constitute an actual contract, requiring both parties to conform “to their ultimate contractual objective in recognition that a contract has been reached, despite the anticipation of further formalities”.<sup>181</sup> The parties agreed to be bound by these terms; however, they also undertake to continue negotiating on other matters to reach agreement on some terms that are left open.<sup>182</sup> This kind of agreement imposes an obligation that parties attempt in good faith to settle the open terms. These terms which would be negotiated would be a part of the ultimate agreement along with the terms that they parties have already agreed upon.<sup>183</sup> Agreements with open terms are enforceable and if the parties fail to agree on the open terms due to one party’s failure to negotiate in

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<sup>179</sup> *Id* at 251-51.

<sup>180</sup> *Id* at 250.

<sup>181</sup> *Tribune*, 670 F Supp at 495-498

<sup>182</sup> *Id*. “the commitment letter did not constitute a concluded *loan agreement*, it was nonetheless a binding commitment which obligated both sides to negotiate in good faith toward a final contract conforming to the agreed terms; it thus committed both sides not to abandon the deal, nor to break it.”

<sup>183</sup> *Id*.

good faith, that party would be held liable.<sup>184</sup> On the other hand, if, even with continued negotiation by both parties, no agreement is reached on those open terms and there is no ultimate agreement, then the parties are bound by their original agreement and the other matters are governed by terms supplied by the Courts.<sup>185</sup>

The Court looks to the UCC and the RESTATEMENT to supply terms or to fill gaps in the agreement. U.C.C. § 2-309(1)<sup>186</sup> provides that in case the time for shipment or delivery has not been provided for, the Courts shall supply the missing term by construing a time that would be reasonable under the circumstances. U.C.C. § 2-305(4) facilitates the Courts in filling gaps when in a typical sale of goods transaction the price has been left open to be decided later on. § 2-305(4) provides that if intent to be bound can be established then even if the negotiations fail in that parties were unsuccessful in fixing the price, then Courts can fix a price and the only criteria that the Courts have to follow is that the price supplied by the Courts should be reasonable at the time of delivery. However for, § 2-305(4) to be applicable ‘intent to be bound’ is the deciding factor. If there is no intent, Courts cannot step in and supply terms, to make a contract.

An agreement with open terms has two consequences; first, it compels the parties who were unable to agree on open terms to be bound by the terms they had agreed upon previously and in addition, it forces the parties to negotiate in good faith the open

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<sup>184</sup> *Id.* “the express terms of this commitment letter, I conclude that it represented a binding preliminary commitment and obligated both sides to seek to conclude a final loan agreement upon the agreed terms by negotiating in good faith to resolve such additional terms as are customary in such agreements.”

<sup>185</sup> *Id.*

<sup>186</sup> U.C.C. § 2-309(1): The time of shipment or delivery or any other action under a contract if not provided in this article or agreed upon shall be reasonable time.

terms.<sup>187</sup> Under this category of preliminary agreement, greater emphasis is placed on the attempt to parley and decide on the open terms in good faith and breach of this duty is considered a legitimate reason to award damages.

An example of a preliminary agreement with open terms and the judicial treatment of the same lie in an early case by the Illinois Supreme Court in *Borg-Warner Corp. v. Anchor Coupling Co.*<sup>188</sup> Borg-Warner wished to acquire Anchor and the parties traded letters of intent defining the proposed terms of the corporate acquisition. However, the acquisition was qualified because it was conditioned upon a satisfactory survey of Anchor's assets and arrangements for continued employment of one of Anchor's directors. In reliance of these conditions, which was stipulated in the letter of intent, Borg-Warner conducted the survey on Anchor. After completing the survey, Borg-Warner agreed to the proposed sale, but one of Anchor's directors reneged because the continued employment condition had not been satisfied. Borg-Warner then sued for specific performance. The trial court dismissed the case finding that the parties had not reached a complete agreement. The Illinois Supreme Court reversed and remanded, holding that "contemplation of a future formal written contract does not preclude enforcement of a preliminary agreement containing the essential material terms. The court also stated that once the parties reach agreement on the material terms, they are obligated to attempt to settle the remaining minor details in good faith."<sup>189</sup>

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<sup>187</sup> *Id.*

<sup>188</sup> 156 N.E 2d at 513, 16 Ill.2d 234(1959).

<sup>189</sup> *Borg-Warner Corp*, 156 N.E 2d at 516-518.

Farnsworth asserted that breach of the duty of good faith could lead the aggrieved party to refuse to perform and depending on the gravity of the breach, that parties could claim expectation damages.<sup>190</sup> This view by Professor Farnsworth was adopted in the landmark case of *Texaco v. Pennzoil*,<sup>191</sup> where the Courts ruled the parties were bound by the preliminary agreement and since the one of the parties had breached the duty to negotiate in good faith and resolves the open terms, they were liable to the aggrieved party for their expectation interest. However there are some who do not agree with this view that expectation damages can be sought in such a situation. They argue that in the said case the terms, which were left open, were very important.<sup>192</sup> They maintain that the enforceability of these agreements could lead to a number of difficulties; one major problem is that is indefiniteness and the unpredictability of the terms that could be supplied by the Courts. However the bigger problem in enforcing these agreements is proving intent on the part of the parties.<sup>193</sup>

This contention that a party, aggrieved by failed negotiations to an agreement with open terms, can claim expectation interests, seems erroneous, as the purpose of awarding damages in any contract dispute is not to punish the breaching party but to compensate the injured party and this measure of expectation damages would have the effect of

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<sup>190</sup> Farnsworth, *supra* note 66, at 255

<sup>191</sup> *Texaco*, 729 S.W. 2d 768

<sup>192</sup> These terms consisted of: (1) who was to purchase the Getty Oil shares owned by the Getty Museum; (2) method of payment and price protection; (3) the details and mechanics of payment of the five dollar "stub"; (4) who would be responsible for payment of Getty Oil's dividend; (5) and whether Pennzoil would agree to honor Getty Oil's employee benefit plans. The author argues that these were essential terms and failure to agree on these principle terms would render the agreement unenforceable. *Texaco*, 729 S.W. 2d 768, 784-795.

<sup>193</sup> Farnsworth, *supra* note 66, at 256.

overcompensating the non-breaching party.<sup>194</sup> There is no proof to indicate that even if the negotiations had carried on in good faith that the parties would have reached an agreement.<sup>195</sup> The parties could have faced a genuine impasse and could have failed to reach an agreement.<sup>196</sup> In such a situation, the non-breaching party should be allowed to recover an amount that would recompense the injury it suffers by relying on the agreement to negotiate in good faith.<sup>197</sup>

In addition the assessment of damages would also depend on a number of other factors like the circumstances of the breach and the complexity and importance of the terms, which have been left open for discussion.<sup>198</sup> And, in the event of partial performance, the wronged party would be entitled to restitution if, for example, part payment had been made.<sup>199</sup>

## **(ii) Agreements to Negotiate**

This is another category that falls within the intermediate regime as described by Farnsworth. Just like in an ‘agreement with open terms’, an agreement to negotiate also contains most important substantive terms of the arrangement between the parties, however the only distinguishing feature is that in this class of agreement the parties do not intend to be bound.<sup>200</sup> This kind of preliminary agreement while not binding the parties to perform the intended objectives of the proposed contract, does obligate the

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<sup>194</sup> Temkin, *supra* note 132, at 163

<sup>195</sup> *Id.*

<sup>196</sup> *Id.*

<sup>197</sup> *Id.*

<sup>198</sup> *Id.*

<sup>199</sup> *Id.*

<sup>200</sup> Temkin, *supra* note 132, at 251

parties to negotiate the open issues in good faith in an attempt to reach the alternate objective within the agreed framework.<sup>201</sup> The parties agree to carry on the process of negotiation in order to reach an ultimate agreement. If, despite continued negotiation by both parties, ultimate agreement is not reached, the parties are not bound by any agreement.<sup>202</sup>

In case of an agreement to negotiate there is no way of knowing if the parties would have managed to reach an agreement or in case they do what would have been the terms of that agreement hence so there is no basis to support a claim for lost expectation under such an agreement.<sup>203</sup> Farnsworth asserted that generally recovery in cases of breach of an agreement to negotiate would be measured by the reliance interest but under some situations recovery measured by the restitution interest will be appropriate<sup>204</sup>. However, Farnsworth avers that since the breach is of an agreement to negotiate, the parties expectations from such an agreement is limited to the belief that the parties would indeed negotiate in good faith and hence if one party decides to withdraw from negotiations, damages assessed on the basis of reliance interest would be sufficient to remedy the wrongful withdrawal.<sup>205</sup>

A court focusing on this duty to negotiate in good faith can create a remedy focusing on the harm that the non-breaching party suffers as a result of the breaching party's

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<sup>201</sup> *Tribune*, 670 F Supp at 495-498.

