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When Should an Offer Stick? The Economics of Promissory Estoppel in Preliminary Negotiations

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When Should an Offer Stick?

The Economics of Promissory Estoppel in Preliminary Negotiations

Avery Katz[†]

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I. INTRODUCTION

A. *The Regulatory Role of Contract Formation Law*

The purpose of this Article is to examine the doctrine of promissory estoppel, as it applies in the context of preliminary negotiations, from the viewpoint of the economic theory of rational choice. This is part of a larger project that attempts to understand better the regulatory role of contract formation law generally. From a regulatory vantage point, estoppel and related legal doctrines operate as economic regulations; they shape the bargaining process by influencing the negotiators' incentives to make and to rely on preliminary communications. As with all economic regulations, however, some rules do better than others at promoting efficient exchange, and lawmakers interested in maximizing social wealth must take this into account.

Because the regulatory perspective differs in important respects from more traditional approaches to the subject, some general remarks are necessary to set the stage. As I have argued elsewhere, the traditional literature on offer and acceptance has taken the primary functional justification for legal doctrine in the area to be coordination.¹ In this traditional view, contract formation rules are primarily social conventions that serve to help contracting parties coordinate their agreements, by ensuring that the parties attach the same meaning to their objective manifestations and that their meaning will be understood by third parties called upon to enforce the agreement. This is what Lon Fuller called the "channeling function" of legal formalities.²

Courts and commentators who view contract formation law primarily as a coordination device will spend most of their time on what I have elsewhere

1. See Avery Katz, *The Strategic Structure of Offer and Acceptance: Game Theory and the Law of Contract Formation*, 89 MICH. L. REV. 215, 216–22 (1990).

2. Lon L. Fuller, *Consideration and Form*, 41 COLUM. L. REV. 799, 801 (1941).

called "convention maintenance."³ By this I mean activities such as describing and promulgating the prevailing conventions; protecting the reliance investments of those who operate according to them; providing newcomers with incentives to learn them; and assisting everyone in applying them in ambiguous and novel situations—all for the sake of averting misunderstandings. The enterprise is primarily an interpretive one: Lawyers are directed to search for the parties' reasonable or customary expectations, given the factual circumstances of the case at hand, in order to determine what inferences the parties are justified in making about each other's intentions. As an illustration, consider the common law doctrine that, absent special circumstances, an offeree's silence in the face of an offer will not constitute assent.⁴ The usual explanation for this rule is based on conventional understanding: Ordinarily, silence does not warrant an inference of consent, since there are too many other reasons to remain silent.⁵

Within this perspective, which I will call the "coordination" or "interpretive" approach, legal analysis proceeds from the bottom up. Because the proper conventions are taken as established and as embodied in the parties' ordinary expectations, lawmaking authority is decentralized; it flows from the parties and the community from which they come to lawyers and judicial officials. Such an arrangement makes sense if parties' expectations are largely independent of legal practices—for instance, if expectations are based on social custom and are enforced by nonlegal sanctions such as reputation that the parties regard as more important than what the courts can do to them. If so, law must defer to the larger society if private individuals are not constantly to be disappointed in their endeavors. Such an approach will be familiar to students of Article 2 of the Uniform Commercial Code (UCC), which defers throughout to commercial practice and usage.⁶

If private individuals can follow the law and adapt their expectations to it, however, an interpretive approach cannot tell us which legal rule is best.

3. Katz, *supra* note 1, at 222.

4. See RESTATEMENT (SECOND) OF CONTRACTS § 69 (1979) [hereinafter RESTATEMENT (SECOND)]. In exceptional circumstances, however, such an inference is justified, as when there has been a course of dealing that leads the offeror to expect a response. *Id.* § 69(1)(c); see also 1 ARTHUR L. CORBIN & JOSEPH M. PERILLO, CORBIN ON CONTRACTS § 3.21, at 414 (rev. ed. 1993) ("[The exceptions to the rule] are all cases in which the conduct of the party denying a contract has been such as to lead the other reasonably to believe that silence, without communication, would be sufficient.").

5. See, e.g., 1 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS 234 (1990) ("[A]n offeree's silence in the face of an offer to sell goods is not ordinarily an acceptance, because the offeror has no reason to believe from the offeree's silence that the offeree promises to buy."); 1 SAMUEL WILLISTON & WALTER H.E. JAEGER, A TREATISE ON THE LAW OF CONTRACTS § 91, at 319–21 (3d ed. 1957) ("Generally speaking, an offeree need make no reply to offers, and his silence and inaction cannot be construed as an assent to the offer . . .").

6. For general discussions of Article 2's deference to commercial custom, see Richard Danzig, *A Comment on the Jurisprudence of the Uniform Commercial Code*, 27 STAN. L. REV. 621 (1975); Zipporah B. Wiseman, *The Limits of Vision: Karl Llewellyn and the Merchant Rules*, 100 HARV. L. REV. 465, 492–541 (1987).

Different conventions for interpreting the parties' external manifestations are possible, and the mere requirement that law accord with expectation does not justify any legal rule in particular. Attempting to ground law in social conventions under such circumstances, therefore, is ultimately circular. This does not mean that deferring to the expectations of the regulated community is an incoherent idea, for in any particular social or historical context, the content of these expectations may be quite clear. But the justification for keeping to the prevailing conventions cannot in the end lie in the protection of expectations. As Justice Holmes famously remarked: "It is revolting to have no better reason for a rule of law than that so it was laid down in the time of Henry IV."⁷ The real long-run argument for perpetuating an established convention is that there are social costs incurred in switching from one convention to another, and the costs are not worth bearing. This is why it is sometimes more important to have the law settled, and less so to have it settled correctly.

Often, however, getting the law settled correctly is important, since the choice among conventions can affect both allocative efficiency and distributional equity. By attaching consequences to the potential acts and omissions individual bargainers might choose in a negotiation, the rules of contract formation influence the parties' incentives to behave strategically: to bluff, delay, make counteroffers, rely, and the like. The legal convention in force will accordingly influence which contracts get formed and the terms on which they get formed, and this is a matter of both private and social concern.⁸

The traditional dominance of the interpretive approach has meant the relative neglect of such policy considerations. In order to take account of them properly, an alternative approach is necessary—one that emphasizes how the law of contract formation works to regulate behavior in negotiation. To illustrate the difference, consider how the rule governing silent acceptance looks from a regulatory perspective. Since responding to offers is costly, the common law rule requiring an affirmative response raises the expense of forming an agreement. A negative-option rule requiring the recipient to

7. Oliver Wendell Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 469 (1897).

8. See generally Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989) [hereinafter Ayres & Gertner, *Filling Gaps in Incomplete Contracts*] (advocating penalty default rules of interpretation to force disclosure of information during bargaining); Jason S. Johnston, *Strategic Bargaining and the Economic Theory of Contract Default Rules*, 100 YALE L.J. 615 (1990) (arguing that strategic incentives might deter disclosure even under regime of penalty default rules); Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729 (1992) (analyzing efficiency effects of default rules in light of transaction costs and strategic bargaining); Katz, *supra* note 1, at 230–32 (noting contract formation rules' effect on structure and sequence of bargaining); Avery Katz, *Your Terms or Mine? The Duty to Read the Fine Print in Contracts*, 21 RAND J. ECON. 518 (1990) (analyzing duty to read); Steven Shavell, *Acquisition and Disclosure of Information Prior to Sale*, 25 RAND J. ECON. 20 (1994) (analyzing duty to disclose).

respond in order to avoid entering a contract, conversely, would make it more costly to reject offers and would increase the number of exchanges. If the chance of an acceptance were high enough, the negative-option rule would economize on the costs of sending communications, and would hence be a more efficient convention.⁹

From the regulatory perspective, the direction of analysis is top-down rather than bottom-up. The central question is not which legal rule is consistent with the parties' expectations, but what expectations the parties should be encouraged to have in the first place. A regulatory approach to contract formation is inappropriate if parties do not or will not respond to legal sanctions. But when new contract formation rules are introduced, when old ones are overhauled, or when ambiguous ones are clarified, regulatory issues are unavoidable. In such circumstances, any decision will generate new expectational conventions, not all of which have equal social value.

Furthermore, taking a regulatory perspective is especially important for private individuals, who often have the power to choose which conventions to use even when the state does not. In our common law system, the majority of contract formation rules are default rules rather than mandatory ones. This fact is sometimes expressed in the maxim that the offeror is "master of the offer"—that is, the offeror, by specifying what is to count as a proper acceptance, may propose changes in the rules of offer and acceptance as well as in the parties' substantive obligations.¹⁰ A similar power is explicitly granted to parties to contracts governed by the UCC.¹¹ For contracting parties to use this regulatory power effectively, however, they must understand the incentives they create for themselves in doing so.

B. *Promissory Estoppel and the Regulation of Reliance*

A regulatory perspective is useful in analyzing many of the rules of contract formation, but one doctrine it particularly helps illuminate is

9. There would also be distributional consequences, since construing silence as acceptance allows the offeror, by imposing the cost of a rejection on the offeree, to obtain a larger share of any gains from trade. For a more complete analysis, see Avery Katz, *Transaction Costs and the Legal Mechanics of Exchange: When Should Silence in the Face of an Offer Be Construed as Acceptance?*, 9 J.L. ECON. & ORGANIZATION 77 (1993).

10. The offeror is described as "the master of the offer" in the sense that, since by the offer the offeror confers on the offeree the power of acceptance, the offeror has control over the extent of that power and over how it may be exercised. The bargain theory of consideration supports this conclusion. . . . What the offeror receives by way of acceptance of the offer must therefore be what the offeror sought in making the offer.

1 FARNSWORTH, *supra* note 5, § 3.12, at 221–22.

11. With certain limited exceptions, the parties are free to contract around the default rules the Code supplies. U.C.C. § 1-102(3) (1994). As for sales, "[a] contract for sale of goods may be made in any manner sufficient to show agreement . . ." *Id.* § 2-204(1).

promissory estoppel. The classic statement of this principle is found in section 90 of the *Restatement (Second) of Contracts*:

A promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee or a third person and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise. The remedy granted for breach may be limited as justice requires.¹²

The doctrine of promissory estoppel is commonly explained as promoting the same purposes as the tort of misrepresentation: punishing or deterring those who mislead others to their detriment and compensating those who are misled.¹³ But these purposes, and the black letter definition of section 90 itself, can be read from either an interpretive or a regulatory perspective. From the interpretive perspective, reliance is reasonable if it is customarily expected under the circumstances, and justice requires compensation for those who suffer loss when relying on the ordinary meaning of the defendant's words and actions. From the regulatory perspective, in contrast, justice encompasses social welfare, and reliance is reasonable when its expected benefits exceed its expected costs—as in Learned Hand's celebrated formula for determining negligence liability in tort.¹⁴

Like all interpretive arguments, the conventional approach to promissory estoppel becomes circular if individual expectations can adjust to the legal regime. A policy of protecting reliance in any given set of circumstances will make it safer to rely in those circumstances, and this will increase the extent to which rationally self-interested promisees will rely. As a result, it will appear more usual to rely. Deferring to conventional expectations will then require protecting this reliance—consistent with the established policy. Conversely, under a rule that one relies at one's peril, reliance will be costlier and less frequent and will come to be perceived as less usual and less reasonable. And once it is less reasonable to rely, a rule that one relies at one's peril comports with social convention.

A specific application helps to focus the discussion. In recent years, one of the more controversial uses of promissory estoppel has come in precontractual negotiations. Individuals and companies doing business in a

12. RESTATEMENT (SECOND), *supra* note 4, § 90(1).

13. *See, e.g.*, 1 FARNSWORTH, *supra* note 5, § 2.19, at 146 (“What is the justification for this alternative ground of recovery? The possibility of an answer founded on principles of tort law is inescapable . . .”); GRANT GILMORE, *THE DEATH OF CONTRACT* 88 (1974) (“We are fast approaching the point where . . . any detriment reasonably incurred by a plaintiff in reliance on a defendant's assurances must be recompensed. When that point is reached, there is really no longer any viable distinction between liability in contract and liability in tort.” (footnote omitted)); *see also* P.S. ATIYAH, *THE RISE AND FALL OF FREEDOM OF CONTRACT* 771–75 (1979) (relating case law of negligent misrepresentation to development of contractual reliance-based liability).

14. *See* *United States v. Carroll Towing Co.*, 159 F.2d 169, 173 (2d Cir. 1947).

variety of industries have found themselves bound by informal statements made in the course of initiating a commercial relationship. In one line of cases, courts have held franchisors and their agents liable for encouraging franchise applicants to spend substantial resources in preparation for a franchise, even though their applications were formally still under consideration.¹⁵ In *Hoffman v. Red Owl Stores*, for instance, the plaintiffs were induced to raise \$18,000, to sell their bakery business, to buy and operate a small grocery store in a neighboring town and then to sell it at the height of the sales season, to purchase a building site for the proposed franchise, and to rent a residence in the town in which the franchise was to be located.¹⁶ Though the franchisor never offered the applicant a contract, the court found a basis for liability in the franchisor's representations that the application was likely to be granted and that the preparations were necessary for a successful franchise.¹⁷

In a second line of cases, the defendants made offers of at-will employment to individual workers who then quit their previous jobs or turned down other employment, though they had neither accepted the offers nor notified the defendants that they planned to accept. When the plaintiffs tried later to accept, they were told that their services were no longer needed. The courts found the defendants liable for the plaintiffs' loss in reliance.¹⁸ And in a third line of cases, subcontractors competing for parts of a construction project submitted bids to general contractors, who then used the subcontractors' proposals in preparing their own bids for the primary contract. Courts bound the subcontractors to their initial bids on the theory that the general contractors' reliance on those bids made them binding.¹⁹

The decisions in these cases differed in their precise doctrinal holdings. In *Hoffman v. Red Owl Stores*, for instance, the franchisors' statements were held to be promises enforceable under section 90, though there was never any explicit offer on the table.²⁰ In the employment cases, the employers' offers were effectively held to be terminable only for cause, though by their formal terms they proposed relationships that were terminable at will.²¹ And in

15. See, e.g., *Hoffman v. Red Owl Stores*, 133 N.W.2d 267, 275 (Wis. 1965); *Goodman v. Dicker*, 169 F.2d 684, 685 (D.C. Cir. 1948).

