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Pre-closing Liability

Omri Ben-Shahar

I. EMPRO v BALL-CO AND THE PROBLEM OF PRECONTRACTUAL LIABILITY

A. Preface

Writing about Judge Easterbrook’s impact on contract law without commenting on his decisions in ProCD v Zeidenberg¹ and Hill v Gateway 2000² is like ordering a Big Mac without the two hamburger patties. Where is the beef? These two cases are probably the most important and influential contract law decisions of our era. They reshaped the doctrine of mutual assent and received a tsunami of scholarly attention. Four major legislative efforts on the national scale—so far unsuccessful—were triggered by the desire to reverse the holdings in these decisions, and in the judicial following they garnered.³

Despite the temptation, I choose not to remark on these branches of Easterbrook’s jurisprudence. They have been dissected in a host of articles, court decisions, and symposia. Contracts doctrinalists largely hate these decisions—it has become almost an instinct among contracts commentators to collectively condemn these decisions—whereas some law and economics writers support the decisions.⁴ Elsewhere, I argue that ProCD and Hill should be viewed as two of the most consumer-friendly cases of our era, since they introduce a novel right to withdraw from a contract.⁵ Here, instead, I am electing to turn

¹ Frank and Bernice J. Greenberg Professor of Law, The University of Chicago Law School. I am grateful to Russell Korobkin, Saul Levmore, and Eric Posner for helpful comments.
² 86 F3d 1447 (7th Cir 1996).
³ 105 F3d 1147 (7th Cir 1997).
⁴ Attempts to override or codify these decisions were at the core of several legislative initiatives, including the Uniform Computer Information Transactions Act (UCITA) § 208 (NCCUSL 2002), Article 2B of the UCC, the Revision to Article 2 of the UCC, and the proposed ALI Principles of the Law of Software Contracts. See, for example, James J. White, Contracting under Amended Article 2-207, 2004 Wis L Rev 723, 736–42; ALI, Principles of the Law: Software Contracts § 2.02(c) (May 19, 2009).
⁵ For example, my colleague Eric Posner’s contribution to this symposium highlights some of the strengths of the decisions. See generally Eric A. Posner, ProCD v Zeidenberg and Cognitive Overload in Contractual Bargaining, 77 U Chi L Rev 1181 (2010).

977

HeinOnline -- 77 U. Chi. L. Rev. 977 2010
my attention to another of Easterbrook's resounding contributions: the problem of precontractual liability.

Writing not long after Texaco v Pennzoil, the case that stunned the business community and threatened to burst the seam of contract formation and to find binding commitments before negotiations ended, Judge Easterbrook stitched the rupture. His decision in Empro v Ball-Co has become a staple in the law of "pre-closing" contractual liability. It has been featured in first-year contracts casebooks as the ultimate statement for why there is no liability before the closing.

B. The Problem

Empro v Ball-Co is a simple case, almost generic: two firms negotiate a deal, reach some substantial understanding over the terms, memorialize them in a document titled "letter of intent" or "agreement in principle," condition it on board approval, and also agree to iron out the remaining details and finalize the deal in a more formal contract. Subsequently, the negotiations collapse, or one party walks away, and the formal document is never finalized. Is the signed memorandum—the preliminary agreement—binding? Is it a contract? Or can either party freely walk away from it?

As common as this dispute is, there is no simple legal resolution to it. Sometimes these preliminary documents are intended to be binding, other times they are not. There are various factors in the surrounding circumstances that can help courts identify the parties' intent: the language of commitment that the parties used (for example, "nonbinding agreement"); the importance of the missing terms (for example, price); conduct indicating that the parties believed they had a commitment (for example, reliance by both parties); and the like.

Some courts are willing to sort through the facts of the dispute to fig-

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6 729 SW2d 768 (Tex 1987).

7 Empro Manufacturing Co, Inc v Ball-Co Manufacturing, Inc, 870 F2d 423 (7th Cir 1989).


9 See Empro, 870 F2d at 424.

10 See Restatement (Second) of Contracts § 27, comment c (1979).
ure out what the parties intended. Other courts prefer to simplify adjudication and reduce errors by relying only on formalized agreements, inducing parties to avoid such disputes and be clearer when they memorialize their understandings.

Interestingly, this is an area of contract law that proved trickier to regulate than other areas of contract interpretation. The law requires courts to reach a yes or no decision, all or nothing, contract versus no contract, freedom to walk away versus full expectation damages, whereas the situation is fundamentally one of intermediate, halfway, assent. On the one hand, it is clear that some substantial consensus has been reached between the parties and that the preliminary agreement is a milestone in reaching assent, and thus allowing the parties to freely walk away would frustrate their initial accomplishment. On the other hand, the parties have also made it clear that additional agreement needs to be reached and some conditions need to be met for there to be a "contract," and thus enforcing their precontractual understanding as if it were a contract (and filling its gaps with majoritarian terms) would deprive each party of the power it sought to maintain—that is, to reject unfavorable additional terms.