<sup>202</sup> *Id.*

<sup>203</sup> *Id.* suggesting that "In some cases, however, the main terms of performance ... may have been so agreed upon ... that an expectation remedy can be computed with as much certainty as is usually required."

<sup>204</sup> Restitution interest would be apt in cases where the aggrieved party pays some amount to the other party or when it confers some benefit on the other party.



failure to negotiate in good faith. It has been suggested that Courts should view the parties to an 'agreement in principle' as entering into a contract with mutual obligations.<sup>206</sup> The purpose of this remedy is not to give the non-breaching party the benefit of the bargain. Rather, it is an attempt to return the non-breaching party, as nearly as possible, to its status quo position at the time of the agreement in principle.<sup>207</sup>

Judicial treatment of agreements to negotiate has been varied. While most Courts refuse to enforce it for want of definiteness, there are others courts that have been willing to consider parties' intention.<sup>208</sup> *Itek Corp. v. Chicago Aerial Industries*<sup>209</sup> is a leading example. There was a proposal by Aerial industries to purchase Iteks' assets, and during the course of the negotiations the parties executed a letter of intent laying down some of the terms of the sale, including a clause specifying that in case the parties fail to agree on all the terms, no liability would attach.<sup>210</sup> Aerial Industries received a better offer and so it refused to go ahead with the negotiations. Itek sued CAI, and the trial courts awarded a

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<sup>205</sup> Farnsworth, *supra* note 66, at 264

<sup>206</sup> *Id* at 164.

“Each party intends that it will withdraw from the market and not seek a better deal elsewhere. Withdrawal from the market is a prerequisite to the finding of an enforceable 'contract to negotiate.' If the parties include a 'shopping' provision in their 'agreement in principle' that allows one or both parties to remain in the market for an alternative deal, then that should reflect the parties' intent not to have forgone opportunities and not to have entered into an enforceable contract to negotiate. It is essential that the parties remain free at this stage in the transaction to conduct the negotiations along the lines that they see fit. Thus, if they intend not to be contractually obligated to negotiate in good faith and if their 'agreement in principle' indicates intent not to be bound, courts should respect that intent. “As a general principle, the non-breaching party's damages can be measured by the extent that it has been harmed by its withdrawal from the market between the time when the parties entered into the 'agreement in principle' and when the withdrawing party terminated the negotiations in bad faith. If during this period the market changed to the detriment of the non-breaching party, then the non-breaching party should be compensated to the extent of that change”

<sup>207</sup> *Id.*

<sup>208</sup> Farnsworth, *supra* note 66, at 265.

<sup>209</sup> 248 A 2d. 625 (Del 1968).

<sup>210</sup> *Id* at 627.

summary judgment for the defendant.<sup>211</sup> However the Supreme Court of Delaware reversed, reasoning that the letter in which "the parties obligated themselves to make every reasonable effort to agree upon a formal contract ... obligated each side to attempt in good faith to reach final and formal agreement."<sup>212</sup>

In *American Cyanamid Co. v. Elizabeth Arden Sales Corp*,<sup>213</sup> the plaintiff and defendant seller met to discuss the possible purchase of defendant company and entered into a preliminary agreement. Relying on the agreement, plaintiff undertook a costly, in-depth investigation of the business, finally agreeing to meet the seller's asking price. They signed a written agreement with a few open terms. Subsequently the defendants received a better offer and so they wanted to get out of the agreement with the plaintiff. They urged that upon its face the letter agreement could not be held as a binding contract because it lacked essential terms. The court held that though letter agreement did not have all the essential elements with respect to subject matter required for a contract and any omissions were not fatal to a determination that the minds of the parties had met on the essential terms of the transaction. However, Courts held that as the letter lacked mutuality of obligation and hence could not qualify as a contract. But Courts held that it would be construed as a valid offer and that it was sufficiently detailed for the acceptance to bind the parties.<sup>214</sup>

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<sup>211</sup> *Id.*

<sup>212</sup> *Itek*, 248 A 2d. at 629.

<sup>213</sup> *Id.*

<sup>214</sup> *Id.*

Though there have been courts willing to assert the enforceability of an agreement to negotiate, often Courts refuse to enforce them. This is because of a number of reasons. One important reason is Courts, in enforcing an explicit agreement to negotiate would have to speculate on the terms of the agreement and Courts are wary of any kind of speculation and in this case there is really no way of knowing what terms the parties would have agreed upon.<sup>215</sup> Another reason courts have advanced is there is no benchmark for courts to follow in determining the scope of the obligation of good faith and fair dealing under an agreement to negotiate.<sup>216</sup> The Courts have reasoned that negotiations can break of without any act of bad faith as parties can simply fail to reach an agreement on all the terms and so no loss is caused and in such a case it would be appropriate to award only expenditure of the party that relied on the negotiations.<sup>217</sup>

What is, however, perplexing about the Farnsworth classification of the intermediate regime of ‘Agreements with Open terms’ and Agreements to Negotiate’ is that in giving examples for both these categories he includes<sup>218</sup> letters of intent from the field of mergers and acquisitions. So one can conclude that in case of mergers and acquisitions a preliminary agreements could either be ‘agreements with open terms’ or they could be ‘agreements to negotiate’. He argued that it was the ‘intent to be bound’ that was to be the primary factor to determine under whether the letter of intent was an agreement with open terms or an agreement to negotiate.<sup>219</sup> In other words if intent could be proved then

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<sup>215</sup> Farnsworth, *supra* note 66, at 267.

<sup>216</sup> *Id.*

<sup>217</sup> Farnsworth, *supra* note 66, at 267 Fn. 210.

<sup>218</sup> Farnsworth, *supra* note 66, at 251.

<sup>219</sup> In case there is intent to be bound it would qualify as an agreements with open terms and in case there is no intent it would amount to an agreement to negotiate.

it would be termed as an agreement with open terms and in case no intent is established then it would qualify as an agreement to negotiate. As we have seen in the preceding paragraphs the standards of good faith applied to these types of preliminary agreements are different, hence the standard applied would primarily depend on whether parties intended to be bound.

However establishing that intent is very challenging. Courts rely on a number of factors to ascertain intent. Some Courts have stated that the relevant factors are the parties' expressed intentions, words, and deeds that constitute objective signs of their intent under the circumstances.<sup>220</sup>

Very often determining the parties' intent in any particular case often presents a difficult question of fact. This solution to the problem of determining the intent of the parties when they reach an agreement in principle can be difficult, doubtful, and unsatisfactory.<sup>221</sup> This intermediate regime as put forth by Farnsworth is inadequate especially in the field of complex commercial transaction. His classification; though helpful in categorizing the kinds of preliminary agreements, provides courts with little help when they try and fit a particular preliminary agreement in a specific category. Courts have to indulge in a fact specific inquiry that leaves room for a lot of inconsistencies and misconstruction.

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<sup>220</sup> R G Group Inc. v. Horn & Hardart Co., 751 F 2d 69, 74 -75(2d. Cir 1984).

<sup>221</sup>Mississippi & Dominion S. S. Co., v. Swift, 86 Me. 248, 259, 29 A.1063, 1067(1894) .

A better way to explain the flaw in Professor Farnsworth theory is by the use of a simple time line. If we draw a time line indicating the different stages of a contract, there is a point in time at which parties enter into negotiations which can be termed the precontractual stage, where the parties exchange a number of draft agreements on a piecemeal basis and then after concurring on all the terms the parties enter into a final agreement which is another important milestone in the time line. Once the contract has been entered into i.e. post contractual stage we can conclude that the parties have some rights and liabilities towards each other and however the problem arises when one needs to determine the scope of the rights and liabilities of the parties before the contract has been entered into, at the precontractual stage. Courts have used ‘intent to be bound’ as a gauge to ascertain whether preliminary agreements should be enforced or in other words were the parties under an obligation to negotiate in good faith.