16. See 133 N.W.2d at 268-72.

17. See *id.* at 274-75.

18. See, e.g., *Hunter v. Hayes*, 533 P.2d 952, 953 (Colo. Ct. App. 1975) (construction worker as plaintiff); *Grouse v. Group Health Plan*, 306 N.W.2d 114, 116 (Minn. 1981) (pharmacist as plaintiff).

19. See *Drennan v. Star Paving Co.*, 333 P.2d 757, 761 (Cal. 1958); *Preload Technology, Inc. v. A.B. & J. Constr. Co.*, 696 F.2d 1080, 1091 (5th Cir. 1983) (holding that subcontractor was bound under theory of promissory estoppel unless bid clearly not final); *Hoel-Steffen Constr. Co. v. United States*, 684 F.2d 843, 848 (Ct. Cl. 1982) ("[A] subcontractor's quotation to a general contractor can form the basis of an enforceable commitment between the parties even prior to formal acceptance by the contractor . . ."); *Air Conditioning Co. v. Richards Constr. Co.—Kaneohe Bay Project*, 200 F. Supp. 167, 171-72 (D. Haw. 1961), *aff'd*, 318 F.2d 410 (9th Cir. 1963) (subcontractor bound by his bid unless it expressly or impliedly provides for revocation).

20. See *Hoffman*, 133 N.W.2d at 273-74.

21. See, e.g., *Grouse*, 306 N.W.2d at 116.

Drennan v. Star Paving Co., the subcontractor's bid was deemed irrevocable though there was never any explicit promise not to revoke.²² Nonetheless, the underlying functional problem is the same in all three lines of cases. In all three contexts, courts held parties bound by communications traditionally thought to be nonbinding—whether promises, factual statements, predictions, requests, or formal offers—because those communications were relied upon. The plaintiffs' reliance was protected because it appeared both reasonable for them to rely and reasonable to expect them to do so. And from the regulatory perspective, both the plaintiffs and defendants needed to be given appropriate incentives to behave efficiently: the defendants with regard to their statements, and the plaintiffs with regard to their decisions to rely.

Since I am more interested in this Article in underlying incentive problems than in the details of legal doctrine, I will for the most part disregard the aforementioned doctrinal distinctions. I will focus instead on the construction cases and the particular rules they have generated, in part because these cases more clearly address the economic problem that I want to discuss and in part to contrast the regulatory approach I advocate with two well-known judicial opinions that reflect the traditional interpretive perspective. Much of my analysis, however, will carry over to the analogous doctrines applied in the employment and franchise cases; the factual settings of those other cases may even better fit the functional analysis I will offer.²³

To foreshadow my main conclusions, it turns out that the efficiency of promissory estoppel in preliminary negotiations depends in large part on which

22. See *Drennan*, 333 P.2d at 759.

23. The construction cases do present two special problems that could further complicate matters. First, in those cases, the offeree's reliance took the form not of making direct expenditures, but of incurring contractual obligations to a third party. This should not in principle make any difference for an efficiency analysis, so long as the amounts payable to the third party under the side contract, or the damages due in the event of breach, fairly represent the third party's costs. If, however, the third party earns more or less than a normal economic profit under the side contract, then changing the rules governing the primary contract could influence the distribution of economic rents between the offeree and the third party. In this case, what is efficient for the offeror and offeree, considered as a pair, may not be efficient for society as a whole. See, e.g., Philippe Aghion & Patrick Bolton, *Contracts as a Barrier to Entry*, 77 AM. ECON. REV. 388 (1987) (setting liquidated damages above actual damages can benefit parties to contract by excluding potential competitive entrants); Tai-Yeong Chung, *On the Social Optimality of Liquidated Damage Clauses: An Economic Analysis*, 8 J.L. ECON. & ORGANIZATION 280 (1992) (showing that supracompensatory damages can benefit contracting parties by redistributing economic rents away from potential third parties); Joseph F. Brodley & Ching-to Albert Ma, *Contract Penalties, Monopolizing Strategies, and Antitrust Policy*, 45 STAN. L. REV. 1161 (1993) (applying Aghion-Bolton model to antitrust policy); Kathryn E. Spier & Michael D. Whinston, *On the Efficiency of Privately Stipulated Damages for Breach of Contract: Entry Barriers, Reliance, and Renegotiation*, 26 RAND J. ECON. 180 (1995) (showing that even when renegotiation is possible *ex post*, incentive still exists for contracting parties to set supracompensatory damages). Second, in the construction cases, the offeror's bid comes as the result of a competitive auction, and the auction process itself may have consequences for efficiency. In particular, the procedure of competitive bidding increases the chances that the winning bidder has made a mistake—the so-called “winner's curse.” Parties to an auction have various options for dealing with this problem, but a consideration of these possibilities would needlessly complicate this Article. In the succeeding analysis, I ignore any special issues posed by auction theory. For a survey of such issues, see Paul Milgrom, *Auctions and Bidding: A Primer*, 3 J. ECON. PERSP. 3 (1989).

party holds the bulk of the bargaining power *ex post*. If the original offeror holds the bargaining power, then the modern doctrine that holds her to her offer is likely to provide the more efficient rule, other things being equal. If, on the other hand, it is the offeree who holds the bargaining power, then it is more efficient to make him bear his own reliance costs, as the traditional common law rule did.²⁴ The reasoning underlying this conclusion is straightforward. Economic efficiency requires that the benefits of reliance and the risk that it will be wasted be balanced against each other at the margin. The level of reliance that is privately profitable for the parties will coincide with the socially optimal level under two conditions: The person who controls the reliance must enjoy its marginal benefits, and he or she must also pay the costs when it is wasted. Since in preliminary negotiations both parties control the reliance and the party with the *ex post* bargaining power gets the gains, it is that party who should also bear the costs.

Two caveats to this argument are appropriate at the outset. First, in this Article, I will be talking about legal rules on the assumption that they actually govern the parties' negotiations and will not address the interaction between default rules chosen by the state or private associations, on the one hand, and rules actually selected by individual contracting parties, on the other. Such an omission may appear misguided to readers who are used to thinking of the problem from the viewpoint of the judiciary and who also think it is easy for private parties to contract around the law. But for the purposes of my analysis, it does not matter whether it is courts, legislatures, or individual contracting parties who set the rules of contract formation. The interaction between default rules and private bargaining is critical from an interpretive perspective because, under that perspective, the central tasks are identifying the default rule and figuring out whether the parties have elected to vary it in the specific circumstances at hand. From a regulatory perspective, however, who sets the rules comes down to a question of comparative institutional competence, turning on the relative transaction costs faced by the various possible lawmakers. If costs of private negotiation are relatively high, then courts or legislatures are in the better position to select a contract formation rule to promote efficient exchange. Conversely, if private transaction costs are relatively low, public lawmakers can simply set a clear default rule—it may not matter which one—and let private parties negotiate their way around it if they wish.

I do not discuss in this Article which of these situations might hold and take no stand on who might be the most appropriate audience for the succeeding analysis. My own suspicion is that the regulatory approach to

24. Except when referring to individual litigants in actual cases, I will use female pronouns to refer to offerors (such as subcontractors and franchisors) and male pronouns to refer to offerees (such as general contractors and potential franchisees).

contract formation will be more useful to private individuals designing their own arrangements than it will be to courts or legislatures, if only because the former are likely to know more of the specific facts that determine which rule is most efficient in their situation. But whoever sets the final rules of negotiation needs to know the consequences of doing so. It may be possible under current law for contracting parties to avoid the constraints of promissory estoppel by explicitly reserving the right to revoke and by conspicuously disclaiming liability for preliminary communications, just as it was possible with the proper formalities to contract into reliance liability under the traditional common law. But in order for contracting parties to know whether they should do this, they first need to know what will happen if they try. Similarly, a court or legislature setting a default rule needs to know how the rule would work when actually in force, both to determine what rule private individuals would most prefer and to predict whether private parties would contract around a different default rule in favor of their own individual arrangements. The analysis below is intended to address these sorts of questions.

My second caveat concerns the normative underpinnings of the analysis. This Article adopts economic efficiency as its primary criterion for evaluating legal rules. It does not consider other policy goals, such as how the rule of promissory estoppel might affect the distribution of wealth among the parties to the transaction. Justifying the efficiency criterion in the contractual setting is beyond the scope of this paper, and the usual admonitions will apply.²⁵ It is worth noting, however, that so long as the transaction in question is an arm's-length one, the parties have the option not to enter into it, and they know the risks and legal consequences, there are no obvious distributional consequences from any change in the legal rules.²⁶ As a general matter, the surplus from exchange tends to be divided among contracting parties in proportion to their relative eagerness to enter into the bargain. Any efficiency gains or losses resulting from a change in regime, accordingly, will be shared by all.²⁷

In the succeeding parts of this Article, I spell out my overall argument in more detail. Part II presents the legal background in the construction bid

25. For more general discussions of the efficiency criterion, see JULES L. COLEMAN, *MARKETS, MORALS AND THE LAW* 95–132 (1988); RICHARD A. POSNER, *THE ECONOMICS OF JUSTICE* 48–115 (1983); *Symposium on Efficiency as a Legal Concern*, 8 *HOFSTRA L. REV.* 485 (1980). More specifically, Kaplow and Shavell argue that even if distributional equity is an important social objective, it is more effectively promoted by using direct public instruments such as tax and transfer payments than by adjusting the rules of private law. Louis Kaplow & Steven Shavell, *Why the Legal System is Less Efficient Than the Income Tax in Redistributing Income*, 23 *J. LEGAL STUD.* 667 (1994).

26. The doctrine of silence as acceptance, discussed in Katz, *supra* note 9, is an exception to this statement because the doctrine influences the cost of declining an exchange.

27. See Richard Craswell, *Passing on the Costs of Legal Rules: Efficiency and Distribution in Buyer-Seller Relationships*, 43 *STAN. L. REV.* 361, 369–72 (1991) (demonstrating convergence of efficiency and distributional goals).

setting—the two most prominent common law cases and the relevant rules of the *Restatement (Second) of Contracts*—and uses this background to expose the limitations of the interpretive approach described in Section I.A. Part III outlines the basic economic problem that underlies the legal one—balancing the benefits of early reliance against the costs of wasted reliance—and presents a simple bargaining model that allows one to evaluate the doctrine of promissory estoppel on efficiency grounds. The main conclusion of this model is that the party with the bulk of the bargaining power *ex post* is in the best position to ensure that reliance occurs at the socially optimal time. Part IV discusses a number of variations on the basic model and comments on how these might be compared and integrated with related work in the literature. It concludes that the basic intuition of the simple model is still generally valid notwithstanding these complications. Part V illustrates the lessons of the model by applying them to a representative set of actual and hypothetical cases. Finally, Part VI summarizes the argument and draws some tentative conclusions.

II. THE LEGAL PROBLEM

A. *The Doctrinal Background*

Under the traditional common law rule, an offer was revocable any time before acceptance. An extreme illustration is *Petterson v. Pattberg*,²⁸ in which the defendant, who had promised to accept a cash payoff of a mortgage held on the plaintiff's realty, informed the plaintiff, while he stood on the defendant's doorstep ready to tender the cash in his pocket, that the mortgage had instead been sold to a third party. The court found an effective revocation.²⁹

This result was traditionally said to be required by the doctrine of consideration: Until he accepted the offer, the offeree had given nothing in exchange to warrant enforcement of a contract. Furthermore, allowing the offeree an opportunity to choose whether to accept an offer without binding him in return would give him a free opportunity to speculate at the offeror's expense. Thus, while it was always possible to sell a binding option for value, without consideration even an explicit promise to hold an offer open—the so-called “firm offer”—was unenforceable, just as any executory gift promise would have been.³⁰

This doctrinal rule was always vulnerable to the criticism that it was out of touch with commercial reality. This is because in a business context,

28. 161 N.E. 428 (N.Y. 1928).

29. *Id.* at 430.

30. 1 FARNSWORTH, *supra* note 5, § 3.23.

promises to hold offers open are not reasonably understood as gifts; rather, offerors make them in the hope of getting something in return. For instance, an offeror might want to commit to a firm offer as an inducement to the offeree to go to the trouble of considering the proposal or to begin preparing to perform—especially if the risk of speculation over price fluctuations is insubstantial. In theory, this inducement could count as consideration, but attempting to persuade a court that it was in fact bargained for would be costly and risky. As a result, courts and commercial lawyers over the years turned to a variety of formal devices in order to make such offers enforceable. Until the abolition of the seal, for instance, it was possible to create a binding option by promising under seal not to revoke. In many jurisdictions, a firm offer can be supported by nominal consideration—the proverbial peppercorn or one cent—or by a formal recital of consideration.³¹ And with the adoption of Article 2 of the UCC, it became possible in sales transactions for merchants to create an option binding for up to three months simply by putting it in the form of a signed writing.³²

After the promulgation of the *Restatement of Contracts*, however, the new doctrine of promissory estoppel offered an alternative approach. There had always been courts that viewed detrimental reliance as sufficient consideration to support contractual liability.³³ With the ascendancy of the classical bargain theory of consideration in the late nineteenth and early twentieth centuries, judges began drawing on the equitable doctrine of estoppel to enforce relied-on promises that, for whatever reasons, could not pass the classical theory's test.³⁴ While the drafters of the *Restatement* adopted the bargain theory in their definition of consideration,³⁵ they incorporated the competing arguments in equitable form in section 90.³⁶ In the decades since, this section has come to be regarded as the *Restatement's* most influential innovation; it has provided a basis for reliance-based recovery in countless situations where the traditional formal requirements for enforcement were lacking.³⁷ Once promissory estoppel became established as black letter doctrine, offerees could argue that their reliance on an offer could make it irrevocable—even if none of the traditional formal devices were used. The theory was that an offer could carry

31. See RESTATEMENT (SECOND), *supra* note 4, § 87 and cases cited therein.

32. See U.C.C. § 2-205 (1994).

33. See ATIYAH, *supra* note 13, at 776; see also *Devecmon v. Shaw*, 14 A. 464, 465 (Md. 1888) (holding nephew's voyage to Europe, following uncle's promise to help defray expenses, sufficient consideration to enforce promise).