It is not surprising, then, that case law is replete with incoherent guidance. In one classic case, the court concluded that prior precedents in this area are "in hopeless conflict." Leading luminaries characterized case law as "confusing," "inconsistent," "all over the board," and the "[le]ast predictable" in the entire area of contract law.

It is also not surprising, when ambiguity reigns, that a Judge Easterbrook decision would surface with a clear position. It is a typical Easterbrook decision: short, forceful, persuasive, lights out. Nevertheless, I argue that the policy it articulates is socially undesirable.

C. Easterbrook's Solution

The agreement in *Empro v Ball-Co* was a three-page letter of intent titled "General Terms and Conditions," for the sale of a manufac-

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11 *Walker v Keith*, 382 SW2d 198, 199 (Ky 1964).
turing company. The price and the payment terms were agreed upon.\textsuperscript{13} The agreement named some issues that needed to be resolved: a non-compete provision, warranties, a consulting arrangement for the sellers, and “the definitive terms and conditions of this transaction.”\textsuperscript{14} The agreement was conditioned on approval by the board of directors of the buyer. The crucial term was the “subject to” clause, stating that the agreement “will be subject to and incorporated in a formal, definitive Asset Purchase Agreement signed by both parties.”\textsuperscript{15} After several months of further negotiations, and before a final formal agreement was reached, the seller walked away from the deal to negotiate instead with a third party. The suit was brought by the buyer to enforce the letter of intent.\textsuperscript{16}

Judge Easterbrook dismissed it. The letter of intent was not binding, he concluded, because the parties intended not to be bound until the formal definitive contract was executed. Their use of the “subject to” language (twice), without otherwise indicating that their commitment was immediate, reinforced the position that the agreement was not binding until formalized. The board approval escape hatch further demonstrated that the buyer wanted to preserve the right to walk, and did not intend to be bound until later. The buyer also secured the right to get the earnest money back, refusing to commit to even a small measure of precontractual liability. Finally, Easterbrook pointed out that when the seller accepted the letter of intent, it stated that “some clarifications” would be needed. In Easterbrook’s words,

> “Some clarifications are needed” is an ominous noise in a negotiation, foreboding many a stalemate. Although we do not know what “clarifications” counsel had in mind, the specifics are not important. It is enough that even on signing the letter of intent [seller] proposed to change the bargain, conduct consistent with the purport of the letter’s text and structure.”

Thus, the combination of the \textit{subject to} wording, the board approval conditions, and the \textit{clarifications needed} statement indicated that no contract was entered and the parties were free to walk away.

\textsuperscript{13} \textit{Empro}, 870 F2d at 424.
\textsuperscript{15} See \textit{Empro}, 870 F2d at 424.
\textsuperscript{16} Id.
\textsuperscript{17} Id at 426.
Easterbrook also dismissed the buyer's more modest claim to at least recover its reliance expenditures—those costs the buyer sunk in reliance on the letter of intent, including the cost of negotiating with the seller, investigating the seller's business, and preparing the acquisition. If there is no contract, there is no liability, however measured:

Outlays of this sort cannot bind the other side any more than paying an expert to tell you whether the painting at the auction is a genuine Rembrandt compels the auctioneer to accept your bid.\(^\text{18}\)

Easterbrook is clear about the rationale for his decision. Approaching agreement in stages is "a valuable method of doing business."\(^\text{19}\) Early in the negotiations parties do not yet know if they will succeed or fail. It is in their interest to reach understandings without fear that they will be forced into an agreement that they do not want, one that includes terms to which they did not agree. As Easterbrook explained in a later case with similar facts,

If any sign of agreement on any issue exposed the parties to a risk that a judge would deem the first-resolved items to be stand-alone contracts, the process of negotiation would be more cumbersome (the parties would have to hedge every sentence with cautionary legalese), and these extra negotiating costs would raise the effective price.\(^\text{20}\)

II. AN ALTERNATIVE SOLUTION: INTERMEDIATE LIABILITY

Easterbrook's no-liability solution is sensible when contrasted with the opposite solution of full contractual liability. The parties' representations suggested that they expected some more negotiations and were not yet ready to call it a deal. Having to choose between two polar alternatives, Easterbrook shows us that the full-contractual-liability solution is too aggressive and thus the zero-liability outcome is inevitable.

The problem with this methodology is that it unnecessarily narrows down the set of possible solutions to two. Between the two polar outcomes of zero liability and full liability lies a whole continuum of intermediate solutions. Since we are dealing with a situation of partial assent, would it not be more appropriate to attach legal consequences that reflect this intermediacy—that assign liability somewhere in the interval between zero and full contractual liability? I argue that such an intermediate measure of liability exists, that it is flexible enough to correspond to the intermediate degree of assent reached between the

\(^{18}\) Id.

\(^{19}\) Empro, 870 F2d at 426.

\(^{20}\) PFT Roberson, Inc v Volvo Trucks North America, Inc, 420 F3d 728, 731 (7th Cir 2005).
parties, and that it dominates the two polar liability regimes. The first step is to explain why an intermediate-liability rule is desirable; I then introduce a specific intermediate precontractual liability rule; finally I apply it to the pre-closing scenario of *Empro*.