However in the time line that is discussed above it is very difficult to exactly pin point the time when ‘intent to be bound’ comes into being. Hence it would be better if Courts would adopt a default rule, a rule that would help resolve all such disputes consistently. Such a default rule would stipulate that no legally binding agreement would exist until the negotiating parties agreed on all of the terms and signed a formal contract.<sup>222</sup>

We have seen that when courts are faced with the task of assessing damages, emphasis is placed on whether or not the preliminary agreement is binding or in other words is it a valid complete agreement in its own accord, in such a case by stipulating the bright line

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<sup>222</sup> Telemeter Corp. v. Teleprompter Corp, 592 F 2d 49 (2d. Cir. 1979).

rule, we are making sure that expectation damages would not be awarded. Expectation damages are awarded, generally for breach of contract. Hence by concluding that such preliminary agreements are not valid agreements, we can limit the damages that could be recovered. This would have a two-fold effect, while on one hand we could reduce the chances of another damaging verdict like in the Texaco case and at the same time recognize that the parties do have a duty to negotiate in good faith.

## **V. Good Faith under Civil Law Systems**

The Civil Law system of contract law concentrates mainly on the relationship between the parties rather than on a “declaration of intent or the creation of a bargain”<sup>223</sup> and therefore civil law courts accept a much broader definition of good faith and are willing to expand its scope even to the precontractual stage.<sup>224</sup> In contrast the common law systems attribute more importance to the formal requirement of contract to make it enforceable and also consider the economic significance of the contract.<sup>225</sup> Hence the Courts in civil law countries recognize a duty of good faith in both precontractual and contractual situations.<sup>226</sup> In a Civil Law context, a contract is a legally enforceable obligation and these obligations can be of different forms. They can be based on a contract or they could be based on a tort. Obligation under the civil law is similar to the obligation as understood under common law.<sup>227</sup> Although most civil law systems generally recognize and enforce a duty of good faith negotiation, the principal justification behind this duty differs.

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<sup>223</sup>These form the basis for contract law under the common law system. Nadia E. Nedzel, *A Comparative Study Of Good Faith, Fair Dealing and Precontractual Liability*. 12 TUL. EUR. & CIV. L.F. 97 (1997) (citing Yoav Ben-Dror, *The Perennial Ambiguity of Culpa in Contrahendo*, 27 AM. J. L. HIST. 148,148 (1983)) [ Hereinafter Yoav Ben Dror].

<sup>224</sup> Paul J. Powers, *Defining the Undefinable: Good Faith and the United Nations Convention on the Contracts for the International Sale of Goods* 18 J.L. & COM. 333, at 336 (1999).

<sup>225</sup>John Klein & Carla Bachechi, *Precontractual Liability and the Duty of Good Faith Negotiation in International Transactions*, 17 HOUS J INT’L L 1, 17 (1994).

<sup>226</sup> William T. Tete, *Tort Roots and Ramifications of the Obligations Revision*, 32 LOY. L. REV. 47, 56 (1986). In comparison, in large parts the common law countries limits its application of the duty of good faith to contract formation and contract enforcement.

<sup>227</sup> CODE CIVIL [C.CIV.] ART. 1756 (Fr.) “an obligation is a legal relationship whereby a person, called the obligor, is bound to render a performance in favor of another, called the obligee. Performance may consist of giving, doing, or not doing something.”

Jhering first recognized this duty of good faith in the precontractual stage in his famous article called “Culpa in Contrahendo” published in 1861. The impact of this article has been wide. When asked about precontractual liability and the duty of good faith and fair dealing in civilian jurisdictions, comparatists and jurist immediately refer to Jhering's concept of culpa in contrahendo.<sup>228</sup> Jhering advanced the thesis that where due to the culpable conduct of one the party the consummation of a contract is thwarted then the aggrieved party should be accorded some protection under law and the culpable party would be liable for “negligently creating the expectation that a contract would be forthcoming although he knows or should know that the expectation cannot be realized.”<sup>229</sup> The gist of the doctrine is that once parties enter negotiations for a contract, a relationship of trust and confidence is formed between the parties. This relationship exists whether or not the relationship culminates in an agreement; so consequently, this doctrine advocates protection against the wrongful act of the other party that resulted in the failure of negotiations. It also advocates that if a party had no intention of entering into a contract but he induced the other party to believe that a contract was imminent he would be liable for his acts.

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<sup>228</sup> Friedrich Kessler & Edith Fine, *Culpa in Contrahendo, Bargaining in Good Faith and Freedom of Contract: A Comparative Study*, 77 HARV. L. REV. 401 (1964) [hereinafter Kessler & Fine]; Steven A. Mirmina, *A Comparative Survey of Culpa in Contrahendo, Focusing on Its Origins in Roman, German, and French Law as well as its Application in American Law*, 8 CONN. J. INT'L L. 77 (1992). [Hereinafter Steven A. Mirmina].

<sup>229</sup> 4 JAHRBUCHER FÜR DIE DOGMATIK DES HEUTIGEN RÖMISCHEN UND DEUTSCHEN PRIVATRECHTS 1 (1861), reprinted in 1 VON JHERING, GESAMMELTE AUFSATZE 327 (1881). As cited in Kessler & Fine *supra* note 223. He posited “that damages should be recoverable against the party whose blameworthy conduct during negotiations for a contract brought about its invalidity or prevented its perfection.”



Before this doctrine was put forth by Jhering, courts in Germany tended to follow the black letter law of the German civil codes very meticulously without any room for interpretation. Jhering believed that this rigid construction worked against the interest of justice and he attempted to fill this gap in German law through his doctrine.<sup>230</sup> His discussion contained two lines of thought, which greatly influenced civilian legal systems: (1) liability for fault (*culpa*) in contracting, and (2) classification of damages into positive and negative damages.<sup>231</sup>

Jhering advocated that a promise in a contract gave rise to a positive and a negative interest; a positive interest being one that is achieved when the contract is fully performed and so damages for the positive interest would be the difference between the position the aggrieved party would have been had the contract been fully performed and the position he is in now due to the failure of the other party to perform or failure to perform according to the terms of the contract.<sup>232</sup> This bears close resemblance to the expectation damages awarded by Courts in Common law systems. Jhering however also defined negative interest as the difference in position between never having entered the negotiations and the present position of the party, due to failure of the parties to negotiate in good faith.<sup>233</sup> Even this negative interest has its counterpart in common law system in reliance damages. But Jhering classification of negative and positive interest were with specific regard to precontractual stage and though these principles of calculating damages are recognized even in Common law countries its ambit does not always extend to the

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<sup>230</sup> Steven A. Mirmina, *supra* note 221, at 79.

<sup>231</sup> *Id.* at 145 .

<sup>232</sup> Yoav Ben Dror, *supra* note 218.

<sup>233</sup> *Id.*

precontractual stage. The framers of the German Civil Code were greatly influenced by Jhering's theory and they incorporated this theory into the German Civil Code.<sup>234</sup> They categorized this duty to negotiate in good faith strictly, failure of which, could lead to liability.<sup>235</sup> The code specified that to obtain the benefit of this section the innocent must establish detrimental reliance.<sup>236</sup> Measurement of damages (the negative interest) would rely on principles of tort.<sup>237</sup>

This doctrine has had profound effect on the laws of a number of European nations. However, this doctrine had its most distinct effect on the Italian laws. The new Italian Civil Code of 1942 has introduced two provisions codifying the doctrine. The Italian Civil code lays down a standard of good faith as the foundation for behavior of the parties to a contract during negotiations.<sup>238</sup> Article 1337 contains an express provision imposing a responsibility precontrattuale in accordance with the principles of good faith i.e. that the parties in the process of negotiations must behave in accordance with good faith.<sup>239</sup> Article 1338 of the Italian Civil Code prescribes that a party who, when entering into the

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<sup>234</sup> § 307 of the German Civil Code: If a person, in concluding a contract, the performance of which is impossible, knew or should have known that it was impossible, he is obliged to make compensation for any damage which the other party has sustained by relying upon the validity of the contract; not, however, beyond the value of the interest which the other party has in the validity of the contract. The duty to make compensation does not arise if the other party knew or should have known of the impossibility.