34. See, e.g., *Ricketts v. Scothorn*, 77 N.W. 365, 367 (Neb. 1898) (holding that granddaughter's reliance in giving up job estopped executor from raising lack of consideration as defense against grandfather's promissory note).

35. RESTATEMENT OF CONTRACTS § 75 (1932).

36. *Id.* § 90.

37. For brief discussions of the historical evolution of promissory estoppel, see ATIYAH, *supra* note 13, at 771–78; 1 FARNSWORTH, *supra* note 5, § 2.19; GILMORE, *supra* note 13, at 63–65.

with it an implied subsidiary promise not to revoke, and that it would be unjust not to enforce this promise once the promisee had relied.

The problem with this argument, though, was in making out all the necessary elements of an estoppel claim. Absent an explicit promise not to revoke, how could one reasonably be inferred from the circumstances of negotiation? And even if the offeror did make an explicit statement that the offer was firm, how could it be reasonable for the offeree to rely on that statement without providing the requested consideration in the form of an acceptance? Didn't such an offeree voluntarily assume the risk of wasted reliance?

These questions were raised in *James Baird Co. v. Gimbel Bros.*,³⁸ one of Judge Hand's most celebrated opinions and a warhorse of the casebooks. In this case, Gimbel Brothers, a seller of linoleum flooring, sent offers to several general contractors who were bidding to construct a building for the Pennsylvania Department of Highways. Due to an error in calculation, however, Gimbel's agent had underestimated the amount of linoleum required by about one-half. When Gimbel discovered its mistake a few days later, it telegraphed a correction to all the offerees. Unfortunately, the correction reached Baird's office only after it had submitted its general bid, which was based in part on Gimbel's. When Baird was awarded the primary contract, Gimbel refused to honor its offer.³⁹

Initially, Baird tried to argue that by using Gimbel's bid as the basis for its own general bid, it had accepted and entered into a mutually binding bilateral contract, albeit one contingent on its being awarded the primary contract. The language of Gimbel's bid, however, made this interpretation a difficult one.⁴⁰ Furthermore, Baird had never notified Gimbel of any acceptance, nor had it taken any publicly observable action that would have enabled Gimbel to prove an acceptance had it been the one seeking to enforce the bargain. As a result, Baird fell back on *Restatement* section 90.

Judge Hand, however, was unsympathetic to the estoppel argument. In his view, it was unreasonable to suppose that Gimbel meant to bind itself to perform while leaving Baird free to seek a better bargain elsewhere. Since Baird had never accepted, Hand concluded, Gimbel's offer had never ripened into the promise that was a necessary element for a section 90 claim:

[A]n offer for an exchange is not meant to become a promise until a consideration has been received, either a counter-promise or whatever else is stipulated. To extend it would be to hold the offeror regardless of the stipulated condition of his offer. In the case at bar the

38. 64 F.2d 344 (2d Cir. 1933).

39. *Id.* at 345.

40. The offer concluded with the words: "[We] are offering these prices for reasonable . . . prompt acceptance after the general contract has been awarded." *Id.*

defendant offered to deliver the linoleum in exchange for the plaintiff's acceptance, not for its bid, which was a matter of indifference to it. That offer could become a promise to deliver only when the equivalent was received; that is, when the plaintiff promised to take and pay for it. There is no room in such a situation for the doctrine of "promissory estoppel."⁴¹

Hand's opinion in *Baird* remained the leading authority on this issue for a quarter century. In 1958, however, the California Supreme Court heard the case of *Drennan v. Star Paving Co.*⁴² Star had telephoned in the low offer for pavement work on a school construction project on which Drennan was bidding to be primary contractor. Drennan used Star's bid in computing his own, and included Star's name on the list of subcontractors required by the school district's rules. Drennan won the bidding and was awarded the contract, but when he stopped by Star's office the next day, he was informed that Star's bid was mistaken and that Star could not do the paving at the price it had offered.

The court might easily have distinguished *Drennan* from *Baird* on the facts. Drennan's use of Star's bid could have been interpreted as an acceptance contingent on Drennan's winning the primary contract. There was nothing in the language of either bid to preclude this, and Drennan had publicly listed Star as one of its subcontractors. Alternatively, since Star did not inform Drennan of the mistake until after Drennan arrived at Star's office to announce that they had won the bidding, the court could have found that Drennan had accepted in time and that Star's revocation was too late. Or, the facts might have supported the conclusion that Star had not tried to revoke at all, but instead had been merely asking for a modification. The court, however, in a celebrated opinion by Justice Roger Traynor, did none of these. Instead, it based its holding on the estoppel theory Judge Hand had rejected twenty-five years earlier:

Had defendant's bid expressly stated or clearly implied that it was revocable at any time before acceptance we would treat it accordingly. It was silent on revocation, however, and we must therefore determine whether there are conditions to the right of revocation imposed by law or reasonably inferable in fact. . . .

When plaintiff used defendant's offer in computing his own bid, he bound himself [to the school system] to perform in reliance on defendant's terms. Though defendant did not bargain for this use of its bid neither did defendant make it idly, indifferent to whether it would be used or not. . . . Clearly defendant had a stake in plaintiff's reliance on its bid. Given this interest and the fact that plaintiff is

41. *Id.* at 346.

42. 333 P.2d 757 (Cal. 1958).

bound by his own bid, it is only fair that plaintiff should have at least an opportunity to accept defendant's bid after the general contract has been awarded to him.⁴³

Traynor's analysis in *Drennan* won out over Hand's analysis in *Baird* in subsequent contractor-subcontractor cases.⁴⁴ More importantly, however, the drafters of the *Restatement (Second) of Contracts* subsequently adopted and extended the logic of *Drennan*. *Restatement (Second)* section 87(2) today provides that "[a]n offer which the offeror should reasonably expect to induce action or forbearance of a substantial character on the part of the offeree before acceptance and which does induce such action or forbearance is binding as an option contract to the extent necessary to avoid injustice."⁴⁵ Under sections 87(2) and 90, courts have applied promissory estoppel over the succeeding years to offers of employment,⁴⁶ offers to pay commissions to sales brokers,⁴⁷ and even to cases such as *Hoffman v. Red Owl Stores*,⁴⁸ in which no offer had been made at all.

As a result of these developments, the traditional rule of interpretation has been reversed. Where firm offers were once entirely unenforceable, they are now both enforceable and presumed so by default—so long as offerees rely. Furthermore, the promisor's obligation is unilateral, not mutual; courts generally have declined to construe the offeree's reliance as either an acceptance or a promise to accept.⁴⁹ As a result, the interpretation Judge Hand thought unreasonable—that offerors intend to provide offerees with a free option when they make offers—has become the standard legal convention.

B. Critique of the Traditional Approach

This doctrinal shift was controversial because using promissory estoppel in the precontractual setting conflicted with a set of longstanding conventions for contract formation—the formal rules of offer and acceptance. In *Drennan* and the employment cases, the offerees had never formally accepted the offers made to them, so binding the offeror contravened the convention that an offer

43. *Id.* at 759–60.

44. See cases cited *supra* note 19; see also *Alaska Bussell Elec. Co. v. Vern Hickel Constr. Co.*, 688 P.2d 576 (Alaska 1984) (adopting rule of *Drennan* over that of *Baird* as better law); *Ferrer v. Taft Structurals*, 587 P.2d 177 (Wash. Ct. App. 1978) (adopting rule of *Drennan*).

45. *RESTATEMENT (SECOND)*, *supra* note 4, § 87(2).

46. See cases cited *supra* note 18.

47. See, e.g., *Marchiondo v. Scheck*, 432 P.2d 405, 407–08 (N.M. 1967) (basing decision on *Restatement (Second) of Contracts* § 45 since offer was for unilateral contract).

48. 133 N.W.2d 267 (Wis. 1965).

49. For example, in the subsequent case of *Southern California Acoustics Co. v. C.V. Holder, Inc.*, 456 P.2d 975, 978 (Cal. 1969). Chief Justice Traynor rejected the argument that listing the subcontractor in a general bid created an analogous subsidiary promise on the part of the general contractor not to reject the subcontractor's bid. See also *Holman Erection Co. v. Orville E. Madsen & Sons, Inc.*, 330 N.W.2d 693 (Minn. 1983) (reaching similar result).

remains revocable until accepted. In the franchise cases, there was not even any offer to be accepted. As a result, courts easily concluded, as Hand had in *Baird*, that it was the defendants in these cases who deserved protection, not the plaintiffs. The defendants, after all, had based their expectations on standard formal conventions of offer and acceptance. Since the plaintiffs should have understood that they were relying at their peril, courts found no injustice in failing to enforce the offers made to them.⁵⁰

Of course, when the doctrine of promissory estoppel was first introduced, it undermined the equally well-settled convention that contracts were not enforceable without consideration. The original advocates of promissory estoppel, however, had taken the position that mere convention should not be regarded as decisive; in appropriate circumstances, reliance justified relief from the harshness of the consideration doctrine. Traynor and the drafters of the *Restatement (Second)* were arguing that reliance should justify relief from other formal conventions of contract formation as well.

Partisans of Hand's more traditional approach could reply, however, that applying promissory estoppel within the context of offer and acceptance doctrine was a different matter from using it to substitute for consideration. Between commercial parties, the consideration requirement served no important coordinating function. Instead, it operated primarily as a substantive limitation on arm's-length bargains⁵¹ and, as such, had been under attack in the commercial setting since the days of Lord Mansfield.⁵² The doctrines of offer and acceptance, in contrast, posed no substantive barriers to the protection of reliance; parties who wished to rely could protect themselves, cheaply and easily, by following established procedure. The primary effect of estoppel in the precontractual setting was to grant such protection to offerees without requiring them to provide anything in return.

In my terminology, however, both sides of this debate argue from the perspective of convention maintenance. Hand and other critics of expanding promissory estoppel were ultimately arguing that enforcing unaccepted offers disrupts the prevailing formal conventions.⁵³ Traynor and the other advocates of liberal estoppel were ultimately arguing that the elegance of the formal rules of offer and acceptance does not matter if they are not really the conventions that people understand to be in force, or if other more compelling

50. If the reliance benefited the promisor, of course, the promisee might have a separate claim in restitution (e.g., if the promisee relied by disclosing valuable ideas). For a discussion of restitution cases in the precontractual setting, see E. Allan Farnsworth, *Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations*, 87 COLUM. L. REV. 217, 229-33 (1987).

51. The possibility of sealed agreement meant that the parties, with some trouble, could contrive to make a gift promise enforceable, but with the decline of the seal this ceased to be a practical alternative in most jurisdictions.

52. See, e.g., *Pillans v. Van Mierop*, 97 Eng. Rep. 1035, 1038 (K.B. 1765) (suggesting in dictum that written promises between merchants should require no consideration).

53. See, e.g., *James Baird Co. v. Gimbel Bros.*, 64 F.2d 344, 346 (2d Cir. 1933) (Hand, J.) ("[A]n offer for an exchange is not meant to become a promise until a consideration has been received . . .").

considerations lead people to ignore them.⁵⁴ Novices in business, such as the franchise applicants in *Hoffman*, may not know the formal legal doctrines, and more experienced parties, such as the general contractor in *Drennan*, may view legal doctrine as subordinate to prevailing social norms or business exigencies. For both kinds of parties, these norms and exigencies may constitute the real conventions in force. In this view, because offerors know about and knowingly benefit from offerees' reliance on such social and business understandings, it would be unfair to allow one party to evade the obligations of such understandings while it reaps the benefits of the other's compliance. Rather than trying to preserve the elegant and official conventions that parties do not really use, the law should try to reflect the messy but realistic conventions that the parties do actually follow.

Both Hand's and Traynor's arguments take conventions as given and try not to influence but to accommodate them. Individuals who interact regularly within the regime of contract law, however, such as construction contractors and subcontractors, will ordinarily have both the ability and the incentive to adjust their expectations to the legal rules in force. They can protect themselves against unfair surprise whatever the legal rule. Under a regime that follows *Baird* rather than *Drennan*, contractors can still choose to rely on subcontractors' bids without accepting. They will only do so, however, to the extent that the benefits of uncovered reliance outweigh the risk of disappointment; and the costs of wasted reliance will be allocated through the price mechanism. Contractors can, for instance, easily protect themselves against revoking subcontractors by including a margin of insurance in their general bids. They will then do worse than average on jobs on which subcontractors actually revoke but will make up for this with increased profits on the occasions when the subcontractors come through. Furthermore, under a rule granting subcontractors the right to revoke, subcontractors are willing to make lower bids in the first place. Indeed, in a competitive bidding environment, they are forced to do so because their expected cost of performance is lower when they do not have to insure against the contractor's lost reliance.⁵⁵

The fact that the parties can adapt their behavior to the prevailing convention does not, however, mean that the choice of convention is irrelevant, and as lawmakers, we need to take account of the regulatory consequences of choosing one conventional rule rather than another. The *Restatement (Second)*'s rule raises the cost to subcontractors of both making and retracting offers; this, in turn, tends to reduce the number of offers and affect the time

54. See, e.g., *Drennan v. Star Paving Co.*, 333 P.2d 757, 760 (Cal. 1958) (Traynor, J.) ("Though defendant did not bargain for this use of its bid neither did defendant make it idly, indifferent to whether it would be used or not.")

55. For a fuller explanation of the process of such price adjustments, see Craswell, *supra* note 27, at 366-68.

at which they are made. The rule also gives the offeror stronger incentives to avoid misrepresentations and to ensure that the calculations that go into her offer are accurate. For the offeree, conversely, the modern rule encourages greater reliance by lowering its cost.

A full regulatory analysis of the problem requires us to consider all these factors. In the next part, however, I will focus on those issues having to do with timing. Rather than ask whether the parties should enter into a binding relationship, I will ask when they should do so. Or, as Karl Llewellyn posed the question: When should an offer stick?⁵⁶ This specific doctrinal problem lies at the center of *Baird, Drennan*, and *Restatement (Second)* section 87(2); and, as the next part shows, it turns out that the answer determines whether reliance investments are made at the appropriate time. Part IV then relates the conclusions of my basic analysis to previous work on the other regulatory issues: incentives to perform, to take precautions against breach, to discover and share information, and to allocate risks.