A. Normative Grounds for an Intermediate-Liability Regime

In complex deals, as Judge Easterbrook acknowledges, it is technically impossible to tackle all issues simultaneously. Consensus is achieved piecemeal; one by one issues are resolved. Usually, when enough such resolutions are amassed, the parties then decide that some memorialization of the agreed-upon terms is useful, and that a structured plan for the remainder of negotiations is desirable. This milestone is not the end, but rather a stage toward a more complete agreement, which is sometimes specifically referred to in the preliminary understanding.

What is the value of this pre-closing memorialization? Surely, the act of signing a letter of intent is more than a secretarial archiving of items. One possibility is that by taking stock of what is already agreed upon and recognizing the mass of accomplishment, the parties create some inertia for the remainder of the negotiations. The parties may believe that the incentive to overcome the remaining issues may increase after most of the agreement is recorded, or that the remainder can be delegated to agents (lawyers), or that some more information is needed to nail down the final issues, or that some of the issues that remain open could be sidestepped, if the likelihood of some contingencies declines.

It is often recommended in negotiation manuals that the harder issues should be avoided early on in the negotiation, as they might "place unbearable strain on the overall settlement process." The psychological basis for this paradigm is a "momentum" notion: if the parties tackle easier issues first and build as much understanding as possible, they increase their own motivation and incentive to find ways to resolve the contentious issues. The effort already spent on achieving

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22 David A. Lax and James K. Sebenius, *The Manager as Negotiator: Bargaining for Cooperation and Competitive Gain* 97, 221 (Free Press 1986) (arguing that parties should avoid contentious issues that "may render agreement impossible").

23 This notion is familiar in international negotiations. See Geoffrey R. Watson, *The Oslo Accords: International Law and the Israeli-Palestinian Peace Agreements* 309 (Oxford 2000) ("One puzzle-solving heuristic is to solve the easy part of the puzzle first; once that part is solved, the harder parts of the puzzle may seem easier."); Fred Charles Iklé, *How Nations Negotiate* 1, 18
partial agreement and the dynamic of goodwill that this effort generated accord a more amenable context for the resolution of the remaining issues. The recording of the preliminary understanding, under this view, helps marshal the parties' goodwill and motivation to continue.

The economic basis for this momentum paradigm could be an incomplete-information account: as issues get resolved, the parties update their beliefs about the expected surplus from the deal. And each party also knows that the other party is performing the same updating. There can be a strategic factor here: each party may believe that by formalizing early understandings, the counterparty becomes more eager to finalize the deal, which would make it possible to extract even greater concessions from that party.

It is one thing to record and memorialize the preliminary agreement. It is another thing to be committed to it. Can the parties be committed only to what they agreed? Why would such gradual commitment, coupled with an intermediate magnitude of liability, be advantageous in these environments of negotiations-in-stages? One type of benefit, often mentioned in the negotiation literature, is the cognitive effect associated with a gradual compromise. Concessions that may be hard to make if framed as a lumpy, all-at-once departure from one's ideal terms may be easier to digest in a series of small slivers. Partial commitments effectively carve up the otherwise hard-to-swallow large commitment. This is the same logic soon-to-be-married couples invoke in making gradual premarital commitments (for example, buying shared assets, moving into a shared residence, opening joint accounts). If it were completely costless, in terms of nonlegal repercussions, to walk away anytime prior to the full formal agreement, these milestones would have less value, and, short of self-deception, they would not help the parties make a gradual assent towards cohabitation. A norm (or legal rule) of unrestricted freedom to retract, to reopen resolved issues, and to break the negotiations for any reason, would undermine the gradual compromise idea.

(Harper & Row 1964) ("If there is a conflict about many issues, the less controversial ones should be solved first because agreement will lead to further agreement.").


25 See, for example, Lax and Sebenius, *The Manager as Negotiator* at 96–97 (cited in note 22) ("Negotiations often leave much ambiguity with the tacit understanding that a definite resolution of the issue perhaps strongly favoring one party will later become necessary.").

26 See, for example, Robert B. Cialdini, *Influence: How and Why People Agree to Things* 27 (Morrow 1984) ("The trick is to bring up the extra[] [expenses] independently of one another so that each small price will seem petty when compared to the already-determined much larger one.").

27 Lax and Sebenius, *The Manager as Negotiator* at 279–80 (cited in note 22) (emphasizing the informal sanctions of breaking contingent agreements); Roy J. Lewicki, et al, *Negotiation* 100
Another benefit of an intermediate commitment arising from precontractual understandings is associated with the “integrity” of negotiations. If parties are free to walk away anytime prior to the full-blown contract, the negotiation arena will be appealing to individuals who are not “serious” and are not truly interested in dealing. The value of such a surrounding to the serious traders would then diminish. The signal that entrance to negotiations transmits with respect to the propensity of a party to work towards a deal is more powerful the greater the sanction for walking away. This is a standard—and desirable—sorting mechanism.