<sup>235</sup> Yoav Ben-Dror *supra* note 218 at 142, 193.

<sup>236</sup> *Id.*

<sup>237</sup> *Id.*

<sup>238</sup> The parties must deal in the precontractual phase with "a sense of probity ... having always in mind the purpose which the contract is intended to satisfy, the harmony of the interests of the parties, and the superior interests of the nation requiring productive cooperation." . " Relazione al codice civile, n. 638, cited in Angelo De Martini & Giovanni Ruoppolo, RASSEGNA DI GIURISPRUDENZA SUL CODICE CIVILE, IV.2, Milano, 1972, 169 seq, at 170 [hereinafter De Martini & Ruoppolo] (as cited in Nicola W. Palmieri, *supra* note 62 at 202.)

<sup>239</sup> Nicola W. Palmieri, *supra* note 62 at 202 (citing a few books and treatises and articles on the subject: LUCA NANNI, LA BUONA FEDE CONTRATTUALE, Padova, 1-143,(1988); *See also* VINCENZO CUFFARO, voce "RESPONSABILITA' PRECONTRATTUALE" IN ENCICLOPEDIA DEL DIRITTO, XXXIX, Milano, 1265 seq.(1988); FRANCESCO BENATTI, LA RESPONSABILITA' PRECONTRATTUALE, Milano, 1963.

contract, knew or should have known of its invalidity must reimburse the other party who innocently relied on its validity.<sup>240</sup> The liability here could be calculated to include expenses and time lost in the negotiations and even lost opportunities. This obligation of good faith has also been recognized by the Highest Court in Italy, Corte di Cassazione, who expanded this duty to even include lack of openness or even mere negligence and silence leading to reliance by the other party.<sup>241</sup>

However, this doctrine has not found much following in France. The French understanding of this concept of good faith to a certain extent reflects the definition of Prof Summers that good faith and fair dealing is an excluder<sup>242</sup>. The French system also based this duty of good faith especially in the precontractual stage on the basis that one must not negotiate in bad faith, which by implication requires good faith during negotiations.<sup>243</sup> French law bases its duty of good faith on the general tort principle that one is obligated to mend the damage caused by one's act or failure to act.<sup>244</sup> However in order to succeed on a claim for damages for failing to negotiate in good faith the general

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<sup>240</sup> Here the parties believe that there is a valid contract, however it is unenforceable because of an illegality, like misrepresentation or failure to reveal vital information, which is known only to one party and. De Martini & Ruoppolo *supra* note 232 Relazione al codice civile, n. 638 "In the precontractual phase, the breach of this duty leads to a liability in contrahendo when one party knows of, but does not reveal to the other, the existence of a cause of invalidity of the contract."

<sup>241</sup> "The need for good faith, taken in its ethical sense, constitutes one of the hinges of the legal discipline of obligations and establishes a legal duty in the true sense of the word ... which is violated not only if one of the parties has acted maliciously to the other party's detriment, but also when the conduct of said party was not guided by openness, diligent fairness, and a sense of social solidarity, which are integral parts of good faith; thus, even if the result of mere negligence, or even silence ... constitute a transgression of the duty of good faith if suitable to induce reasonable reliance in the other party...." Cass. 27.10.1961, n. 2425, Foro it. rep., 1961, voce "Obblig. e contr.," n. 138 (emphasis added). See also Cass. 29.2.1960, n. 387, Foro it. rep., 1960, voce "Obblig. e contr.," n. 114 as cited Nicola W. Palmieri, *supra* note 62, at 70.

<sup>242</sup> Summers, *supra* note 6, at 228 (1968). "Good faith and Fair Dealing excludes certain bad faith behavior".

<sup>243</sup> Nadia E. Nedzel, *A Comparative Study of Good Faith, Fair Dealing, and Precontractual Liability*, 12 TUL. EUR. & CIV. L.F. 97 at 114 (1997).

<sup>244</sup> Nadia E. Nedzel, *supra* note 238, at 115.

requirements of tort must be satisfied: a) causation – ‘but-for’ the act (or failure to act) of one party the loss would not been incurred b) the damages could be calculated with certainty and c) that the parties have not yet been compensated.<sup>245</sup>

In French usage, bad faith consists of any behavior that deceives the other party, including breach of negotiations when the other party reasonably expected the contract to be concluded;<sup>246</sup> refusal to renew a contract when the other party reasonably relied on a promise to renew;<sup>247</sup> disclosure of information the other party expected to be kept confidential;<sup>248</sup> and misrepresentation about the elements of a negotiated contract (though misrepresentation is usually dealt with as fraud, rather than bad faith).<sup>249</sup>

The French Civil System accepts ‘consent’ between the parties to be the primary element of any contract and hence is more receptive to a precontractual agreement to be a valid contract, if there is proof that the contract in question related to a specific obligation.<sup>250</sup> Even in France precontractual agreements fall into several categories, however the classification is based on the type of obligation created.<sup>251</sup> When the French Court awards damages they restrict recoveries to loss of time spent negotiating and

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<sup>245</sup> *Id* at 115-116.

<sup>246</sup> Nadia E. Nedzel, *supra* note 238, at 115 (citing Joanna Schmidt-Szalewski, France, in Formation of Contracts and Precontractual Liability 86-95(1991)( [ hereinafter Schmidt-Szalewski]).

<sup>247</sup> *Id* at 115 (citing Cass. Com. Feb. 9, 1981).

<sup>248</sup> *Id* (citing Cass. Com., Oct. 3, 1978).

<sup>249</sup> Schmidt-Szalewski, *supra* note 242, at 96

<sup>250</sup> *Id* at 126. Joanna Schmidt-Szalewski, reporting for France in Precontractual Liability: Reports to the XIIIth Congress International Academy of Comparative Law, Montreal, Canada, 18-24 Aug 1990 at 153. “The French system believes that duty of good faith in the context of a preliminary agreement depends on the nature of that agreement. If the agreement contains specific obligations, then the contractual duty of good faith is attendant to the performance of those obligations.”

<sup>251</sup> *Id*.

money spent in reliance that the negotiations would culminate into a contract.<sup>252</sup> The compensation for "missed benefits" is limited, though some damage may be compensable under a "loss of a chance" to conclude the contract and make benefits.<sup>253</sup> Courts tend to refuse to award expectation damages when negotiations fail as they feel it would require them to speculate about the terms of the contract, which was never really entered into by the parties due to the failure in negotiations.<sup>254</sup> Courts in France have the 'sovereign discretion' to award damages and Judges have a propensity to award a lump sum without providing parties with an details as to how it arrived at that conclusion.<sup>255</sup>

The primary point of divergence between the civil and common law approaches to good faith negotiation stems from certain fundamental differences between their general philosophies of contract law. The concept of good faith, in the civil law systems, is firmly entrenched in the public policy and as a result this doctrine is considered more encompassing of whole process of contract formation. As a result, the courts in civil law jurisdictions are more likely to declare the parties legally bound at an earlier stage of the negotiation process than courts in common law countries.<sup>256</sup> On the other hand, common law systems are inclined to focus on the intent of the parties and base their decision on all such factors that would indicate the intent of the parties.

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<sup>252</sup> Nadia E. Nedzel, *supra* note 238, at 149 (citing Schmidt-Szalewski, *supra* note 242, at 96).

<sup>253</sup> *Id.*

<sup>254</sup> *Id.*

<sup>255</sup> *Id.* Here we see the similarity between some civil law countries; the German Courts in this regard also try and asses damages for precontractual liability on the basis of what we can term reliance interest or restitution interest and restrict expectation damages only assessing the positive interest in the contract.

<sup>256</sup> John Klein & Carla Bachechi, *supra* note 221, at 17 (citing Ralph B. Lake, *Letters of Intent: A Comparative Examination Under English, U.S., French, and West German Law*, 18 GEO. WASH. J. INT'L L. & ECON. 331, 352 (1984)).