A final caveat is appropriate here. In most of the discussion below, I abstract from issues of damages. There is some dispute, both in the case law and among commentators, whether the proper remedy in estoppel cases is measured by the promisee's lost reliance expenditures or by his lost expectation.⁵⁷ But since both expectation and reliance measures fully insure the promisee against wasted reliance, both measures encourage the promisee to act as though performance were certain.⁵⁸ For our purposes, therefore, the issue is secondary. In many cases, moreover, reliance and expectation damages are approximately equal, since reliance is generally a good proxy for expectation, especially when opportunity reliance is considered.⁵⁹

56. K.N. Llewellyn, *Our Case-Law of Contract: Offer and Acceptance* (pt. 2), 48 *YALE L.J.* 779, 802 (1939).

57. See, e.g., Edward Yorio & Steve Thel, *The Promissory Basis of Section 90*, 101 *YALE L.J.* 111 (1991).

58. Expectation damages do this by guaranteeing promisees the returns from their reliance investments, and reliance damages do this by guaranteeing a full refund if the returns are not achieved. Specifically, if the benefits from reliance are represented as B , the costs as C , and the probability of a completed bargain as p , it is socially desirable to invest in reliance if $pB > C$. Expectation damages guarantee the promisee a return of B , inducing him to rely whenever $B > C$. Reliance damages compensate the promisee's investment in the $(1 - p)$ fraction of cases in which there is no performance, making his effective cost of reliance equal to pC rather than C . He will rely if $pB > pC$, or equivalently, if $B > C$. Under either system, damages are excessive if $B > C > pB$.

59. See Robert Cooter & Melvin A. Eisenberg, *Damages for Breach of Contract*, 73 *CAL. L. REV.* 1432, 1434-44 (1985); L.L. Fuller & William R. Perdue, Jr., *The Reliance Interest in Contract Damages* (pt. 1), 46 *YALE L.J.* 52, 60 (1936).

III. THE UNDERLYING ECONOMIC PROBLEM

A. *The Planning Problem*

The legal controversies in the area of precontractual negotiations stem from one basic fact: There are economic gains to negotiating contracts over an extended period of time. A minority of transactions, mostly involving the exchange of homogeneous goods, can be conducted in spot markets without any loss in value, but ordinarily parties benefit from planning exchanges in advance. One reason for this is that time and effort are needed to decide on the bargain. The parties must determine whether an exchange is desirable at all, what terms are best, and how they will split the cooperative surplus. Equally important is the fact that advance planning increases the gains from trade by allowing the parties to rely. In most exchanges, the parties have opportunities to make investments that can make the bargain more valuable, and such investments are cheaper and more productive when made in advance. For instance, suppliers of goods with advance notice of an exchange can typically lower their production costs by buying materials when the prices are low or by doing work when business is slow. Last-minute production is more expensive because it involves rush, leading to increased overtime pay, more waste of materials, and the like.

Conversely, buyers can increase the utility of their purchases by investing beforehand in complementary inputs such as specialized storage facilities, or in such services as training workers to use the goods. If buyers are purchasing for resale rather than immediate use, advance dealing also gives them more time to find a better resale price. Furthermore, both buyers and sellers can rely by giving up opportunities to make substitute deals, thus saving the potentially significant cost of searching for and maintaining contact with alternative contractual partners. All these investments are relationship- or transaction-specific; the parties would not make them apart from the particular underlying exchange. These factors represent, in the terminology of Professors Goetz and Scott, the beneficial aspect of reliance.⁶⁰

Indeed, dealing in advance promotes beneficial reliance whether or not a bargain is concluded, for, if there is to be no exchange, it will benefit the parties to find this out early. So long as there is a possibility of an exchange, it pays to hedge by making some transaction-specific investments, and ruling out the possibility of exchange allows such expenditures to be saved. For instance, suppose that performance will require the physical transportation of goods. Waiting until the last moment to trade in spot markets may mean that

60. See Charles J. Goetz & Robert E. Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 YALE L.J. 1261, 1267-70 (1980). Even the time and effort put into considering the merits of a particular exchange may be a form of reliance, if the information gained cannot be applied to competing offers.

unsold goods have to be brought back and forth from the marketplace. If shipping costs are high and the chances of not finding a buyer are significant, it is better to negotiate before any goods are shipped.

On the other hand, early dealing has an obvious countervailing disadvantage. Over time, the parties' attitudes toward an exchange may change. New opportunities may arise, or they may discover new information relevant to the bargain. For example, after a buyer and seller agree on a sale, a second buyer with a more valuable use for the goods may come along. Alternatively, the seller's production cost may increase unexpectedly, or the buyer may suffer business reverses that render him unable to purchase. If such developments are enough to make a previously desirable bargain undesirable, any transaction-specific reliance investments will go to waste, and the parties will regret that they contracted so early. The costs of regret are, in Goetz and Scott's terminology, the detrimental aspect of reliance.⁶¹

Economic efficiency in preliminary negotiations requires that the advantages of beneficial reliance and the disadvantages of detrimental reliance be balanced against each other at the margin. Deciding to enter into a contract too early, when the level of uncertainty is high and the productive value of reliance low, results in too much reliance. It leads to sinking costs at a time when they are likely to be wasted. Contracting too late, on the other hand, forgoes the benefits of early planning and preparation. So, because both the productive value of reliance and the level of uncertainty change over time, there exists in any given negotiation, and for any given transaction-specific investment, a moment at which it is optimal to begin investing. We can identify this moment by comparing the incremental value of waiting to see what uncertainty will be resolved with the incremental cost of delaying an otherwise productive investment. As time passes, the incremental cost of delay will begin to exceed the incremental benefits of waiting. From the standpoint of a planner concerned with maximizing social wealth, this is the moment when the parties should be directed to rely.

To illustrate, consider a simple numerical example, depicted in Table 1. In this example, a subcontractor and general contractor can contract for the subcontractor's services at any time over a five-week period. For simplicity, suppose that the only risk involved is that the subcontractor may be unable to perform; her ability to do so turns on the successful completion of a previous job at another site. If the subcontractor cannot perform, the general contractor will have to abandon the overall project. The subcontractor's uncertainty, however, is resolved over time. At the outset of the period, in Week 1, the chance that she cannot perform is 20%. By Week 5, she will know for certain whether or not she can perform. The uncertainty is resolved at a constant rate: With each week that passes without bad news, the chance that the

61. *See id.* at 1267-69.

subcontractor will be unable to perform falls by 5%. This declining uncertainty is depicted in column (a) of the table, labeled "Chance of Breach."

	(a)	(b)	(c)	(d)	(e)
START WEEK	CHANCE OF BREACH	DISCOUNTED LOST RELIANCE $(a) \times \$60,000$	POTENTIAL PROFITS	DISCOUNTED PROFITS $(c) \times (1 - (a))$	EXPECTED NET PROFITS $(d) - (b)$
1	20%	\$12,000	\$20,000	\$16,000	\$4000
2	15%	\$9000	\$16,000	\$13,600	\$4600
3	10%	\$6000	\$12,000	\$10,800	\$4800
4	5%	\$3000	\$8000	\$7600	\$4600
5	0%	\$0	\$4000	\$4000	\$4000

TABLE 1. *Optimal Reliance*

In order to begin preparations for the job, the general contractor must spend \$60,000 on labor and specially manufactured materials that will have to be thrown out if the project is canceled.⁶² The risk of this happening decreases the longer the contractor waits before starting work. Column (b) shows the expected waste from lost reliance, which equals the \$60,000 reliance investment multiplied by the chance that the project will have to be canceled. If, on the other hand, the subcontractor can perform, the project will yield a return sufficient to repay the reliance investment, providing the general contractor with an overall profit.

As explained above, however, the amount of profit to be earned depends on how soon the contractor begins work. If the contractor begins in Week 1 and the job is successfully completed, there will be profits of \$20,000; starting in Week 2 means profits of only \$16,000, and so on. The relationship between the potential profits to be earned and the starting date is shown in column (c), labeled "Potential Profits." Of course, the parties will earn these profits only if the job is completed, so they must be discounted by the chance that the subcontractor will be unable to perform. The discounted level of profits is shown in column (d). In Week 1 it is \$16,000 (equivalent to an 80% chance of a \$20,000 profit); in Week 2 it is \$13,600 (equivalent to an 85% chance of a \$16,000 profit); and so on.⁶³ Finally, column (e) shows the bottom

62. More realistically, the reliance will increase as the general contractor continues work, and will be greater the later the subcontractor backs out. A given reliance investment, furthermore, may be more expensive to make the longer it is delayed. The example ignores these possibilities for the sake of simplicity, but the basic intuition would be the same if they were included.

63. I am assuming here that the parties are risk-neutral, so that this discount accurately reflects the risk of nonperformance. Section IV.A extends the analysis to cover the case of risk aversion.

line—expected net profits from the project, equal to the difference between discounted profits and discounted lost reliance. For instance, the \$4000 expected profit in Week 1 reflects the 80% chance of a \$20,000 profit, minus the 20% chance of a \$60,000 loss.

Given the above assumptions, the optimal time to begin is Week 3, since expected net profits are highest then—they are \$4800, reflecting a 90% chance of a \$12,000 profit, less a 10% chance of a \$60,000 loss. This is the optimal time because it balances the incremental costs and benefits of waiting another week. For each week of construction delay, expected lost reliance falls by 5% of \$60,000, or \$3000. The discounted profits, conversely, fall only \$2400 between Weeks 1 and 2 and \$2800 between Weeks 2 and 3, so it is worth waiting to see what happens. It is not worth waiting past Week 3, however, since discounted profits fall \$3200 between Weeks 3 and 4 and another \$3600 between Weeks 4 and 5.

Nothing in this example, by the way, requires us to assume that there is only one offeror and one offeree. It might well be optimal for an offeree to rely simultaneously on offers from multiple offerors if he does not know which one he ultimately will want to accept. The benefits from early reliance on the successful offer might be sufficient to outweigh the costs of waste on the unsuccessful ones. For the same reasons, it might be optimal for multiple offerees to rely on a single offeror who can deal with only one of them. Of course, for any individual party, the optimal length of time to delay reliance will increase as the number of potential trading partners and the uncertainty over who should contract with whom increase.

The problem becomes more complicated when an offeree can make multiple reliance investments in response to the same offer. In general, it is not optimal to make all such investments at the same instant, for they will differ in size, productivity, salvage value, and availability of substitutes, and their costs may change at different rates over time. Instead, each individual investment will present its own trade-off between beneficial and detrimental reliance. For reliance investments that yield large increases in profits when made incrementally earlier or that are partially salvageable if the bargain is canceled, the optimal moment for reliance is early. For investments that could be delayed without much loss in productivity or that are highly transaction-specific, the optimal moment for reliance is late.

B. *The Incentive Problem*

The foregoing analysis tells us which reliance decision would maximize the expected gains from trade. Whether the parties actually choose to rely at the optimal time, however, depends on the information and incentives provided them by the legal regime. In the presence of uncertainty, parties faced with

investment decisions generally find it profitable to take an intermediate position—that is, to hedge. In the case of precontractual reliance, the privately profitable hedge will coincide with the socially optimal hedge if the person choosing the hedge enjoys the incremental gains of beneficial reliance and pays the incremental costs of detrimental reliance. The legal regime, together with the parties' relative bargaining strength and the information available to them, will determine whether these conditions are met.

One obvious way for the legal system to promote optimal reliance is for courts to examine the parties' reliance decisions directly and to condition liability explicitly on the efficiency of those decisions. To some extent, the doctrinal requirements that reliance be reasonable and that liability be limited as justice requires already imply such an approach. Under the provisions of *Restatement (Second)* sections 87(2) and 90(1), an offeree whose reliance vastly exceeds the amount a court finds reasonable will not get full protection. Instead, he will recover only his reasonable reliance expenditures and will have to bear the costs of any excess on his own. Such a limitation will in theory give him the incentive not to overrely. In order for this method of regulation to work effectively, however, courts must be able to compare the potential costs and benefits of reliance after the fact, and they must be willing to associate this cost-benefit calculus with the *Restatement (Second)*'s standard of reasonableness. It is questionable whether actual judges and juries can perform this exercise in practice, except with the roughest approximation. Given the difficulty of the task and given the courts' traditional focus on convention maintenance, they are more likely to identify the reasonableness standard with customary expectations than with efficiency.⁶⁴

This problem is analogous to a longstanding controversy over efficient incentives in the economic analysis of tort law. Various commentators on tort, most prominent among them Judge Richard Posner, have argued that a negligence standard for liability provides potential tortfeasors and victims with the best incentives to take proper precautions against accidents. The reasoning is that of the famous Hand Formula. If potential tortfeasors are found negligent when (and only when) their precautionary decisions fail a cost-benefit test, they will internalize both the costs and the benefits of precaution and come to an efficient decision on their own. This will induce them to meet their legal duty of care. The victims, who will bear any residual costs of accidents, will then face the correct social incentives when it comes to making a cost-benefit decision regarding their own defensive precautions.⁶⁵

64. *But see* Richard Craswell, *Offer, Acceptance, and Efficient Reliance*, 48 STAN. L. REV. (forthcoming Feb. 1996) (suggesting that courts are often in position to evaluate whether reliance has been efficient, and arguing that a variety of rules in contract formation law ought to be, and often are, applied on this basis).