Still, it might be conjectured that this is too crude a sorting device, that it will deter parties who are potentially serious but not ready to assume some liability. Namely, even a partial precontractual commitment—any limitation of the freedom from contract—might “chill” the incentives to bargain, reducing the incidence of surplus-creating negotiations and thus reducing, rather than enhancing, the parties’ payoffs. In Judge Easterbrook’s words, parties would fear that “they have bargained away their privilege to disagree on the specifics,” which would undermine their incentive to enter precontractual understandings.

This intuitive conjecture is misguided. If there is a chilling effect caused by some measure of precontractual liability, it is disproportionately weighty on nonserious parties—those who are less likely to enter the contract and are thus more likely to be subject to the precontractual liability rule. This disproportionate burden on the nonserious parties would deter their entry. The more serious parties would find the liability regime desirable. For one, it would deter and filter out wasteful negotiations. Moreover, it would induce more efficient reliance investments. As recognized in a court decision to which Judge Eas-

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28 This “signaling” effect is recognized in the international negotiations literature. See, for example, Lloyd Jensen, Soviet-American Behavior in Disarmament Negotiations, in I. William Zartman, ed, *The 50% Solution: How to Bargain Successfully with Hijackers, Strikers, Bosses, Oil Magnates, Arabs, Russians, and Other Worthy Opponents in This Modern World* 288, 289 (Anchor 1976).


30 *Empro*, 870 F2d at 426.

31 For the argument that liability can enhance precontractual reliance, see Avery Katz, *When Should an Offer Stick? The Economics of Promissory Estoppel in Preliminary Negotiations*, 105 Yale L J 1249, 1270–71 (1996); Richard Craswell, *Offer, Acceptance, and Efficient Reliance*, 48 Stan L Rev 481, 483–84 (1996). For a formal analysis of the particular rules of liability that can induce efficient reliance, see Lucian Arye Bebchuk and Omri Ben-Shahar, *Precontract-
Pre-closing Liability

Terbrook concurred, "The parties may want assurance that their investments in time and money and effort will not be wiped out by the other party's footdragging or change of heart or taking advantage of a vulnerable position created by the negotiation." Such precontractual investments take many forms. Parties forego opportunities to negotiate with other partners; give up offers and promotions; invest in relationship-specific training and assets; acquire information; build capacity; and so forth. These investments increase the value that the potential deal would subsequently divide.

In the absence of some kind of commitment from the counterparty and liability to back it up, each party would fear that these investments are more likely to be wasted or expropriated. Without liability, it is more likely the other party would turn around and walk away. And even if the other party stays, greater reliance investment would make the investing party more vulnerable to hold-up. Thus, if negotiations lead to a contract, the benefits a party could enjoy from its own reliance investments are diminished by the ability of the other party to expropriate some of the surplus it creates. Since the other party could threaten to walk away, it could reopen negotiations and resplit the postinvestment surplus. This hold-up problem would reduce the incentive to invest. From a social perspective, the reduced levels of precontractual reliance that result are inefficient in two different ways: deals that do get formed generate a lower surplus, and some efficient deals that could have been formed are never entered into.

According to this view, parties who enter into preliminary agreements without expressly stipulating the liability consequences have in mind a commitment that is neither full-contract nor zero liability, but rather carries some binding force. They want to accord each other some measure of security, thereby encouraging the other to keep investing in the success of the relationship and to screen out, ex ante, frivolous partners. Each party must sacrifice some of its own freedom to walk away in order to encourage the other party to take a chance. The benefit from higher overall investment, which would materialize if a contract eventually forms, more than offsets the cost of restricting the freedom to walk away.

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32 Venture Associates Corp v Zenith Data Systems Corp, 96 F3d 275, 278 (7th Cir 1996).
33 See Hoffman v Red Owl Stores, Inc, 133 NW2d 267, 268–69 (Wis 1965).
34 See Bebchuk and Ben-Shahar, 30 J Legal Stud at 429–30 (cited in note 31); Craswell, 48 Stan L Rev at 553 (cited in note 31); Katz, 105 Yale L J at 1302 (cited in note 31); Schwartz and Scott, 120 Harv L Rev at 690 (cited in note 21).
B. A Specific Intermediate-Liability Rule

Any precontractual liability rule has to answer two questions: (1) when is a party liable for breaking off negotiations; and (2) what are the legal remedies available to the disappointed party. As we shall see, question (2) is easier to answer. It is question (1)—the grounds for liability—that is more difficult to answer. Surely, not every incident of negotiation termination should lead to liability. Most negotiations simply fail, or go stale, or are terminated by one party for good reason after giving the negotiations a good honest chance. Thus, much of the thinking about precontractual liability, and most of the legal innovations in the field, identify some conception of fault as the basis for inflicting liability on a party who abandons negotiations or refuses to follow through on an agreement in principle. The party who is more at fault has to compensate the party who is less at fault, at least for the latter's reliance costs.