Pennzoil claim could have been a two fold one for the breach of the preliminary agreement and other for the breach of duty of good faith.<sup>257</sup> Pennzoil's could have sued Getty interest in US, but it chose to sue Texaco for tactical reason. Professor Farnsworth made an interesting comparison by hypothesizing about the decision in Texaco<sup>258</sup> in a European civil law system. Some jurisdictions in Civil Law countries in such a case would award expectation damages but most would probably award only reliance damages but no punitive damages could have been awarded.<sup>259</sup> Thus Farnsworth contended that had the case been heard under the civil law systems- the decisions would have been more efficient and worked towards the benefits of all parties. He claimed that, "Damages for breach of a court-imposed duty of good faith would have been far more modest -- Pennzoil's out of pocket expenses in negotiating and perhaps some allowance for lost opportunities. Thus, it would have been possible to give Pennzoil adequate relief without going to the extreme of the actual verdict upheld by the Texas courts."<sup>260</sup>

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<sup>257</sup> E.Allan Farnsworth, *Developments In Contract Law During the 1980's: The Top Ten*, 41 CASE W. RES. L. REV. 203 at 211 (1990).

<sup>258</sup> *Texaco*, 729 S.W. 2d. 768 (Tex. Ct. App. 1987).

<sup>259</sup> *Id.*

<sup>260</sup> *Id* at 211.

## **VI. Good Faith Obligation- International Perspective.**

**UNIDROIT Principles:** In the early 1930s, the International Institute<sup>261</sup> for the Unification of Private Law (UNIDROIT) organized a group of European scholars to draft a document to govern international transactions and, in so doing; set in motion the prospect of achieving a uniform set of laws for the international sale of goods.<sup>262</sup> The UNIDROIT Principles were created in order to address deficiencies in modern international trade law.<sup>263</sup> These principles have no binding force and have only persuasive value.<sup>264</sup> They are similar to a "restatement for international commercial transactions".<sup>265</sup>

UNIDROIT principles reflect the concept of good faith in several articles. The Principles' main provisions on good faith are found in Articles 1.7 and 2.15. "Article 1.7 states that "each party must act in accordance with good faith and fair dealing in international trade," and "the parties may not exclude or limit this duty." Article 2.15 provides:

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<sup>261</sup>This Institute is an independent intergovernmental organization whose purpose is to examine ways of harmonizing and coordinating the private laws of various countries and to prepare for the adoption of uniform rules of private laws by those countries.

<sup>262</sup>JOHN HONNOLD, UNIFORM LAW FOR INTERNATIONAL SALES UNDER THE 1980 UNITED NATIONS CONVENTION 49 (1991). [Hereinafter HONNOLD].

<sup>263</sup>Michael Joachim Bonell, *The Unidroit Principles of International Commercial Contracts: Why? What? How?* 69 TUL. L. REV. 1121, 1123 (1995).

<sup>264</sup>Joseph M. Perillo, *Unidroit Principles of International Commercial Contracts: The Black Letter Text and a Review*, 63 FORDHAM L. REV. 281, 283 (1994).

<sup>265</sup>*Id.*

“(1) A party is free to negotiate and is not liable for failure to reach an agreement. (2) However, a party who negotiates or breaks off negotiations in bad faith is liable for the losses caused to the other party. (3) It is bad faith, in particular, for a party to enter into or continue negotiations intending not to reach an agreement with the other party.”

The principles also recognize the doctrine of good faith even in the negotiation stage of contracts; "a party who negotiates or breaks off negotiations in bad faith is liable for the losses caused to the other party."<sup>266</sup> These principles do recognize the freedom of contract but, this is not an absolute freedom and Article 2.5 attempts to provide a balance between that freedom and a duty to negotiate in good faith.<sup>267</sup> In addition, several other articles incorporate the concepts of good faith, fair dealing, or some variation thereof. Article 4.8 states that good faith and fair dealing should be considered when an otherwise omitted contractual term must be supplied."<sup>268</sup>

**Scope of Precontractual Liability:** The UNIDROIT explicitly recognizes a duty of good faith. But the only drawback is that these principles have no binding effect and as a result it does not have the same force as other provisions of the international conventions.<sup>269</sup> However these principles can be incorporated into a contract and then

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<sup>266</sup> UNIDROIT Principles *supra* note 251 at art. 2.5.

<sup>267</sup> Nadia E. Nedzel, *supra* note 238, at 153.

<sup>268</sup> International Institute For The Unification Of Private Law, Principles Of International Commercial Contracts - Art 1.7, Art. 2.5 and Art 4.8 (1994) [hereinafter UNIDROIT PRINCIPLES].

<sup>269</sup> Alejandro M. Garro, *The Gap-Filling Role of the UNIDROIT Principles in International Sales Law: Some Comments on the Interplay Between the Principles and the CISG*, 69 TUL. L. REV. 1149, 1164-65 (1995).



failure to follow these principles would lead to damages for breach of contract.<sup>270</sup> Another way these principles are actually applied are when an arbitrator or a judge looking for a rule to fill a gap encountered in the regulation of a given international commercial contract and they find that these UNIDROIT principles provide the required rule to interpret a contract or help fill the gaps in the contract.<sup>271</sup> Moreover, if the rules of conflict of laws point to a State whose law is ambiguous or undeveloped the judges could refer to these principles for a neutral resource to apply.<sup>272</sup> “Even if these two former requirements are met, the UNIDROIT Principles will apply only to the extent that autonomy permits the parties to displace the otherwise applicable non-mandatory municipal law.”<sup>273</sup> The UNIDROIT principles are general principles and hence work best when applied to a particular provision of any international contract or to supplement or to complement and add to a particular domestic law or international instrument governing that transaction.<sup>274</sup>

**Vienna Convention:** On April 11<sup>th</sup>, 1980, a United Nations conference held in Vienna adopted the Convention on the International Sale of Goods. This came to be known as CISG and it became effective only in 1988.<sup>275</sup> The phrase "good faith" generated considerable controversy during the drafting of the Convention. One group of delegates

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<sup>270</sup> UNIDROIT Principles, *supra* note 251, at art. 1.4. ("Nothing in these Principles shall restrict the application of mandatory rules, whether of national, international or *supranational* origin, which are applicable in accordance with the relevant rules of private international law."). The Comments make clear that mandatory rules of law preempt the application of the UNIDROIT Principles regardless of whether they are incorporated in the contract or are applied as the law governing the contract.

<sup>271</sup> *Id.*

<sup>272</sup> Joseph M. Perillo, *Unidroit Principles of International Commercial Contracts: The Black Letter Text and a Review*, 63 *FORDHAM L REV* 281 at 283 (1994).

<sup>273</sup> *Id.*

<sup>274</sup> *Id.*

advocated that the doctrine of good faith is implicit in every contract and hence should be included in CISG, while another group of delegates argued that this doctrine had no precise definition and hence would have to be applied subjectively and this would lead to a lot of uncertainty and unpredictability.<sup>276</sup> It was also further argued by them that the lack of a clear definition of this doctrine would leave the Judges and arbitrators with no specific rules to guide them.<sup>277</sup> The delegates finally compromised and agreed to impose a general duty of good faith in the interpretation and application of the provisions of the Convention.<sup>278</sup>

Article 7(1) provides that “In the interpretation of this Convention, regard is to be had to its international character and to the need to promote uniformity in its application and the observance of good faith in international trade.”<sup>279</sup> It has been submitted that there are three alternative ways in which Art. 7(1) can be interpreted.<sup>280</sup> Depending on the interpretation of Art 7(1) the ambit of the duty of good faith would vary, each nation would interpret this doctrine in its own way. The Civil law countries would be more open to accept this doctrine in every phase of the contract, whereas Common law countries would be reluctant to do so. As a result there would be no uniformity.

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<sup>275</sup> Final Act of the United Nations Conference on Contracts for the International Sale of Goods, U.N. Doc. A/Conf. 97/18, Annex I (1981) [hereinafter Vienna Sales Convention].

<sup>276</sup> *Id* at 146.

<sup>277</sup> *Id*.

<sup>278</sup> This is the gist of *Article 7(1)*. United Nations Conventions on Contracts for International Sale of Goods (hereinafter CISG) reprinted in 19 I.L.M 668 (1989); Final Act of the United Nations Conference on Contracts for International Sale of Goods, U.N. Doc. A/Conf. 97/18, Annex 1 (1981).