65. *See* RICHARD POSNER, *TORT LAW: CASES AND ECONOMIC ANALYSIS* 1-9 (1983); Robert Cooter, *Unity in Tort, Contract, and Property: The Model of Precaution*, 73 CAL. L. REV. 1 (1985); Richard Posner, *A Theory of Negligence*, 1 J. LEGAL STUD. 29 (1972). For a formal comparison of the abilities of

An opposing group of commentators, however, including most prominently Judge Guido Calabresi, have argued that courts are in a substantially poorer position than the disputing parties to make cost-benefit decisions about optimal care. The parties, after all, have more information and experience relevant to their individual situations, allowing them to evaluate costs and benefits at the time they act. They can also consider a wider variety of possible precautions than courts can, including precautions that take the form of reductions in the frequency or intensity of their activities. Given these advantages, and given the greater administrative costs of conducting an inquiry into the parties' negligence, strict liability is preferable to a negligence standard. Courts should not try to perform their own cost-benefit analysis after the fact. Instead, they would do better to identify and hold liable the party that is best able to make and act on such an analysis in the first instance—the so-called “least-cost avoider.” Focusing on the least-cost avoider will direct the courts' limited enforcement capacity where it is most effective; this will come closer to the second-best outcome than will attempts to split incentives between the parties under an inaccurate and administratively costly negligence standard.⁶⁶

For purposes of promoting optimal reliance in preliminary negotiations, the metaphor of the least-cost avoider is more useful than the algorithm of the Hand Formula. It is much easier for a tribunal to identify which party was in the better position to make the reliance decision than for the tribunal to make that decision itself after a dispute has arisen. Reliance in commercial contexts, after all, is highly specific to the individual transaction. The efficiency of potential investments depends on the probability of a completed bargain at the time an investment is made, but the tribunal can only assess this probability in hindsight after substantial delay. Measuring the proper timing of reliance after the fact is even more daunting, for it requires the court to determine not just expected costs and benefits at the moment of reliance, but also how these costs and benefits (and the probability of a bargain as well) changed over time throughout the relevant period. The task is made more difficult because reliance typically comes in intangible forms such as turning down substitute opportunities for exchange. Such “opportunity reliance” is notoriously difficult and costly to prove; this is why the reliance interest has often been protected in practice by awarding not reliance damages, but the expectation or restitution measure as a substitute.⁶⁷

strict liability and negligence rules to reduce accident losses, see Steven Shavell, *Strict Liability Versus Negligence*, 9 J. LEGAL STUD. 1 (1980).

66. See Guido Calabresi & Jon T. Hirschoff, *Toward a Test for Strict Liability in Torts*, 81 YALE L.J. 1055, 1060–76 (1972).

67. See Fuller & Perdue, *supra* note 59, at 60. For theoretical explanations of why expectation and restitution are good proxies for reliance, see Cooter & Eisenberg, *supra* note 59, at 1444–52; Avery Katz, *Reflections on Fuller and Perdue's "The Reliance Interest in Contract Damages": A Positive Economic Framework*, 21 U. MICH. J.L. REF. 541 (1988).

Accordingly, the subsequent analysis will follow Calabresi rather than Posner and will assume that, except in extreme cases, the fact-finding tribunal is not in a position to make a substantive determination regarding optimal reliance. Instead, it must place the liability for lost reliance on one side or the other, searching for the least-cost avoider. It turns out, however, that this search will often be reasonably straightforward. Other things being equal, the least-cost avoider is the party with the bargaining power *ex post*.⁶⁸

Suppose, then, that the two parties have equally good information about the costs and benefits of reliance and about the risk that the bargain will fail to be executed.⁶⁹ Then a rule that binds the offeror to an option contract as soon as she makes an offer, like that imposed by *Drennan* and the *Restatement (Second)*, makes reliance safe for the offeree. If the offer comes too early in the process, however, what is safe for the offeree will be too safe from the social point of view. The problem here is moral hazard, in which a person who is insured against losses from an activity ignores the real social risks attached to it. Because the prospect of a damage recovery insures the offeree against some of the costs of detrimental reliance, he has less of an incentive to avoid it. Under a rule of either expectation damages or reliance damages, the offeree gets full insurance against the offeror's nonperformance. Accordingly, if he gets any benefit at all from the productive value of reliance, he will have an incentive to rely as soon as possible.

By the same token, however, liability for reliance damages imposes the costs of wasted reliance on the offeror. She will therefore have an incentive to control these reliance costs by delaying her offer. If she can capture the full productive benefits of reliance, which she can accomplish if she has all the bargaining power, she will have the appropriate incentive to weigh costs against benefits. This position will induce her to wait to make an offer until the very moment it is socially optimal to rely, leading to the desired outcome. If the offeror cannot capture the full benefits of reliance, on the other hand, she will weigh the wasted reliance too heavily from the social viewpoint, and her incentive will be to wait too long before making an offer.

Conversely, a rule that leaves the offeror free to revoke places the costs of wasted preparations on the offeree. The offeror will then have little incentive to delay her offer or otherwise to restrain the offeree from relying. If the offeree can capture the full productive benefits of reliance, he will be the one with the correct incentive to weigh costs against benefits. This position will lead him to rely at the optimal moment even without any legal protection. If the offeree cannot capture all the productive benefits of reliance, however, he will be overly cautious and will rely too late. One way that this situation

68. In Section IV.F, I will briefly discuss how the analysis would be altered in those situations where courts can determine the level of efficient reliance *ex post*.

69. I discuss in Section IV.D how the analysis would change if this were not the case.

can occur is if the offeror has all the bargaining power *ex post*; she can then capture the value of reliance by raising the offer price after the offeree has relied. For this reason, the offeree will have no incentive to rely at all, unless he can bind the offeror to an agreement beforehand.

To illustrate, consider again the numerical example of Table 1 above. Suppose the subcontractor has full information about all the figures in the table and has all the bargaining power. For the sake of simplicity, one might imagine that she is allowed to make a single take-it-or-leave-it offer, so that by offering a contract price that just barely affords the contractor a profit on the transaction, she can capture virtually all the gains from trade.⁷⁰ In this case, if the subcontractor waits until the last week to make her offer, after all uncertainty is resolved, the price she can charge depends on whether and when the contractor relied. If he has not relied prior to that point, she can charge him up to \$4000 over her cost—the entire profit from the transaction.⁷¹ If he was foolish enough to rely in Week 1, however, she can charge him up to \$64,000 over her cost. This represents the sum of his \$60,000 reliance investment, which successful completion of the project will return to him, and the \$4000 profit he expects to make over and above that.⁷² This possibility exists because reliance is a sunk cost for the contractor; once he has relied, he prefers a losing contract that allows him to get back some of his expenditures to no contract at all. Similarly, if he relied in Week 3, the subcontractor can charge him up to \$64,800 over cost. Reliance before the subcontractor is bound gives her the power to expropriate the contractor's sunk investment. As a result, a rational contractor without any bargaining power would refuse to rely at all, since he cannot capture any of the incremental gains from early reliance, but he bears all of the risk.

There is a simple way out of this predicament. A subcontractor with all the bargaining power can offer a binding option in Week 3—by making an offer that she knows a court would construe as binding—to do the work at a price of slightly less than \$12,000 over cost. The contractor will be willing to accept

70. Alternatively, the subcontractor will have the bargaining power if she is the only seller of her particular service in the market, and the contractor is one of many potential buyers, all bidding against each other. For a fuller discussion of the conditions giving rise to *ex post* bargaining power, see *infra* Section V.A. The discussion in the text assumes that the contractor will accept a one-sided offer because a bare profit is better than a loss or no profit at all. This assumption is a stylized one, of course; in reality, an offeree may be so put off by an offer that does not give him what he regards as a fair share that he will reject it, despite the fact that it would be in his immediate interest to accept. Just how much constitutes a fair share, of course, will vary among offerees and is one of the key determinants of bargaining power. For a discussion of how the parties' views of fairness influence the bargains they are willing to accept, see Daniel Kahneman et al., *Fairness as a Constraint on Profit Seeking*, 76 AM. ECON. REV. 728 (1986).

71. Minus whatever slight amount of profit is necessary to induce the contractor to accept, which I ignore for expositional simplicity. My colleague Steven Salop informs me that the technical term for this quantity is a "smidge."

72. Again, minus a smidge. A contractor with no bargaining power would rather pay the subcontractor \$63,999 above cost than let the deal fall apart. If the deal falls apart, he loses his entire \$60,000 reliance investment, which is a sunk cost. If he agrees to the subcontractor's inflated price, he will lose only \$59,999.

this offer, because it affords him a small profit in the event of performance and insures him against lost reliance in the event of nonperformance. Once the option is made binding, the contractor will want to rely immediately. He is now fully insured, and with the subcontractor bound not to increase her price, he can capture all the profits that come from early reliance. Indeed, he is forced to rely immediately in order to avoid a loss, since if he waits a week, his profits will not cover the costs of the subcontract. Under this arrangement, the contractor breaks even, whether or not the subcontractor performs. For her part, the subcontractor earns just under \$12,000 if she is able to perform, which occurs with 90% probability. She must pay out \$60,000 in reliance damages if she cannot, which occurs with 10% probability. Her expected profit is then just under \$4800, the total surplus from the transaction.⁷³ Since this is the maximum amount she can expect to earn (she can capture the expected net profits in any of the five weeks by a similar strategy), her incentives are socially optimal. She will want to bind herself just in time for optimal reliance.⁷⁴

Conversely, suppose it is the offeree rather than the offeror who has all the bargaining power, so the offeror is unable to charge a price that exceeds her own expected cost of performance.⁷⁵ For ease of exposition, let us suppose simply that the offeree can somehow commit to rejecting any offer that exceeds the offeror's cost. In this case, the offeree will have the incentive to rely optimally even if the offeror is not bound by her offer.

To illustrate, consider once again the example in Table 1, assuming that the contractor has all the bargaining power and that the subcontractor can

73. An alternative, though less simple, way to provide an equivalent result is for the subcontractor to make a binding offer in which she disclaims liability for lost reliance, but promises to do the work for only \$5333.33 over cost in the event that she is available to perform. If this option is enforceable, it will yield the contractor a profit of \$12,000 less \$5333.33, or \$6666.67, with 90% probability—enough to cover the 10% risk of a \$60,000 loss. For her part, the subcontractor gets 90% of \$5333.33, or \$4800. In this alternate contract, the subcontractor still bears the cost of lost reliance, but she pays for it indirectly rather than directly. Essentially, she pays the contractor an actuarially fair insurance premium in the form of the \$6666.67 profits when the deal goes through. What is critical, however, is that she bind herself in advance to pay this premium; the fixed-price option represents her promise not to expropriate the gains from reliance. In contrast to the simple contract discussed in the text, this arrangement has the advantage of encouraging the contractor to keep down the costs of reliance as well as to rely at the optimal moment.

74. If the contractor will not enter the deal unless he gets some minimum level of expected profits, his insistence will affect the price the subcontractor includes in her take-it-or-leave-it offer, but will not alter the basic logic of the argument. For example, suppose the contractor must have at least \$900 to go along with the deal. If the subcontractor waits to make her offer and the contractor waits to rely until the last week, the subcontractor can charge a price of \$3100 over cost, leaving the contractor his \$900 profit. If the transaction occurs in Week 3, she can charge a price of \$11,000 over cost. This will give the contractor his necessary expected profit of 90% of \$1000, or \$900, leaving expected profits for the subcontractor of 90% of \$11,000 less 10% of \$60,000, or \$3900. The subcontractor will still capture the increased profits that stem from earlier reliance, so she will still have the incentive to make her offer at the optimal time.

75. This situation would occur, for instance, if the offeror were one of many sellers in a competitive market, if the offeree were the only possible customer in a market with excess capacity, or if the offeror were highly impatient for a bargain, and the offeree were not. For a fuller discussion, see *infra* Section V.A.

freely revoke her offer. Now, the contractor knows he will suffer the costs of wasted reliance if the subcontractor cannot perform. He also knows, however, that if she does turn out to be available, he can always hire her to do the work at cost. In that case, he will be able to keep the entire surplus resulting from the job. If he begins work in Week 3, therefore, he will earn expected profits of \$4800: \$12,000 profit with 90% probability, less a \$60,000 loss with 10% probability. This is the best he can do, so by rationally maximizing his own profits, he acts just as an optimal social planner would direct. The contractor does not need any legal protection to be induced to rely optimally; his bargaining power provides adequate protection.

If, conversely, the contractor has all the bargaining power, no subcontractor will want to commit to a binding option before the last week. This is because, in order to break even on such an option, she must charge enough of a profit to cover the reliance damages she must pay if she is unable to perform. For example, a subcontractor offering a binding option in Week 3 would have to include a markup of \$6000 over cost because, as soon as she binds herself, the contractor will spend \$60,000 in reliance and there is a 10% chance that she will be held responsible for this expenditure. There is no effective way, however, for the subcontractor to collect this necessary markup while using an option contract. If it turns out that she is available to do the work, which occurs 90% of the time, the contractor will not want to exercise the option, for he can instead turn around and offer her or one of her competitors a last-minute, take-it-or-leave-it offer to do the job at just over cost. Such a last-minute offer would be irresistible, since this slight profit would be better *ex post* than no deal at all. Accordingly, an early option is a sure loser for the subcontractor without bargaining power, as she never makes any profit from it and sometimes winds up paying for the contractor's wasted reliance.⁷⁶

Thus, if the contractor has the bargaining power and the legal system regards relied-upon offers as binding options, as in *Drennan v. Star Paving Co.*, the contractor will have too much protection against wasted reliance and the subcontractor will have too little. Rational subcontractors will then tend to avoid making offers until the last possible moment, when the uncertainty over their ability to perform will be resolved. This problem does not arise if the contractor does not need to communicate with the subcontractor in order to rely effectively. The contractor can begin work on his own, confident that negotiations can take place at a later time. But if he needs to coordinate with the subcontractor in order to prepare properly to make use of her performance,

76. This should make clear why the only reliance investments needing protection are those that are specific to the transaction or relationship. If the offeree's investment is fully salvageable through resale or a substitute contract, then there is no holdup problem. Because the offeree can then make the offeror compete against all other possible market uses for the investment, he will have all the bargaining power, and she will have none.

as is more likely, delaying the offer will mean delaying or distorting the reliance investment. A last-minute offer may mean no time for reliance at all. Such incentives underlie the criticism, made by some of the more traditional commentators on promissory estoppel, that too much liability for precontractual communications runs the risk of chilling preliminary negotiations entirely.⁷⁷

All this suggests that the efficiency of promissory estoppel in precontractual negotiations turns on the relative bargaining power of the parties *ex post*. If offerors have the bargaining power, then holding them responsible for lost reliance under the estoppel doctrine promotes optimal reliance. If offerees have the bargaining power, then optimal reliance requires them to bear the risk of loss.