The problem, of course, is to identify what would constitute faulty refusal to negotiate. Fluid conceptions like "bad faith" and *culpa in contrahendo* merely restate the problem or provide labels in Latin for the solutions, but do not advance the ball. Instead, they often lead to the type of skepticism that Judge Easterbrook rightly voices: that vagueness would breed excessive precontractual regulation and would merely introduce anxiety to the negotiations. What is needed is a compact conception of what it is that should be regarded as bad faith—which subset of negotiation breakdowns is socially undesirable.

This question cannot be answered without first articulating the exact benefit the liability is trying to generate. In the discussion above, I mentioned several potential benefits to precontractual liability—inducing reliance investments, protecting the integrity of the negotiation arena, making agreement easier to accomplish, and more. Each of these objectives might justify a different liability rule. It would be overly ambitious to claim that all these goals can be optimally addressed by the same rule. Thus, in the discussion here, I focus on one objective: optimal pre-closing reliance.

In my previous writings on this issue, some done in collaboration with Lucian Bebchuk, I explored a variety of intermediate-liability rules that, under some assumptions, provide optimal incentives to invest precontractually. Some of these rules place unrealistic informational burdens on courts. There is one regime, however, that places

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only a modest informational burden on courts and can lead to optimal incentives in a subset of negotiations—those in which parties reached a preliminary understanding.

Imagine a rule that imposes liability on a party who retracts from the terms to which it had previously agreed—any of the terms included in the preliminary understanding.\(^3\) Sometimes the preliminary understanding is formalized in a letter of intent, making it easy to identify. Other times it may require some subtlety to identify the set of terms that a party agreed to—the terms that the party represented to be acceptable. Once these terms are identified, a retraction would be any attempt by the party to reopen the negotiations over these terms in order to extract a more favorable division of the surplus, or an outright refusal to negotiate the remaining open terms, thereby violating the plan to proceed with the negotiations. The party who retracts would be liable for the other party’s reliance expenditures—those incurred after the preliminary understanding.

This no-retraction norm is recognized in a variety of negotiation contexts. In international negotiations, for example, when a negotiating party manifests its position, it is considered improper to “revert to a harder position from a more conciliatory one.”\(^3\) Treaties are negotiated article by article, and partial understandings cannot be reopened and must be preserved in the final agreement.\(^3\) Even the agreed-upon terms in agreements to agree, famously unenforceable in private law, cannot be reopened. In treaty law, “there is little doubt that parties can enter into legally binding ‘agreements to agree.’”\(^9\) Or, to take another example, in collective-labor negotiations parties to preliminary and tentative agreements have an obligation to further negotiate in good faith.\(^4\) Courts have developed heuristics to determine what counts as bad faith. Interestingly, it is often held that withdrawing from tentative agreements or making regressive proposals

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\(^3\) Variants of this rule were applied in several famous cases. See, for example, *Hoffman*, 133 NW2d at 275 (imposing liability on a franchisor who retracted from terms it previously represented); *Grouse v Group Health Plan, Inc*, 306 NW2d 114, 116 (Minn 1981) (imposing liability on an employer who revoked his employment offer, even before the offer was accepted); *Arcadian Phosphates, Inc v Arcadian Corp*, 884 F2d 69, 70 (2d Cir 1989) (imposing liability on a seller who changed its position as to what terms would be acceptable).

\(^7\) Id at 99 (“The very fact that the parties laboriously negotiate with each other to settle their issues point by point constitutes an implied promise that yesterday’s work will not be destroyed tomorrow by reopening these partial agreements.”).

\(^8\) *Watson, The Oslo Accords* at 65 (cited in note 23).

\(^9\) See National Labor Relations Act, 29 USC § 158(a)(5), (b)(3).
(two forms of "retraction"), if not reasoned by a change of circumstances, are evidence of bad-faith bargaining.\footnote{See, for example, \textit{Mead Corp v NLRB}, 697 F2d 1013, 1022 (11th Cir 1983); \textit{Oklahoma Fixture Co}, 331 NLRB 1116, 1118 (2000).}

Notice that this no-retraction rule is \textit{not} equivalent to enforcing preliminary understandings as contracts. If they were contracts, liability for retraction would equal the expectation interest and the court would need to supplement all the missing terms. Also, this rule is \textit{not} equivalent to a rule that effectively prohibits renegotiation of agreed-upon terms. Under the rule considered here, a party can, after the preliminary understanding, push to reopen its terms and insist on more favorable terms. But this strategy is no longer free. The intermediate liability he would face, if that strategy led to negotiation breakdown, does not block renegotiation; it merely affects the bargaining range in the renegotiation stage by restricting the retracting party’s profitable maneuvers. It thus provides more bargaining leverage to a party that relied on the agreement.

What about the missing terms? Many preliminary agreements leave some issues open, anticipating that they would be further resolved before the closing. (These are the "clarifications" Judge Easterbrook refers to.) If courts were to use standard gap-fillers to supplement the missing terms, the preliminary agreement would be transformed into a full-blown, enforceable contract. Instead, and consistent with the no-retraction idea, the gaps should be filled with terms most favorable, within reason, to the defendant. In other words, a party who wants to enforce the preliminary agreement must concede the open terms to its counterpart.