<sup>279</sup> *Id* article 7(1).

<sup>280</sup> E Allan Farnsworth, *Duties of Good Faith and Fair Dealing under UNIDROIT Principles, Relevant International Conventions, and National Laws*, 3 TUL. J. INT’L & COMP. L 47 at 56 (1995) [Hereinafter Farnsworth –International Conventions].

As discussed above Art 7(1) can be interpreted in three ways: under the first interpretation the Convention could be construed literally to mean that the duty of good faith cannot be gleaned from the general principles of the Convention, and then recourse would have to be had to the rules of private international law, such as conflicts laws.<sup>281</sup> One case governed by the Convention involved a contract for the sale of automobiles between a German seller and an Italian buyer.<sup>282</sup> The parties did not fix a specific delivery date. When the seller informed the buyer that the goods were ready for delivery, the buyer refused to accept delivery.<sup>283</sup> The buyer then claimed that there was a breach as the seller failed to deliver the cars when it was required by the buyer and this failure by the seller to deliver the right gave him a right to avoid the contract. Since the parties had not stipulated a particular delivery date, the Courts in Germany had to rely on the principles of good faith under the rules of its private international law and they found that to allow the buyer, over two years later, to declare the contract avoided, would violate the principle of good faith. Though the Courts in this case did not expressly refer to Article 7 of the Convention, the decision captured the spirit of the duty of good faith embodied in Article 7(1) of the Convention.<sup>284</sup> It could be speculated that this case would have had the same result even in a Common Law system. This is because the Common law system recognizes that the duty of good faith is implicit in every contract and in this case allowing the buyer to avoid the contract would violate the doctrine of good faith and fair

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<sup>281</sup> *Id* at 56.

<sup>282</sup> OLG [Provincial Court of Appeal] Feb. 8, 1995, [F.R.G.], abstract reprinted in *Unilex: International Case Law & Bibliography on the U.N. Convention on Contracts for the International Sale of Goods* (Michael J. Bonell Et Al. Eds., 1996)[ hereinafter *Unilex*].

<sup>283</sup> *Id.*

<sup>284</sup> *Id.*

dealing. Courts have frequently frowned upon a behavior whereby one party uses its position or a gap in the contract to gain an unfair advantage over the other.<sup>285</sup>

“This article could also be interpreted not too literally but to interpret it in such a way as to be able to extract a duty of good faith from the general principles of the conventions.”<sup>286</sup> In that event, the parties would be held to that duty, within whatever form a court regards to be warranted by the Convention under the circumstances.<sup>287</sup>

There are a few cases that suggest that Courts are willing to accept this interpretation of Art. 7(1). The French case *SARL Bri Production "Bonaventure" v. Societe Pan African Export*<sup>288</sup> also indicates that national courts are reading a general provision of good faith into the Convention. In other words, Courts were willing to accept the tenet of CISG that regard is to be given to the observance of good faith in international trade. In the said case, a buyer from the United States sued a French seller in a French court of Appeals for breach of contract. The parties had agreed that the products would be resold to a South American distributor but instead of doing that the buyer began to resell to a distributor in Spain. The buyer later misrepresented this fact to the seller. When the seller discovered that some of the goods had been sold in Spain, he refused to deliver the final installments. The buyer sued for breach of contract and the seller counter-sued claiming misrepresentation and that sale by buyer in Spain was affecting its sales in Spain. The

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<sup>285</sup>“Even where one party retains, by virtue of the contract, a right of approval or disapproval or a discretionary power over the rights of the other, such powers must be exercised "within the parameters of the duty of good faith .” Larwin –Southern California, Inc. v. JGB Investment Co., 101 Cal App. 3d. 626, 639-40, 162 Cal. Rptr 52, 59 (1979)

<sup>286</sup> Farnsworth – International Conventions, *supra* note 271, at 56

<sup>287</sup> *Id.*

<sup>288</sup> CA Grenoble, February 22, 1995, reprinted in UNILEX, D.1995-7 (1995).

court held that the case was governed by the Convention. In making its decision in favor of the seller, the court relied on Article 7(1). The court found that the buyer's actions were inconsistent with the principle of good faith in international commerce as decreed by Article 7(1) of the Convention. Here the Courts interpreted the duty of good faith from Article 7(1) from the convention and extended it to apply to the parties. "Because Article 7(1) includes a general provision of good- faith in interpreting the Convention, good faith may appear to be one of the "general principles" underlying the Convention as a whole and courts may, under this interpretation, hold parties to that duty."<sup>289</sup> There has been some arbitration decisions too that have relied on Art 7 to include good faith as a general principle of the CISG.

Thirdly, Article 7(1) may be read very broadly. The provision that requires the interpreting court to consider the observance of good faith might instead be read to impose that same duty on the parties.<sup>290</sup>

However most of these cases have been decided in civil law jurisdictions and civil law systems have been traditionally more inclined towards recognizing an implied duty of good faith. And it cannot be determined from these cases whether the Courts will consistently incorporate a duty of good faith upon contracting parties.<sup>291</sup>

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<sup>289</sup> Farnsworth –International Conventions, *supra* note 271, at 56-57.

<sup>290</sup> Farnsworth –International Conventions, *supra* note 271, at 56.

<sup>291</sup> Diane Madeline Goderre, *INTERNATIONAL NEGOTIATIONS GONE SOUR: PRECONTRACTUAL LIABILITY UNDER THE UNITED NATIONS SALES CONVENTION*, 66 U. CIN. L. REV. 257 at 278 (1997).

**Precontractual Liability under CISG:** The essential problem is that although the goal of the Convention was to promote uniformity, no provision of the Convention expressly addresses the issue of precontractual liability and as a result, potentially differing decisions would result in various countries. If courts find that a particular area of law is unsettled or not addressed under the Convention, they are to base their decisions upon the general principles of the Convention or, in the absence of applicable general principles, may apply local law to supplement the existing Convention provisions.<sup>292</sup> Consequently, the same case in different jurisdictions could lead to the very diverse results, as each country would apply its standards of precontractual duty of good faith. This could lead to uncertainty and unpredictability and the basic objective of CISG to promote uniformity would be lost. Further this uncertainty could serve as a deterrent to cross border transactions.

The CISG failed in its attempt to integrate the doctrine of good faith in its rules. In attempt to keep this doctrine of good faith, which the drafters believed to be vague out of the CISG, they much unpredictability. The Courts are unsure about the ambit and scope of this doctrine under the CISG, and this fact is leading to inconsistent decisions. The only article the Courts could refer to and rely on in cases of negotiations is Art. 8, which provides: "In determining the intent of a party or the understanding a reasonable person would have had, due consideration is to be given to all relevant circumstances of the case including the negotiations, any practices which the parties have established between

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<sup>292</sup> CISG, *supra* Note 274, article 7(2) states: "Questions concerning matters governed by this Convention which are not expressly settled in it are to be settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the law applicable by virtue of the rules of private international law".

themselves, usages and any subsequent conduct of the parties." <sup>293</sup> These are some provisions that have been incorporated in the comments to the UCC<sup>294</sup> and that are used by the Courts in the US to determine intent. These provisions thus could be looked to by International Courts.<sup>295</sup>

To be sure, the doctrine of good faith is hard to define, and most jurisdictions do not have a functional definition of this term. Rather they rely on the Courts to interpret the meaning of good faith on a case by case basis nonetheless the drafters of CISG should have imposed this duty on parties to the convention and let the case law develop.<sup>296</sup>

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<sup>293</sup> CISG, *supra* note 274, at art. 8(3).

<sup>294</sup> RESTATEMENT, at § 27-comment c.

<sup>295</sup> Diane Madeline Goderre, *supra* note 287, at 279 (1997).

<sup>296</sup> *Id* at 278.

## **VII. Conclusion**

### **a) Bright Line Rule**

Laws, in general, have to be uniformly applied in order to achieve fairness and to encourage people to plan and be confident that their interests will be protected. For any legal system to work, it is important that people should believe that the laws would be applied objectively and impartially. Thus uniform application of the laws will encourage competition and promote trust in the legal system. As we have seen in the earlier chapters, there is an about the elusiveness to the concept of good faith, especially in the precontractual phase. We have seen especially in cases involving preliminary agreements how difficult it is to identify the rights and liabilities of the parties involved, and this fact makes it particularly difficult to determine the standard of good faith applicable in such situations. In addition, it not easy to assess damages in bad faith a situations.