C. *The Policy Problem*

1. *In Specific*

Can we say whether the *Baird* or the *Drennan* rule is more efficient in the context of precontractual negotiations? On the assumption that a substantial number of contractors and subcontractors operate in local construction markets (as ordinarily will be the case, else the underlying job would be awarded by negotiations and not by an auction), we can. The *Baird* rule is better. While various alternate contractual partners are available for negotiation beforehand, once the general contract is awarded, the winning contractor tends to have the bargaining power. He is the only one with whom the subcontractors can deal on the underlying project and is thus in a monopoly position to expropriate any specific investments they have made in preparing their bids. This conclusion is supported by the common complaint on the part of subcontractors that winning contractors engage in “bid shopping” or “bid chiseling” after the fact. Specifically, they play rival subcontractors against each other in order to get them to do the work for a price lower than their original bids.⁷⁸

If this account of the facts is correct, then Judge Hand had the better appreciation for economic efficiency, as he often did. General contractors had sufficient incentives for optimal reliance under *Baird*. They were perfectly capable of insuring against lost reliance by including a margin of safety in the price of their general contracts. Conversely, general contractors are overprotected under the *Drennan* rule, and will tend to overrely. The

77. See, e.g., Farnsworth, *supra* note 50, at 243. This set of incentives also poses the main disadvantage to Professor Kostritsky's recent proposal that courts generally hold negotiating parties liable for the reasonable value of all lost reliance by the other side. See Juliet P. Kostritsky, *Bargaining with Uncertainty, Moral Hazard, and Sunk Costs: A Default Rule for Precontractual Negotiations*, 44 HASTINGS L.J. 621, 672–73 (1993).

78. For a description of this practice, see Franklin M. Schultz, *The Firm Offer Puzzle: A Study of Business Practice in the Construction Industry*, 19 U. CHI. L. REV. 237, 240–52 (1952).

subcontractors who must pay for this overreliance cannot fully cover themselves by marking up the price, since the contractor can bargain them down once he has the contract in hand. As a result, subcontractors have an incentive to delay excessively in making offers and, in extreme cases, to avoid making offers entirely. This perhaps explains why, in practice, so many subcontractors choose to make their offers at the last possible minute.⁷⁹

This stereotyped scenario, of course, will not fairly describe all construction contracts. There are surely some construction bidding disputes in which the subcontractor holds the bargaining power *ex post*. In some specialized lines of work, only a small number of potential subcontractors may be available. The job may require unusual expertise, or arrangements may have to be made far in advance, making it difficult to find a replacement if the winning subcontractor withdraws after bidding is closed. In such cases, the argument for the *Drennan* rule may be stronger.

In any event, the inferior incentives provided by the *Drennan* rule in the construction industry have been partially moderated by later cases that have limited a contractor's freedom to speculate *ex post* at the subcontractor's expense. Specifically, general contractors who engaged in bid shopping or chiseling after the award of a primary contract have been denied the benefit of promissory estoppel.⁸⁰ From the standpoint of promoting optimal reliance, this appears to be a sensible limitation on the estoppel rule. The strongest cases for applying promissory estoppel in preliminary negotiations may not be in the construction bidding cases at all.

2. In General

Regardless of which party holds the bargaining power, the practical problem remains the same—the risk of holdup. Investing in a relationship-specific asset makes the investor vulnerable to opportunistic behavior after the fact. Because the asset is worth little outside the specific relationship, the party with the bulk of the bargaining power can appropriate its value; the party without bargaining power has nowhere else to go. For this reason, he or she may wind up no better off for having made the investment and, in the event that the relationship dissolves, will be worse off.

Encouraging specific investments in situations where one's counterpart holds the bargaining power has long been recognized as a standard problem in

79. See the description of a typical construction bidding process in Dorothy H. Bishop, Comment, *The Subcontractor's Bid: An Option Contract Arising Through Promissory Estoppel*, 34 EMORY L.J. 421, 424–28 (1985). The comment takes the position, however, that the general contractor lacks bargaining power and that it is the person offering the underlying job for bidding who is in the catbird seat. *Id.* at 426–27.

80. See *Preload Technology, Inc. v. A.B. & J. Constr. Co.*, 696 F.2d 1080, 1089 (5th Cir. 1983).

contracting and in business organization.⁸¹ The simple model of the previous section, in fact, closely resembles models developed by Oliver Hart and other economists to describe analogous organizational problems such as the vertical integration of a firm, the division of an insolvent company's assets, and the allocation of corporate control between capital and labor.⁸² These models all have a similar three-stage structure. In the first stage, the parties' property or contract rights are established by the rule of law. In the second stage, the parties choose whether and how to make any relationship-specific investments. In the third stage, the parties bargain over any resulting productive surplus. For example, in the case of insolvent companies, the parties' rights are set by debtor-creditor law, the relationship-specific investments are the efforts they make on the eve of insolvency to save or salvage the failing firm, and the bargaining in the third stage takes place under the auspices of a bankruptcy court or in a prebankruptcy workout.

In this class of models, first-stage property and contract rights matter because they set the framework for the bargaining that takes place in the third stage. Different legal rules change what the parties can obtain in the absence of a cooperative agreement, altering the threats and offers available to them. These background alternatives, along with relative bargaining power, determine the respective shares of surplus that the parties are able to obtain in the end; and these expected shares in turn determine their incentives to make specific investments in stage two. For example, such models suggest the importance of giving control rights within a firm to those persons whose investments in human capital are complementary with and specific to the firm's physical and financial assets: skilled workers, for instance, who must spend long hours learning how to use specialized machinery. Otherwise, such persons will anticipate that the fruits of their investments will go primarily to the owners of the physical and financial assets and will lack sufficient incentives to invest.

The business organization literature has focused primarily on property rights, but the same lesson applies to contract rights as well. Indeed, the problem of opportunism remains even after an official agreement is reached. A party to an agreement might demand a unilateral modification, or insist on

81. See generally Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978) (arguing that riskiness of specific investments determines efficient choice between contracting and vertical integration); Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233 (1979) (discussing specific investments as type of transaction cost). For an insightful discussion of the problem in the precontractual setting, see G. Richard Shell, *Opportunism and Trust in the Negotiation of Commercial Contracts: Toward a New Cause of Action*, 44 VAND. L. REV. 221, 228-51 (1991).

82. See, e.g., Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691 (1986) (applying model to vertical integration); Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119 (1990) (providing mathematical exposition of basic model); Oliver Hart, *An Economist's Perspective on the Theory of the Firm*, 89 COLUM. L. REV. 1757 (1989) (offering nonmathematical exposition of basic model); Bengt R. Holmstrom & Jean Tirole, *The Theory of the Firm*, in 1 HANDBOOK OF INDUSTRIAL ORGANIZATION 61 (Richard Schmalensee & Robert D. Willig eds., 1989) (surveying research in field).

interpreting ambiguous terms and exercising discretionary ones to his or her sole advantage. Once a contract has been concluded, however, the law deploys a variety of doctrinal tools to limit such opportunistic behavior. Under common law, the preexisting-duty rule⁸³ and the rule of *Foakes v. Beer*⁸⁴ invalidated contract modifications not accompanied by fresh consideration. Under modern doctrine, the requirement that modifications be fair and equitable in light of circumstances not anticipated by the parties⁸⁵ or, in sales cases, that they be in good faith,⁸⁶ serves a similar function. More generally, the implied duty of good faith and fair dealing⁸⁷ serves a similar purpose. Such rules free contracting parties to invest in their relationship without fear that their investments will be expropriated.

Protecting specific investments in preliminary negotiations, however, raises more difficult problems than does protecting them after a contract has been signed. Once there is a contract, holdups in the form of unilateral modifications can be policed by enforcing the original bargain. In the precontractual setting, in contrast, there is no specific bargain to enforce. It is difficult to prevent reliance investments from being expropriated by a subsequent adjustment in the contract price or other terms of the bargain. As a result, one's natural response is to find some preliminary communication—an offer, an estimate, a tentative prediction of the bargain—and enforce that instead. And this has been the courts' approach under the modern law of promissory estoppel.

As the previous discussion showed, however, whether treating early offers as binding options solves the problem of opportunism depends on which party holds the bargaining power. In situations in which offerors hold the bulk of the bargaining power, the rule of *Restatement (Second)* section 87(2) may indeed make sense. By forcing the offeror to bear the costs of precontractual reliance, the law gives her the incentive to weigh those costs against the benefits she obtains from it. In situations in which offerees hold the bulk of the bargaining power, however, the common law rule of free revocability makes more sense, for in that case it is the offeree who needs the incentives. Furthermore, if bargaining power is equally distributed between the parties, there may be no particular efficiency advantage to either rule. In that case, the advocates of simple convention maintenance would be right; public decisionmakers would be better off sticking to a clear default rule while private parties adjust their expectations to it. Of course, persons who know more about their individual bargaining power than does the legislature might wish to contract around this

83. See *RESTATEMENT (SECOND)*, *supra* note 4, § 73.

84. See 9 App. Cas. 605 (H.L. 1884).

85. See *RESTATEMENT (SECOND)*, *supra* note 4, § 89(a).

86. See U.C.C. § 2-209 cmt. 1 (1994).

87. See *RESTATEMENT (SECOND)*, *supra* note 4, § 205 (implied duties of good faith and fair dealing); U.C.C. § 1-203 (1994) (general requirement of good faith).

general default rule, just as some business organizations choose to contract around the default rules of corporate control.

In Section V.B of this Article, I survey a number of other commercial settings and apply my basic model to them. First, however, it is necessary to explore several complications to the analysis.

IV. EXTENDING THE REGULATORY ANALYSIS

The discussion of Part III considered only the simplest reliance decisions. I assumed that only one party to the transaction faced the opportunity to rely, that reliance took the form of a one-time investment, and that the risk of revocation came only from the offeror. I also assumed that both sides had full information about the costs and benefits of reliance and about the risk that the exchange would fall through. With these simplifying assumptions, I was nonetheless able to reach several important insights. First, the value of an exchange is maximized when reliance takes place at the optimal time. Second, optimal reliance is best promoted when a party in the position to influence that reliance's timing enjoys both its costs and its benefits. Third, both the distribution of bargaining power and the legal rules allocating the costs of wasted reliance help determine which party pays the costs of reliance and which one enjoys its benefits.

In most actual transactions, of course, reliance decisions are more complicated. There may be multiple opportunities for the parties to invest in transaction-specific assets, and there is some chance that either party will be unable or unwilling to go through with the exchange. The parties may be averse to risk. The chance of a failed bargain may be influenced by the precautions the parties take in preparation: for instance, by laying in an inventory of extra materials or spare parts, making sure one has sufficient production capacity, or simply by considering more fully whether one really wants to go through with the deal before making a bid. It may also be that one side has better information about the likelihood that the bargain will fall through. For example, the seller, based on her experience in marketing goods, may know more than the buyer about the possibility of alternate buyers with higher-value uses showing up at the last minute.

Some of these issues have already been addressed in the literature on the economics of contracts. It has been recognized for some time how the prospect of liability can influence parties' incentives to perform, breach, take precautions against breach, mitigate damages, and make relationship-specific investments after a contract is signed.⁸⁸ More recently, lawyers and economists have analyzed the incentives that legal doctrine provides for parties

88. See Cooter, *supra* note 65, at 11-19; Steven Shavell, *The Design of Contracts and Remedies for Breach*, 99 Q.J. ECON. 121 (1984).

to discover and share information during negotiations—both about the amount of damages in the event of breach, and about the likelihood of breach itself.⁸⁹ In particular, Richard Craswell has argued that rules, like that of *Hoffman v. Red Owl Stores*, that make promisors liable for reliance damages, provide efficient incentives for parties engaged in preliminary negotiations to investigate and disclose the likelihood that an offer will actually be forthcoming before making any promises.⁹⁰

It turns out, though, that the basic lessons of the preceding analysis remain valid notwithstanding these additional complications. I will want to expand the scope of the inquiry beyond the distribution of bargaining power; and it may be that we have to settle for a second-best result, in contrast to the complete efficiency achieved in the simple example. But we will still want to place the cost of wasted reliance on the least-cost avoider. These other complications—multiple reliance investments, information, incentives to take precautions against having to withdraw—are all relevant to this overall goal. But in general it remains the case that incentives are most efficient when the party who gains the bulk of the anticipated benefits from reliance also pays the cost when it is wasted. In this part, I will briefly survey a number of variations on this theme and relate my basic conclusions to previous work in the economics of contracts.

A. Risk Aversion and Insurance

In the discussion so far, I have assumed that the parties are risk-neutral, that is, that they view an uncertain prospect as equivalent to its expected value: the amount of the gain or loss in question multiplied by the probability of its occurrence. In general, however, most people are averse to risk and willing to pay a premium to avoid it. This is why relatively risky assets pay a higher return in the market than relatively safe ones; they have to in order for investors to be willing to hold them.⁹¹

Reliance investments are no exception to this general rule. Risk-averse parties would prefer to give up some of the productive returns from a reliance investment in exchange for reducing the risk that the investment will be

89. For analyses that discuss asymmetric information over the amount of damages, see Ayres & Gertner, *Filling Gaps in Incomplete Contracts*, *supra* note 8 (proposing penalty default rules as information-forcing device); Johnston, *supra* note 8 (criticizing Ayres-Gertner proposal). For discussions of asymmetric information regarding the probability of breach, see Richard Craswell, *Performance, Reliance, and One-Sided Information*, 18 J. LEGAL STUD. 365 (1989) [hereinafter Craswell, *Performance*] (discussing incentives for promisor to reveal information regarding probability of performance); Richard Craswell, *Precontractual Investigation as an Optimal Precaution Problem*, 17 J. LEGAL STUD. 401 (1988) [hereinafter Craswell, *Precontractual Investigation*] (discussing incentives to gather information about probability of performance).