Can a party disguise a retraction and circumvent the no-retraction rule by making unreasonable demands related to one of the missing terms? Technically, this would not conflict with the parties’ original understanding. It would have the same effect of ending the relationship, but without incurring any precontractual liability. For example, if the parties agreed upon an express price to be paid in several deferred installments, a party wishing to retract could cause the deal to fail by insisting on an unreasonable interest rate. How would the intermediate-liability rule prevent such circumvention?

In order to avoid masqueraded retractions, a court would have to determine if any party’s demands regarding the missing negotiable terms are unreasonable. A party would be deemed to retract when he insists on an unreasonable term, or is unwilling to enter the contract even under the specification of the missing term that, within the range that the parties could reasonably have intended, is the most favorable
to him. Rejecting such a package is as unreasonable as retracting an explicit agreement. Essentially, then, a party entering a preliminary agreement is making a commitment to its terms, supplemented in all the open issues with terms most favorable, within reason, to him. He will not be forced to accept, or face liability for rejecting, a contract less favorable than this package of agreed terms plus the most favorable gap-fillers.

Thus, this liability rule is "intermediate" relative to full contractual liability in several important ways. First, it kicks in only if the other party is willing to concede the open terms—a less than likely event. One can imagine that many parties to preliminary agreements would not be willing to concede the open terms in a manner most favorable to their counterparts. In such cases, there is no liability and each party would be free to walk away. Second, even when the liable party is compelled to be part of the deal, the burden involved is quite minor. It is a deal that contains the terms he agreed to in the preliminary understanding, supplemented by the terms most favorable to him. Finally, if, despite it being favorable to him, the liable party refuses to accept this deal, the liability is measured by reliance damages—only those expenditures reasonably undertaken after the agreement.

Here is a graphic way to describe what the pre-closing liability rule does:

FIGURE 1
The dark line in the figure traces the rise of liability as the parties agree to more terms. Initially, when negotiations begin, and all the way until the preliminary understanding, the magnitude of liability is zero. Eventually, if and when the parties reach the closing stage and full agreement, the magnitude of liability is highest (full expectation liability). In the interim, between the preliminary agreement and the closing, liability is intermediate. At the time of the preliminary agreement it rises above zero, to reflect the option to enforce, but remains below full liability, to reflect the one-sided terms of this option and the lower measure of damages. As the parties agree to more terms and iron out one detail after another, this intermediate liability increases, to reflect the fact that the enforcing party has incrementally fewer terms to cede to the other party.

This rule has several attractive features that other approaches do not offer. First, it decouples the preliminary incomplete agreement into a set of two different complete agreements, one that the seller can enforce (with pro-buyer terms) and one that the buyer can enforce (with pro-seller terms). This is an additional dimension that can overcome deadlocked negotiations. Second, unlike the full-contract solution, here the deal that a plaintiff can enforce is no worse than what the defendant could have intended when he entered the preliminary agreement. It is the only deal to which it can confidently be said that the defendant manifested her "constructive" intent to be bound. What reasonable grounds would the enforced-against party have to reject such a favorable deal? Third, it allows parties to enter preliminary agreements without the fear that they are binding themselves to unwanted terms that some future activist court might install in the contract. Nor are they bound to some fuzzy and unpredictable obligation to negotiate in "good faith." Thus, it addresses Judge Easterbrook's concern that parties ought not fear that they bargain away their privilege to disagree on the specifics. The knowledge that they may be surrendering to a deal that is most favorable to them is not a deterrent but rather an inducement to enter a preliminary agreement.

Most importantly, under this rule, parties have the optimal incentive to make reliance investments at the pre-closing period—the time between preliminary understanding and the closing of the formal contract. This rule succeeds in inducing efficient reliance because it shields an investing party from the hold-up problem. By formally sanctioning any retraction from the preliminary understanding, the rule changes the incentives of the parties to retract and negotiate different terms. While renegotiation might still occur, the retracting party must restrain its claims so as to avoid negotiation breakdown and incur liability. This party cannot extract any of the added surplus created by the other party's reliance. He cannot hold up the other party and
exploit the fact that reliance costs are sunk, because reliance costs are no longer effectively sunk. Any such hold-up attempt gives the other party a chance to recoup its reliance costs by imposing retraction liability on the holding-up partner. Thus, a retracting party who has to pay reliance damages is effectively limited in its ex post bargaining strategy and would not engage in hold-up attempts. Since the investing party cannot be held up, its incentive to invest would be optimal.42

Finally, the rule is easy to opt out of, by stamping the preliminary agreement with any statement that would indicate intent to remain in one of the polar outcomes. Parties can state “enforce this” on the letter of intent, or—conversely—that it is “nonbinding.” To be sure, every precontractual liability regime, including the one chosen by Judge Easterbrook, is a default rule. My argument throughout this Part is intended to demonstrate that the intermediate-liability rule is a superior default because it increases social welfare, and thus it is the one that most parties would prefer most of the time.