The previous chapters have confirmed that Courts often use ‘intent to be bound’ as a yardstick to permit the enforceability of preliminary agreements. And we have observed how fact specific that inquiry can be and how cases with similar facts have generated different results in different jurisdictions depending on the emphasis placed on particular facts. In such a situation, law loses its effectiveness and becomes unpredictable. The best solution to this problem would be follow a bright line approach, or in other words, a default rule that no contract would exist prior to the execution of a formal agreement.<sup>297</sup>

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<sup>297</sup> Telemeter Corp v. Teleprompter Corp., 592 F 2d. 49, 57-58(2d Cir. 1979). This rule was first stated by Judge Friendly. “Under a view conforming to the realities of business life, there would be no contract in



At the least this might apply to complex business deal. This would mean there would be there would be no legally binding agreement between the parties unless all the terms have been agreed upon and the agreement has been formally executed. This way the parties could be sure when the agreements would be validly enforceable.

However, the Courts do not recognize this bright line rule. They prefer to focus on the ‘intent to be bound’ by the parties. The Courts have always struggled to find evidence that parties intended to be bound by the precontractual agreement. It would be helpful to review some of factors considered by Courts, to understand the complexity of the task faced by Courts. Such a case-by-case analysis leaves no room for the doctrine of ‘stare decisis’<sup>298</sup>, to develop and this lead to a number of inconsistent decisions. Courts scrutinize a plethora of factors before considering the finality or the validity of the preliminary agreement. Among the factors considered are:

(i) The language of the agreement: This factor provides some indication whether the parties intended to be bound or whether they reserved the right to be bound only after the final agreement was executed. Courts often look to the agreement in dispute to determine the intent of the parties and have held that, despite an agreement on all essential terms, since the parties did not agree to be bound prior to the signing of the formal document there is no contract.<sup>299</sup> On the other hand, Courts also have held that if the parties agreed

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[complex business agreements] until the document is signed and delivered; until then either party would be free to bring up new points of form or substance, or even to withdraw altogether.”

<sup>298</sup> “This is the doctrine of precedent, under which, it is necessary for the Courts to follow earlier judicial decisions when the same points arise in litigation.” BRYAN A. GARNIER, BLACK’S LAW DICTIONARY, Seventh Edition, 1414 (1999).

<sup>299</sup> R.G Group, Inc v Horn & Hardart Co., 751 F2d 69, 74 (2d Cir. 1984).

on all of the substantial terms of the contract with nothing left for future settlement, then an informal agreement was binding as long as the parties understood that the agreement was binding even without writing. The court stated the rule as follows: “Where there is no understanding that an agreement should not be binding until reduced to writing and formally executed, and ‘where all the substantial terms of a contract have been agreed on, and there is nothing left for future settlement,’ then an informal agreement can be binding even though the parties contemplate memorializing their contract in a formal document.”<sup>300</sup> The Courts tend to look at the when, during the process of the negotiations did the parties intend to be bound.<sup>301</sup>

(ii) The existence of open terms: Courts also look at the significance of the terms that have yet to be resolved. The numerous open terms indicate a lack of intention on either side to be bound.<sup>302</sup> “If the issue is whether the parties have reached final agreement requiring only formal memorialization, the recognized existence of open terms may be a strong indication that they have not. If, on the other hand, as here, the question is whether a preliminary expression of commitment was intended to bind the parties to negotiate the open terms in good faith, the mere fact of the existence of open terms is, of course, far less persuasive. Although the existence of open terms may always be a factor that suggests intention not to be bound, it is by no means conclusive.”<sup>303</sup> Here we the Court indulges in the consideration of a factor that it takes into account but lessens its impact but finally concluding that it is not conclusive.

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<sup>300</sup> *Id* at 74.

<sup>301</sup> A CORBIN, CORBIN ON CONTRACTS (1963) § 30 98-99.

<sup>302</sup> *Winston v. Mediafare Entertainment Corp* 777 F.2d 78 C.A.2 (N.Y.,1985).

<sup>303</sup> *Tribune Co*, 670 F Supp at 499, 502 “To consider the existence of open terms as fatal would be to rule, in effect, that preliminary binding commitments cannot be enforced. That is not the law.”

(iii) The kind of parties involved: Courts have also been influenced by the kind of parties involved.<sup>304</sup> If the Courts believe the parties were experienced, courts would be more willing to make the assumption that in case of complicated deal they would have planned to enter into a formal agreement at a later date.<sup>305</sup> Here we see the courts also look at the experience of the parties involved in order to determine their intent. This is another situation where the perception of the Courts about the experience parties could be incorrect.

(iv) The context of the negotiations: Courts often look into the context of the negotiations and if that changes fundamentally, Courts have held that a party may cease to negotiate. However, it would have to be an underlying change, a change on which the transaction would depend on and not a change in market condition or interest rates.<sup>306</sup> Here again the facts of each case and circumstances that surround them would essential factor that would govern the way the Courts would decide on matter.

(v) Partial performance: Courts tend to focus on this issue. It does to some extent support the inference that partial performance took place because the parties believe that they were bound by the preliminary agreement. But there are some courts, that have ruled that partial performance takes place to act as an incentive for the other party to enter into the agreement, and not so much because the party believes that commitment has been entered into.<sup>307</sup>

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<sup>304</sup> *Stanton v. Dennis* 64 Wash 85, 89; 116 P. 650 Wash. 651( 1911).

<sup>305</sup> *Id* at 89 “Both parties were men of ability and experience, and it would hardly seem that if they intended this writing to be a complete contract between them they would solemnly provide, both in writing and orally, for a further agreement.”

<sup>306</sup> *Tribune*, 670 F Supp at 500-01.

<sup>307</sup> *Id* at 502-503.

(vi) Whether the transaction was of such a kind that normally it would require the execution of a final agreement as dictated customary practice of that field; considering this factor in detail would require an in-depth analysis into the practice of that particular field and the business community.<sup>308</sup> In general, however, the question that the Courts try to answer is whether in that specific business community preliminary agreements are understood as being binding.

(vii)UCC and the RESTATEMENT: Sometimes, Courts look to the UCC to provide factors to determine intent. RESTATEMENT (Second) of Contracts § 27 provides some aspects to determine intent. These factors include oral testimony, correspondence, or preliminary or partially completed writings.<sup>309</sup>

Another issue, which adds to complexity of the determination, is the issue of burden of proof. Courts have not explicitly laid down who bears the burden of proof.<sup>310</sup> Some

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<sup>308</sup> *Id* at 503.

"This factor advocates an ad hoc investigation into the customary practices regarding preliminary agreements in a particular business community. If a business community typically gives preliminary agreements binding force, then a preliminary agreement used in that setting would be considered binding, even though that same preliminary agreement may be considered non-binding in a different business community. As justification for such a potentially arbitrary factor. The point is that the practices of the marketplace are not rigid or uniform. They encompass a considerable variety of transactions negotiated to suit the needs of the parties.... Each transaction must be examined carefully to determine its characteristics."

<sup>309</sup>RESTATEMENT, § 27-comment c.

These eight factors are: [1] [T]he extent to which express agreement has been reached on all the terms to be included, [2] whether the contract is of a type usually put in writing, [3] whether it needs a formal writing for its full expression, [4] whether it has few or many details, [5] whether the amount involved is large or small, [6] whether it is a common or unusual contract, [7] whether a standard form of contract is widely used in similar transactions, and [8] whether either party takes any action in preparation for performance during the negotiations.

<sup>310</sup>Johnston v. Johnston 346 Pa.Super. 427, 431; 499 A.2d. 1074, 1076.

courts that have addressed the issue, however, have held that the party claiming the enforceability of the preliminary agreement bears the burden.<sup>311</sup>

The above discussion elucidates that determinations of intent present are questions to be determined by the fact-finder. Here we see how fact specific the inquiry becomes and how difficult it is to derive a rule that could offer some form of predictability. The rules with regard to establishing intent are imprecise.