90. See Craswell, *Performance*, *supra* note 89; Craswell, *Precontractual Investigation*, *supra* note 89.

91. For an introduction to risk aversion and the economic theory of choice under uncertainty, see generally STEVEN SHAVELL, *ECONOMIC ANALYSIS OF ACCIDENT LAW* 186–205 (1987).

entirely wasted. What this means in practice is that they will prefer to make such investments somewhat later than they would if they were risk-neutral. To illustrate, consider Table 2, which presents a variation on the example of Table 1. Both parties now regard an uncertain loss as worse than its expected value. In the example, I assume a risk premium of 10%. For instance, a 20% chance of losing \$60,000 is seen as equivalent to a sure loss of \$13,200 (20% x \$60,000, plus 10% for the risk). Similarly, a 15% chance of losing \$60,000 is seen as equivalent to a sure loss of \$9900, not \$9000. The discounted lost reliance, adjusted for this risk premium, is shown in column (b') of the table.

The expected net profits from the transaction must also be adjusted for risk aversion. Adjusted profits are found in column (e'). Each entry in this column is calculated by taking discounted net profits and subtracting from it the risk-adjusted cost of lost reliance found in column (b').⁹² Inspection of the numbers shows that for risk-averse parties, early reliance is discounted relatively heavily and later reliance relatively less so. The difference this makes can be seen by comparing columns (e) and (e'). It is still profitable to rely—just not as far in advance as it is when the parties are risk-neutral. With risk aversion, expected net profits are highest when reliance occurs in Week 4. Social efficiency should also take account of the parties' attitudes toward risk, since risk is a real economic commodity and its reduction is of real value. Thus in Table 2, delaying reliance until Week 4 is optimal as well.

But all this affects only the specific numerical calculations of the example. It does not alter the logic of the general argument, or its conclusions. The costs of wasted reliance, risk premium and all, should still be placed on the least-cost avoider. With or without risk aversion, a contractor without any bargaining power will not wish to rely if the subcontractor can freely revoke, because he bears the costs and reaps none of the benefits. With or without risk aversion, a contractor with all the bargaining power will rely optimally under a rule of free revocation because he reaps the benefits along with the costs. He will choose to rely later than he would if he were risk-neutral, but that is as it should be. Conversely, a subcontractor with bargaining power can still protect herself under the rule of the *Restatement (Second)* by committing to a binding option in advance. The price of the option will include a risk premium, and the subcontractor will delay offering it until Week 4—but again, that is just what is needed to maximize the surplus from the transaction.

92. Strictly speaking, the productive value of investment should be discounted by a risk premium to reflect the fact that it is uncertain as well, but I ignore this complication for the sake of simplicity.

	(a)	(b)	(c)	(d)	(e)	(e')
START WEEK	CHANCE OF BREACH	DISCOUNTED LOST RELIANCE WITH RISK PREMIUM $((a) \times \$60,000) + 10\%$	POTENTIAL PROFITS	DISCOUNTED PROFITS $(c) \times (1 - (a))$	EXPECTED NET PROFITS $(d) - ((a) \times \$60,000)$	WITH RISK PREMIUM $(d) - (b')$
1	20%	\$13,200	\$20,000	\$16,000	\$4000	\$2800
2	15%	\$9900	\$16,000	\$13,600	\$4600	\$3700
3	10%	\$6600	\$12,000	\$10,800	\$4800	\$4200
4	5%	\$3300	\$8000	\$7600	\$4600	\$4300
5	0%	\$0	\$4000	\$4000	\$4000	\$4000

TABLE 2. *Optimal Reliance with Risk Aversion*

Risk aversion can alter the basic analysis in one respect, however; it can influence our view of who is the least-cost avoider. The contracting parties may have different attitudes toward risk, depending on their size, their ability to investigate and control risk, or their access to diversification or insurance markets. For example, one party may be a sole proprietorship while the other may have many shareholders; in this case, risk borne by the former will come out of the proprietor's pocket, while risk borne by the latter can be spread among its shareholders and pooled with other risks in their portfolios. Or it may be that one party's profits are a function of many independent variables, so that unexpectedly high costs on one component or on one job tend to be balanced by low costs on others. If the parties do differ in their costs of bearing risk, then it will be efficient, other things being equal, to place the risk of wasted reliance on the one who can bear risk more cheaply.⁹³

If the party who can insure against risks more cheaply is not the one with the bargaining power, then we face a trade-off among costs, the precise nature of which will depend on the distribution of bargaining power. For instance, if the stronger bargainer can appropriate the entire gain from exchange *ex post*, then relative risk aversion should be ignored. Placing the cost of wasted reliance on a more risk-averse party is not ideal, but placing it on one with no bargaining power whatsoever is worse. Even if he is risk-neutral, his vulnerability to holdup makes him entirely unwilling to rely in advance. Indeed, even if the stronger bargainer has less than absolute power, it may be

93. For a general discussion of risk allocation, see A. Mitchell Polinsky, *Risk Sharing Through Breach of Contract Remedies*, 12 J. LEGAL STUD. 427 (1983).

better to put the risk of lost reliance on her, if her cost advantage in bearing it is sufficiently great.

In the majority of cases, however, there may be no real trade-off in requiring the party with more bargaining power to pay the costs of wasted reliance. Risk aversion, after all, is one of the key determinants of bargaining power. Successful bargaining often requires bluffing, threatening, and holding out. All these strategies involve the risk that the bargaining will delay the deal or even end in failure. Negotiators who are more willing to take this risk are likelier to get the lion's share; those who find it costlier to bear this risk are likelier to yield.⁹⁴ For instance, an employee who has quit a previous job in reliance on an offer of employment is likely to have relatively limited resources to bankroll a long negotiation; he may be ineligible for unemployment insurance, and may not be able to take a temporary or alternative position without giving up the one for which he is negotiating. A large employer, on the other hand, has many employees whom the employer can temporarily redeploy or work overtime. This imbalance in the parties' negotiating power comes down to a difference in their ability to spread and diversify unexpected costs. The same characteristics that help determine which side can better bear risk in general—size, access to diversification, and insurance markets—thus also tend to determine which can better bear risk in bargaining.

B. *Multiple Reliance Investments*

In the basic analysis, I assumed that there was need for only a single reliance investment. If multiple reliance investments are possible, it will generally be optimal to sink them at different times.

For example, negotiating parties might optimally delay turning down other contractual partners until late in the negotiations when most uncertainty has been resolved, while they may take on other forms of reliance, such as hiring unskilled workers or renting multipurpose machinery, early on. But such fine-tuning may not be possible under a regime in which enforcing courts are not able directly to measure and supervise the efficiency of reliance. If instead the offeror's obligation must come into force at a single moment, it may be necessary to balance the timing of investments. This may mean making one investment later than would be ideal, in order to prevent another from being sunk too early. But it is still optimal, given this qualification, to put the cost of lost reliance on the least-cost avoider—in general, the party with the bargaining power. For example, suppose that in the basic example the contractor faces two possible reliance investments. The pipes used for plumbing can be partially salvaged for another job if this one falls apart, so it

94. On the relation of risk aversion to bargaining power, see *infra* Section V.A.

would be optimal to begin installing them four weeks in advance of the planned exchange. The electrical wiring, however, cannot be salvaged at reasonable cost, so it is optimal to hold off on installing it until two weeks before the exchange. If the general contractor has all the bargaining power, and the legal rule makes him bear the cost of wasted reliance, there is no problem. He will properly internalize the risk of waste for each investment; he will also anticipate reaping all the returns if the job is completed. As a result, he will bear both the costs and the benefits and will have incentives to make both investment decisions optimally. If, on the other hand, the legal rule puts the cost of wasted reliance on the powerless subcontractor, she will want to wait until the last possible moment to make her offer, sacrificing all the potential benefits from reliance.

Conversely, if the subcontractor has all the bargaining power, it is best to place the cost of wasted reliance on her. The contractor will not be willing to do any work ahead of time absent a binding option, for the same reasons as before; he will bear all the risk of waste and will receive none of the productive benefits. But in this situation, the first-best solution may no longer be achievable. The subcontractor, who can now capture the gains from reliance, will be willing to offer a binding option in advance—but it is unclear how far in advance. If she waits to grant the option until two weeks ahead of time, the contractor will install the wiring at the proper time, but install the pipes too late. If she grants it four weeks ahead of time, the contractor will install the pipes at the proper time, but will also have every reason to go ahead and install the wiring as well.

What the subcontractor would like to do is give the contractor enough assurances four weeks in advance to induce him to start on the pipes, but to delay any assurances relating to the wiring until two weeks in advance. If reliance expenditures are specifically contractible, she can do this, for instance, by offering a binding option conditional on a two-week delay before installing any wiring. Such an offer will guarantee her a first-best outcome and all the expected profits that result. The special condition will require additional negotiations, however; and enforcing such a condition *ex post* will require proving to a court's satisfaction both the condition's existence and whether it has been met—all of which are costly. If the time of reliance cannot be contracted for and verified at reasonable cost, it will instead be necessary to draw a balance between the timing of the two investments.

In general, reaching the optimal balance will mean sacrificing the ideal timing on one investment to avoid even greater inefficiency on the other—a second-best outcome. For instance, in the example above, it may be best to begin both the plumbing and electrical work three weeks in advance, rather than two or four, given that there is no way to provide incentives to make the two investments at different times. But so long as the subcontractor has the bargaining power and the legal rule makes her bear the costs of wasted

reliance, she will have the correct incentives to choose the second-best outcome. She can determine the right starting date, and guarantee herself the profits associated with it, by making her offer three weeks ahead of time. Putting the risk on the powerless contractor, in contrast, means no incentives for reliance at all.

I have so far been assuming that all the reliance investments are made by the offeree. If both parties can rely, the analysis has to be modified further, but the basic intuition remains: It is still best to place responsibility for lost reliance on the party with the bulk of the bargaining power. To see this, let us change the last example slightly. Suppose that the contractor is responsible for the electrical work and plumbing, and the subcontractor is responsible for the heating, cooling, and ductwork. Both parties can lower their cost of performance by buying special materials in advance, but the project is a custom job and if it cannot be completed these materials will be wasted. On the same reasoning as before, there exists an optimal time for the contractor's reliance and an optimal time—in general a different one—for the subcontractor's reliance.

If the subcontractor has the bargaining power, she will have the incentive to make her investment correctly, but the contractor will not unless his reliance expenditures are protected by a binding option. Interpreting the subcontractor's offer as such an option, moreover, will induce her to make it at the right time, and all reliance investments will be optimal. If the contractor has the bargaining power, conversely, we have a different problem. Now the contractor has the proper incentives to rely and the subcontractor does not. In this case, efficiency requires the contractor to be legally bound in order to protect the subcontractor. The law could achieve this either by having the contractor offer the subcontractor a binding option, or by having the subcontractor offer the contractor a mutually binding bilateral contract. The important thing is that the contractor somehow binds himself not to appropriate the fruits of the subcontractor's reliance investment through his superior bargaining power.

C. Two-Sided Uncertainty

The discussion so far has also assumed that the only uncertainty regarding the completion of the bargain concerns the offeror's performance. In actual transactions, of course, there is some risk that either party will be unable or unwilling to perform. None of the foregoing analysis, however, depends on a particular side being the origin of the uncertainty. So long as both sides have equally good information about the costs and benefits of reliance and the total risk of waste, the logic of the argument is unchanged. There is still an optimal time at which to rely, and an offeree lacking bargaining power will not rely properly unless he is given a binding option at that time. Conversely, if the

offeror lacks the bargaining power, she will refuse to offer any option before all the uncertainty is resolved.

To illustrate, consider the following variation on the example in Table 1. In Week 1, there is a 10% chance that the subcontractor will be unable to perform, and a separate and additional 10% chance that the contractor will be unable to perform. The total chance that the bargain will fail to come to pass is 20%.⁹⁵ As before, suppose that the chances of nonperformance decline steadily over the precontractual period, so that in Week 2 the chance of each party withdrawing is 7.5%, for a total risk of 15%, and so on. Then the economics of the situation, and all the calculations, are identical to the original example. Specifically, it is still optimal to rely in Week 3, and a contractor with bargaining power will happily do so even without the protection of promissory estoppel. A contractor without bargaining power, on the other hand, will not rely unless the subcontractor binds herself in advance to perform at a fixed price. A subcontractor with bargaining power will be willing to do this—either explicitly, or in the form of an offer made binding by promissory estoppel.⁹⁶ A subcontractor without bargaining power, however, will refuse to issue a binding option in advance, and if the law treats her offers as such, she will delay and make them past the optimal moment.

Accordingly, efficient reliance is still promoted by putting the costs of lost reliance on the party with the bulk of the bargaining power. This will mean, perhaps counterintuitively, making that party pay for lost reliance even when it is occasioned by the default or withdrawal of the other side.⁹⁷ The reason for this result is that, so long as the parties have equally good information about the risk of a failed bargain and so long as this risk is exogenous, the party with the bargaining power is still the least-cost avoider. If information

95. To keep the arithmetic simple, I suppose that the two events are mutually exclusive; it will never be the case that both parties are unable to perform. Nothing turns on this except the round numbers.

96. There are a variety of option contracts that will do this. The simplest would provide the subcontractor with a price of \$12,000 above cost in the event of performance, but would bind her to pay for lost reliance no matter which side was unable to perform. The subcontractor would then earn expected revenues of \$10,800 and pay out expected reliance losses of \$6000, for net profits of \$4800—the maximum available. Alternatively, the subcontractor could disclaim liability for all lost reliance but bind herself to a price that allows the contractor enough profits to cover the expected cost of an insurance premium for lost reliance; this would mean a price of \$5333.33 above cost, as demonstrated *supra* note 73. Or the subcontractor could agree in her option to pay for lost reliance if she withdraws but could disclaim liability for reliance if the contractor is unable to perform; many readers may find this arrangement most natural. In order for the contractor to go along with this, however, she will have to bind herself to a price that allows him enough profits to cover this expected loss. Specifically, if 5% of the time he cannot perform and must pay \$60,000 in wasted reliance, this is \$3000 of expected losses that must be covered by the 90% of cases in which the contract proceeds as planned. This means the contractor must be assured of profits of \$3333.33 in those cases—so the subcontractor must commit to a price of \$8666.67 above cost (that is, \$12,000 – \$3333.33). It should be recognized that the subcontractor is still bearing all the costs of wasted reliance under each of these option contracts, including costs resulting from the contractor's failure to perform. Even when she disclaims liability for reliance, she pays the contractor an actuarially fair insurance premium sufficient to cover it in the form of a lowered price.