C. Applying the Pre-closing Liability Rule to *Empro v Ball-Co*

Judge Easterbrook provided only a brief description of the facts of this case before concluding that the parties never intended the letter of intent to be binding. He emphasized that the parties left some issues open, and those issues were not resolved. Hence they could not have intended the memorandum to be a binding contract.43 A crucial underlying question, though, was not answered in the decision. Why did the seller, who was the party that initiated the negotiations in the first place and agreed to the terms in the letter of intent, decide to walk away from the negotiations? Was this a true failure to reconcile the positions on the open issues, or was it an outright retraction by the seller? Easterbrook’s decision makes sense if this were indeed a case of a dead end in the negotiations over the remaining issues. It makes less sense if, say, the seller suddenly decided that it wants to double the price—if this were a case of the seller’s regret and retraction.

The correspondence between the parties in the period that followed the letter of intent (which I pulled out from the district court’s file44) demonstrates back-and-forth negotiations after the letter of intent, primarily over one sticky issue: the nature of the security to be maintained by the seller. Of the $2.4 million price, $1.75 million was deferred, to be paid with ten-year promissory notes. The seller was

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42 For a formal proof that reliance damages are sufficient to generate efficient precontractual reliance, see Bebchuk and Ben-Shahar, 30 J. Legal Stud. at 435–38 (cited in note 31).
43 *Empro*, 870 F.2d at 426.
44 See Letter of Intent from Gary J. Graf (cited in note 14).
legitimately concerned about the buyer's indebtedness, and hence demanded some security arrangement. The buyer agreed that the inventory and equipment of the purchased company would serve as collateral. The seller demanded that in addition the real estate of the company would be included as security. This impasse was not resolved and the seller turned to sell to another bidder.

Had the security arrangement been an open issue, it would be right to conclude that the failure to resolve it indicates the absence of a binding contract. For one, it is not clear how to fill the gap to make the agreement complete. More importantly, given the structure of this deal as a credit transaction, the credit terms are its essence. If the parties made their initial agreement subject to resolution of this security issue, the failure to resolve it means that there was no mutual assent, no intent to be bound.

But the security arrangement was not an open issue. It was resolved in no uncertain terms in the letter of intent, in a manner consistent with the buyer's position. The letter of intent stated, in paragraph (3):

c. Empro shall sign and deliver to Ballco a ten (10) year Installment Promissory Note in the amount of $1,750,000 .... Empro shall secure said Promissory Note with the inventory and equipment of Ballco.

The letter of intent continues to specify the issues that need to be resolved to reach the final agreement, including, for example, a non-compete agreement and a consulting arrangement with the outgoing directors of the company. But nowhere in the agreement does it say that the security arrangement needs to be further negotiated. This part of the agreement was resolved.

Indeed, it was only in the subsequent negotiations that the seller made a new demand for additional security. The seller retracted his earlier agreement as to which assets suffice for security and reopened this issue in an attempt to extract a more favorable term. When the buyer rejected this demand, the seller walked away.

If this is the proper account of the negotiation failure, the intermediate-liability regime I outlined above would impose some liability on the seller. Specifically, the rule would accord the buyer an option. He would be entitled to bind the seller to a contract consisting of all the agreed-upon terms (which include the letter of intent's term on the security arrangement) supplemented by provisions favorable to

45 Empro, 870 F2d at 424.
46 See Letter of Intent from Gary J. Graf (cited in note 14).
the seller. Thus, with respect to the issues that were specifically left open (for example, the noncompete provision) and were not resolved in the subsequent negotiations, the buyer must concede them to the seller if he wishes to bind the seller to the letter of intent.

It could well be, though, that this account overstates the degree of assent manifested in the letter of intent. Judge Easterbrook emphasized that at the time of signing the letter, the seller informed the buyer that “some clarifications are needed in Paragraph 3(c) (last sentence).” Easterbrook viewed this as an early sign of the ensuing stalemate. Does “some clarifications needed” mean “nothing is agreed upon, everything can be reopened”? Or does it merely mean “we need to iron out some technicalities in implementing the agreement”? Indeed, some of the issues raised by the seller—who will pay accrued employee vacation, what accounting version of the “prime lending rate” will be used, what happens to the security if the buyer resells the company, and more—qualify as minor technicalities and were eventually resolved. The record shows that the buyer surrendered to every one of the seller’s demands over these issues. It is not clear, though, that revising the essence of the security arrangement was a “clarification.”

In any event, regardless of the position the judge takes concerning whether issues were truly left open, the intermediate-liability rule I proposed would prescribe a result under which the buyer could enforce a contract if he were willing to concede the seller’s positions over the non-agreed-upon issues. If the set of open issues were narrow, including only the technicalities I mentioned, the option would be more valuable to the buyer and more burdensome on the seller. If, instead, the set of open issues were broader and included also the security provision, as Judge Easterbrook perceived, the option would be less valuable to the buyer who would need to concede some additional issue in order to bind the seller. The more issues left open—the “thinner” the initial agreement—the less valuable is the buyer’s option and the less will the buyer rely. Thus, with more issues left open, the burden borne by the seller who wishes to walk away but must surrender to the buyer’s option to enforce is lighter. In this manner, liability effectively increases (continuously) with the measure of assent.