In the present day context, commercial transactions generally involve huge sums of money and intricate details and such transactions are not suited to inquiry that predominantly factual in nature as this leaves room for manipulation.<sup>312</sup> Even is the commercial transaction in question, is a routine one, this fact based approach would take up too much time of the Courts and severely hamper timely resolution of cases by the Courts. The bright line rule proposal, that no contract exists until the parties have executed the formal agreement, would go a long way in doing away with the uncertainties that have cropped up by following a fact-based method to determine cases. This rule would be simple and also generate predictability in decisions. This would encourage business community into entering into negotiations as they would have clear guidelines to the parties about when the agreements would be binding and when they would be liable under an agreement. This way one could also eliminate the problem of labels in other words 'preliminary agreements' or letters of intent' and the like. At present courts do place some importance on the usage of labels like preliminary

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<sup>311</sup>Miller Constr Co. v. Stresstek A Div. of L.R. Yegge Co., 108 Idaho 187, 189; 697 P. 2d. 201, 1203 (Idaho Ct.App. 1985).

agreements as being indicative of the fact that perhaps the parties intended to enter into a formal agreement at a later date. So in cases where parties have not used such labels and have just an agreement, courts have had to look at the terms to make the determination that it is in fact preliminary in nature. However with the bright line rule, it would not matter what names are being used to describe the preliminary agreement. The Courts would not have to subject its decision by looking at the merits and could just conclude about its validity on the basis whether the agreement was executed. Many Courts are faced with myriad rules and decisions, which are inconsistent, when deciding on a case about the enforceability of preliminary agreements.

But by adopting this default rule, or bright line rule one could provide a clear principle for the Courts to apply. However this bright line rule does not imply that there exists no liability before a formal and final agreement is entered into. As stated in the previous chapters, this duty of good faith is both contractual and non contractual. This duty exists whether or not there is a contract. This bright line rule by advocating that unless there is a formal contract does not mean that aggrieved party to a negotiations has no remedy, it just limits the remedy the parties can seek when negotiations fail. In case of failure to fulfill this duty the aggrieved party does have recourse to claiming expenses spent in reliance of the negotiations<sup>312</sup>; he can claim his out of pocket expenses. However the parties must have contemplated that such expenses would be wasted in the event that the negotiations fail. This bright line rule just works at limiting the recovery of the parties

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<sup>312</sup> Christopher M Goffinet, *supra* note 100, at 1377.

<sup>313</sup> Here the aggrieved party has no expectations that the negotiations will in fact result in an agreement but he does expect that the other party will negotiate in good faith and in reliance of that-is he incurs some expenses he could recover the same by claiming for reliance damages.

in case of failure in negotiations.<sup>314</sup> This bright line rule helps more in the assessment of damages that to a great extent simplifies the work for the Court. By stating there is no agreement until it has been formally executed, attempt is being made to restrict the cause of action in such cases to that of breach of a duty to negotiate in good faith and remove the possibility that parties can claim for breach of an agreement. We have seen the courts are willing to acknowledge that parties who breach their duty to negotiate in good faith would be liable to the aggrieved party for the reliance damages.<sup>315</sup> In this way, duty to negotiate in good faith could be upheld and at the same time it could be balanced with the broad freedom to contract.

However, no Courts has yet recognized the bright line rule and hence Courts continue to decide such matters on a case by case basis and so great caution is to be undertaken while drafting a preliminary agreement.

## **b) Drafting of a Preliminary Agreement**

As stated above courts have not yet recognized the bright line rule and hence as of now lawyers have to be prepared to deal with preliminary agreements. Most lawyers will

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<sup>314</sup> John Calamari & Joseph Perillo, CONTRACTS 604 (3d ed. 1987).

“In addition, any recovery should continue to be subject to the generally accepted "losing contract" limitation that mandates that a reliance damages recovery may not exceed the size of the plaintiff 's hypothetical expectation interest-based recovery, but must be reduced by the amount of any losses that would have resulted under the contract if fully performed.”

<sup>315</sup> Precontractual recovery could also be based on restitution interest. However to qualify for such an interest the aggrieved party must have conferred some interest on the other party. But in many cases the expenses incurred by the aggrieved by the party are for it's own purpose. In other words, the aggrieved party spends money in contemplation that the negotiations would bring about a final agreement but do not in the process convey any benefit to the other party. Hence it would be difficult to put forward that restitution interest could always provide a remedy to the aggrieved party. But such an interest does have some applicability in cases where the aggrieved has in fact conferred some benefit on the other party- like for instance when they have paid some money to the other party or have

at some time be asked to prepare a preliminary agreement. These preliminary agreements are a valuable method to confirm the existence of an 'agreement in principle' by which financial institutions and other investors are persuaded to invest.<sup>316</sup> Very often lawyers fail to appreciate the dangers of a poorly drafted letter of intent. Hence it is vital that careful attention is paid to every detail that goes into a preliminary agreement. These are basically understood to be a written statement of the terms of the agreement that have already been agreed upon, however, it is important that such a preliminary agreement should reflect the expectation of the parties that further negotiations are still needed and that another final agreement would be entered into by the parties.<sup>317</sup>

Although such preliminary agreements are not considered to be enforceable, it would be prudent to specifically and clearly state the binding or non-binding nature of the preliminary agreement. "The precontractual agreement must therefore explicitly announce the objective intent of the parties in language that a court will not consider ambiguous."<sup>318</sup> Courts have generally honored such provisions. However language like "not binding until final agreement is executed"<sup>319</sup>; Letter confirming "agreement in principle ... subject to negotiation and execution of a mutually satisfactory purchase agreement. ....and neither of us will be under any legal obligation ... unless and until such an agreement is executed and delivered"<sup>320</sup> will be sufficient.

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conducted some valuable study relevant for the transaction and have submitted the reports to the other party.

<sup>316</sup> John.S Hollyfield, *Letters Of Intent*, SF85 ALI-ABA 225, 227 (2001)

<sup>317</sup> *Id.*

<sup>318</sup> *People v. Solis* 565 N.E. 2d. at 1010 (Stamos, J., specially concurring)

<sup>319</sup> *Id.* at 257.



The parties must be careful to include such statements in all the documents and correspondence. Language as suggested above could be proof that the parties did not intend to be bound; it does not always categorically prove it. Nonetheless, Courts have rejected the assertion that the label of a preliminary agreement indicated no intent to be bound.<sup>321</sup> When Courts have certain reservations about enforcing a preliminary agreement, they look at several factors such factors as the magnitude and intricacy of the business deal, enormity of the terms which have not yet been decided the detail and completeness of the preliminary agreement and the language used and finally Courts also place a lot of importance on the actions and conduct of the parties and the surrounding circumstances in determining intent.<sup>322</sup> The parties also should make sure that no third party has any right to enter into a binding agreement on their behalf. In additions the parties should maintain detailed notes of all negotiations, as these would later be very useful in determining intent. However these notes should be cautiously and scrupulously made as sometime such notes misleading information as to when the an agreement was reached.<sup>323</sup>

Keeping these factors in mind, a conscientiously drafted preliminary agreement may be organized which explicitly states that the parties do not intend to be bound until a contract is executed or that the parties are to be bound only after the happening of some event or that to be enforceable the agreement requires some corporate action backing

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<sup>320</sup> *Pepsico Inc v. W R Grace Bros. & Co* , 307 F Supp. 713, 715 ( S.D.N.Y, 1969).

<sup>321</sup> *APCO Amusement Co v. Wilkins Family Restaurant of Am., Inc.* ,673 S.W 2d. 523 (Tenn. Ct of App., 1984)

<sup>322</sup> Stephen R. Volk & Melissa McMahon *LETTERS OF INTENT--GETTY AND BEYOND*, PRACTICING LAW INSTITUTE PLI ORDER NO. B4-6694 AT 465-66 (1984)

<sup>323</sup> *DiBlasi v. Cyganowski*, *A Guide to Handshakes-Higher Bids*, N.Y.L.J., June 2, 1986, at 23, col. 6.

(i.e., Board of Directors' approval of the transaction so as to achieve one's client's expectations.<sup>324</sup> Then such an agreement can hope to withstand even a strict scrutiny by Courts.

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<sup>324</sup> *Id.*

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