Notice how the intermediate-liability rule reduces the stakes. The judge no longer needs to assign an extreme and very specific meaning to the vague and casual statement “some clarifications needed.” It no longer has to choose between “nothing is binding,” or “we have a contract.” This language can mean what many parties probably think it means: “some things—but not everything—still need to be worked

47 Empro, 870 F2d at 426.
out.” All that remains for the judge to decide is which issues were closed (and thus cannot be reopened) and which remained open. The latter, if unresolved in the subsequent negotiations, must be conceded by the enforcing plaintiff.

Unfortunately, Judge Easterbrook did not partition the issues according to this methodology. The statement “some clarifications needed,” which the seller included in the cover letter attached to the preliminary agreement, was taken as eliminating any kind of commitment, even to the express terms of the agreement. This is an extreme result. It does not try to reconcile the seller’s simultaneous signing and requesting clarifications in a way that would make both acts meaningful. Rather, it empties the signing of the letter of intent of any meaningful consequence.

The seller’s violation of the no-retraction liability rule would lead to a recovery of damages. Since the purpose of this liability rule is to induce optimal reliance, it suffices to compensate the buyer for its reliance costs. Here, the buyer’s reliance costs were nontrivial: hiring attorneys to proceed with due diligence, making several trips to investigate and review the company, paying for appraisals, and participating in several negotiation meetings. These are socially desirable pre-closing investments and they ought to be protected by a liability regime.

**CONCLUSION: WAYS OF CRITICIZING A JUDGE**

The analysis here suggests that judges do not need to walk the razor’s edge between no liability and full contractual liability every time they adjudicate a pre-closing case in which the agreement was subject to a formal contract. Currently, the razor’s edge methodology leads courts to seek clues about the parties’ intent in factors that are too subtle, while recognizing that this formula is often ambiguous. There is confusion whether the parties’ intent is an issue of law or fact; whether parol evidence can be included; whether the subject to statement is a condition precedent, and the implications of such category. It is often hard to interpret what the parties’ intent was when they used this language. Courts tend to infer from the breakdown of subsequent negotiations that the original agreement was not binding. Against this, and in attempt to enrich the dichotomous nature of the liability problem, I have shown that a pre-closing agreement can be binding but not final. The No-Retraction principle provides one possible grounding for such a mechanism, setting the magnitude of liability on a continuum that reflects the quantum of agreement reached by the parties.

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It is not altogether fair, you might think, to criticize a judge for failing to apply a "new" rule, one that is not part of the accepted jurisprudence in the area. Judge Easterbrook felt compelled to choose between two polar outcomes. This is the standard methodology that most courts follow. He may have made the choice seem too easy, overlooking the magnitude of assent already reached, but the choice is still plausible.

The idea of no-retraction, which I advanced here, is not a proposal to reform the law and install a new doctrine of precontractual liability. Rather, it is an analytical framework for a doctrinal trend already in motion. In a subtle and interesting way, many courts have been breaking away from the dichotomous, all-or-nothing methodology, developing instead “categories” of precontractual liability. Using existing doctrines like the duty of good faith, promissory estoppel, unjust enrichment, and implied contract, common law courts occasionally impose liability on parties who walk away from advanced negotiations without a good reason. Even Easterbrook’s court has been at times innovative in this area. The problem with these emerging practices is their ad hoc nature. What is bad faith? How early should parties begin to rely on the negotiations? How severe should the remedy be? For precontractual liability to make sense (and be predictable), it needs to rest on a coherent conceptual foundation. The No-Retraction norm provides one possible foundation. Viewed as such, it is neither a “new” rule nor a proposal for reform, but merely an organizing criterion.

The critique, then, is not of the specific outcome in the case. It is a critique of the jurisprudence that Empro prominently represents, which adheres to the all-or-nothing module of liability. The concerns that Judge Easterbrook invokes in choosing the no-liability outcome—predictability, freedom to choose one’s partners, and loyalty to the parties’ expectations—point not to either one of the polar outcomes, but to an alternative methodology, expanding the choice of intermediate solutions.

49 For prominent examples, see Teachers Insurance and Annuity Association of America v Tribune Co, 670 F Supp 491, 499 (SDNY 1987) (holding that even a letter of intent obligates parties to negotiate); Itek Corp v Chicago Aerial Industries, Inc, 248 A2d 625, 629 (Del 1968); Copeland v Baskin Robbins USA, 117 Cal Rptr 2d 875, 880-81 (Cal App 2002) (holding that an agreement to agree obligates parties to negotiate); Hoffman v Red Owl Stores, Inc, 133 NW2d 267, 274-75 (Wis 1965) (finding that precontractual understandings, even short of an agreement, create reliance liability).

50 See Venture Associates Corp v Zenith Data Systems Corp, 96 F3d 275, 278 (7th Cir 1996) (discussing various liability measures for breach of an obligation to negotiate).