97. As the previous note showed, however, this payment need not be a direct one. It may instead take the form of a price reduction in an amount equivalent to the fair insurance premium against lost reliance.

about risks is not equally distributed, however, or if the parties have differing abilities to control risks, this may not be the case. This brings us to the next two variations.

D. *Asymmetric and Imperfect Information*

One commonly offered justification for promissory estoppel is misrepresentation—that the promise misled the promisee. In the discussion so far, I have sidestepped this argument by assuming that both parties to the exchange have equally good information. An offeree without accurate information about costs, benefits, and risks is unlikely to be the least-cost avoider, however, even if he enjoys all the gains from the exchange and pays all the losses from wasted reliance. If he mistakenly thinks that the probability of nonperformance is lower than it really is, he will rely earlier than he should from a social viewpoint. If, conversely, he thinks the probability is higher than it really is, he will rely too late.

A rule of free revocation, therefore, poses problems if the offeror is better informed than the offeree about the risk of revocation. In this case, the offeror will want reliance to take place earlier than would be optimal. Early reliance means increased gains when the bargain goes forward, and the offeror will enjoy at least a fraction of these gains so long as she is not utterly without bargaining power. The associated increase in wasted reliance, however, is borne by the offeree alone. Accordingly, the offeror with superior information has an incentive to try to induce early reliance by misrepresenting the risk. *Hoffman v. Red Owl Stores* offers a possible illustration. Since Red Owl stood to receive a fraction of the revenues from the business under their standard franchise contract, they benefited substantially from the Hoffmans' early reliance. While the Hoffmans had some experience in running a grocery, they were new to franchising and knew less than the defendants did about the factors that would govern the decision whether to award a franchise. Red Owl certainly had better information about its own internal procedures and about the actual authority of its regional agent, who had made most of the specific representations that induced the Hoffmans to rely so heavily.⁹⁸

Hoffman is usually regarded as an extreme case, and it has not often been followed despite its prominence in the casebooks and the commentary.⁹⁹ But it illustrates an important general point. The risk of a revocation or withdrawal

98. On the other hand, the Hoffmans had better information than Red Owl did about the sources of their financing, which ostensibly turned out to be the ultimate deal breaker. It is unclear from the court opinion whether or not this objection was a pretext on Red Owl's part, however, and the court seemed to treat it as one. See *Hoffman v. Red Owl Stores*, 133 N.W.2d 267, 270–71 (Wis. 1965).

99. See 1 FARNSWORTH, *supra* note 5, § 3.26, at 311 (“Although the decision in *Hoffman v. Red Owl Stores* has not been warmly embraced in later opinions, it has attracted the attention of commentators and may ultimately provoke a significant reappraisal of attitudes toward the bargaining process.” (footnote omitted)).

often turns on the factual circumstances of the offeror's business, and the offeror will generally be better informed about these circumstances than the offeree. Admittedly, a more sophisticated offeree (at least, more sophisticated than the Hoffmans) who realizes his inferior informational position could protect himself by attaching an appropriate discount to the offeror's representations and delaying his reliance accordingly. But even this response would not be fully efficient, since the discount and resulting delay would reflect the average risk across all similar transactions, not the actual risk in the particular instance. For some offers, the actual risk of revocation is lower than the market average and the extra delay is unnecessary; for others, the risk is higher than average and the delay is insufficient. The problem is asymmetric information, and the proper response may be an information-forcing rule—what Ayres and Gertner have labeled a “penalty default.” By holding liable the party with superior information, the law can provide an incentive for disclosure. Other things being equal, this is an efficient rule because it encourages reliance decisions to be made on the best information possible.¹⁰⁰

Similarly, even if neither party is in actual possession of information about the risk of nonperformance, one of them may be able to discover such information at lower cost than the other. There is always some chance that any offer has been issued by mistake or that further reflection will reveal it was ill considered. One way to guard against this is to put more effort into formulating the offer in the first place. The calculation errors in *Drennan* and *Baird* illustrate this possibility. Though there was no allegation in either *Baird* or *Drennan* that the subcontractors were negligent in calculating their bids, they were very likely in a better position than the contractors to prevent such errors. Since neither bid was so low as to put the contractor on notice of an obvious mistake, it would have been easier for each bidding subcontractor to recheck her figures than for the contractor to recheck all bids he received. More generally, those who make offers are ordinarily better able to obtain information regarding the risk of revocation or withdrawal than those who receive them. Putting the cost of lost reliance on offerors is a way of providing them incentives to search for and discover such information.¹⁰¹

This is not the full story, however. We must also worry about the parties' information regarding the costs and benefits of the reliance investment; here the offeree is likely to have superior information. He knows his resale market and where to buy complementary inputs. He knows more about the other opportunities he must turn down, and how well they substitute for the primary bargain. If the offeree's costs are psychic or nonpecuniary, indeed, it may be impossible for the offeror or anyone else to know their magnitude reliably. Of

100. See Ayres & Gertner, *Filling Gaps in Incomplete Contracts*, *supra* note 8, at 97. Craswell defends the doctrine of promissory estoppel on just these grounds. See Craswell, *Performance*, *supra* note 89, at 366–67.

101. See Craswell, *Precontractual Investigation*, *supra* note 89, at 408.

course, reliance or expectation damages that are entirely unforeseeable to the offeror will be limited by the principle of *Hadley v. Baxendale*¹⁰²—the classic example of a penalty default.¹⁰³ But even with this limitation, the offeree's superior information will still put him in a relatively better position to make the relevant cost-benefit analysis, other things being equal.

What this all means is that informational asymmetries must also be considered when searching for the least-cost avoider. If the offeror's information is vastly better, as in cases of misrepresentation or unilateral mistake, then she should be held liable for the offeree's lost reliance. Conversely, if the offeree's information is vastly better, as in cases falling under the *Hadley* principle, then he should be liable for his own lost reliance. But in less extreme cases, information should be factored in with all the other considerations I have identified: relative risk aversion, the presence of multiple investments, and so on. The basic intuition, though, remains the same. For optimal timing of reliance, we want to put the loss from wasted reliance on the person in the best position to anticipate getting the gains from it at the end of the game, for that is the person with the best incentive to do the cost-benefit analysis. This will tend to be the party with the bargaining power, and it will also tend to be the party who is better informed.

We still need to take account of bargaining power, however, as a primary consideration in the search for the least-cost avoider. Even if one party has superior information or ability to gather information, he or she will not wish to disclose it if the other side has all the bargaining power. Disclosure in that case is particularly dangerous; it will merely mean that the dominant bargainer appropriates all the benefits of full information in the form of a price change. As a result, the relatively well informed party will prefer to keep quiet, to delay the reliance investment, and to bear any remaining costs of wasted reliance.¹⁰⁴ In many if not most cases, however, there will be no conflict between putting the cost of lost reliance on the party with superior bargaining power and putting it on the party with superior information. Superior information, like a taste for risk, is an advantage in bargaining. The party who knows the other's reservation price can get more of the gains from trade, other things being equal; a party who can conceal his or her own bottom line has a

102. 156 Eng. Rep. 145 (Ex. 1854).

103. See Ayres & Gertner, *Filling Gaps in Incomplete Contracts*, *supra* note 8, at 101; see also William Bishop, *The Contract-Tort Boundary and the Economics of Insurance*, 12 J. LEGAL STUD. 241, 252-60 (1983).

104. It is for this reason that penalty default rules do not work well when the less informed party has all the bargaining power; the informed party would rather take the risk of liability than yield the informational advantage to the stronger bargainer. Cf. Shavell, *supra* note 8, at 33 (stating that incentives to investigate quality of property before exchange depend on ability to capture gains from better-quality information in exchange). See generally Johnston, *supra* note 8, at 620-23 (arguing that rule of *Hadley v. Baxendale* is not efficient when carrier is a monopolist).

corresponding advantage. The franchisor in *Hoffman*, for this reason, probably had the stronger bargaining position as well as better information.

E. *Incentives to Reduce the Risk of Revocation*

We have been supposing that the risk that performance is impractical or uneconomical is an exogenous event, outside the control of either party. In many if not most cases, however, both sides will be able to take precautions not just to discover this risk, but to reduce it—albeit at a cost. In the basic example laid out in Table 1, for instance, delay in the subcontractor's previous job need not make her performance impossible. If she had invested in a larger stock of machinery and hired a larger workforce in the first place, she would have enough capacity to complete both jobs. And even without this extra capacity, she might still be able to go out and hire additional workers and machinery on a short term basis. Whether it is worth her doing so, of course, depends on whether the value of maintaining the contract justifies the cost.

This is the same problem that the doctrine of efficient breach addresses.¹⁰⁵ The rules of contract damages affect whether contracting parties find it in their interests to complete their bargains or to take precautions so that they will be able to complete. As is widely recognized, liability for the disappointed party's lost expectations (and for reliance losses, insofar as they approximate expectation) provides efficient incentives in this regard. This is because holding a promisor liable for the actual losses stemming from a failed bargain gives her the proper incentives to balance these losses against her costs of performance.

The goal of efficient breach suggests, at first glance, that offerors should be held liable for their offers whether or not there has been an acceptance, since this will encourage them to take proper precautions against nonperformance. But this argument proves too much; indeed, on the same logic, perfect strangers to the transaction ought to be charged with liability also, to give them proper incentives as well in the event that their later participation turns out to be relevant. A better solution lies in the least-cost avoider principle, since even though strangers could take some precautions, their incentives are much less important than those of the parties. Similarly, the offeree's incentives may be more important than the offeror's. He may be able to reduce the risk of a failed bargain by altering his own plans, to reduce costs by mitigating, or to reduce or delay his reliance in the first place. We need to determine whether these precautions are more or less effective than those that the offeror could take.

105. I have ignored efficient breach until now because other scholars have thoroughly discussed it in the literature. See, e.g., Cooter, *supra* note 65, at 11–19 (illustrating economics behind efficient breach); Cooter & Eisenberg, *supra* note 59, at 1438–44 (outlining basic damage formulas); Shavell, *supra* note 65, at 9–22 (describing conditions under which breach is efficient).

In the end, as the existing literature recognizes, we may not be able to provide efficient incentives across all dimensions of the potential transaction.¹⁰⁶ Efficient breach, efficient precautions to avoid breach, efficient mitigation, efficient risk bearing, and efficient reliance—these multiple objectives cannot be promoted by a single legal rule without some compromise. Instead, we need to choose priorities and decide along which dimension it is most important to provide incentives. Precaution incentives, therefore, are yet another element of the least-cost avoider inquiry, along with information, risk aversion, and bargaining power. As before, however, bargaining power remains critical for the decision to rely, since charging an offeror with the costs of a failed bargain will do little good if she cannot share in the benefits of a successful one. Instead, it will just give her an incentive to avoid making any communication that could be interpreted as an offer for as long as possible. This result would not be efficient either. In the extreme, she may even shun the transaction.

F. *When Courts Can Police the Efficiency of Reliance*

Throughout the discussion, I have focused on identifying which party to the transaction is the least-cost avoider. Assigning losses to the least-cost avoider, however, is a second-best strategy, used because it is too difficult to supervise reliance decisions directly. The idea is to delegate the responsibility of performing a cost-benefit analysis to the party best suited to carrying it out when courts or regulatory authorities are not up to the task.¹⁰⁷

It can be argued, however, that *Restatement (Second)* section 90(1) presupposes that courts can supervise reliance at least in part, since it tells them not to protect reliance that could not reasonably have been foreseen and to limit the remedy awarded as justice requires. While these doctrinal elements are not equivalent to the efficiency criterion—the former can be read as incorporating the principle of *Hadley v. Baxendale* and the latter as restating the inherent limits of an equitable remedy—efficiency surely is relevant to their application. Unreasonable reliance will not usually be foreseeable, and justice will not usually favor a claimant whose reliance investment was manifestly wasteful. Similarly, some notion of efficiency is inherent in a number of other principles used to limit promisors' liability, ranging from the duty to mitigate to basic notions of legal causation.¹⁰⁸ Indeed, Richard

106. See Cooter & Eisenberg, *supra* note 59, at 1462 (cataloguing various dimensions of efficiency); Polinsky, *supra* note 93, at 433–44 (asserting that, since optimal payment varies with parties' risk aversion, no one remedy for breach of contract is uniformly appropriate); Shavell, *supra* note 65, at 16–17, 20–23 (asserting that relative performance of liability rules in terms of efficiency depends on knowledge victims have about risks).

107. See *supra* text accompanying notes 66–68.

108. See generally Cooter, *supra* note 65, at 29–36 (discussing ability of common law liability rules to promote efficient behavior).

Craswell has recently proposed that courts should understand a host of doctrinal requirements across the field of offer and acceptance as based implicitly on the underlying principle of efficient reliance.¹⁰⁹ How, then, should the above analysis be modified if courts can partly condition liability on the efficiency of the offeree's reliance?

First of all, as the preceding sections have made clear, nothing in the least-cost avoider concept requires us to abandon the principles of mitigation, foreseeability of damages, or proximate cause. These doctrines may not be necessary in those special situations where one side or the other can capture the entire gain from exchange, but, in the more general case, they do help to promote efficient reliance. If bargaining power is distributed among the parties, if the party with bargaining power lacks good information about costs and benefits, or if multiple or variable reliance investments are possible, then both offeror and offeree need incentives for efficient behavior. Even if it is best on balance to bind the offeror to her offer, unlimited liability for lost reliance creates a moral hazard for the offeree. Since he gets a positive fraction of the benefits from reliance, insulating him from all its costs will encourage him to rely as early and intensively as he can. Making him pay for his imprudence will moderate these effects. Accordingly, courts should continue to deny recovery for reliance that is clearly excessive or premature.

This is simply a concrete instance of a general principle of the economic analysis of liability. If two people can influence the probability or magnitude of some costly event, whether it is an automobile accident, a breach of contract, or a conflict between competing uses of neighboring property, it is desirable to give both some incentive to take precautions—what some authors have called “double responsibility on the margin.”¹¹⁰ This is why strict liability alone is generally inferior to strict liability with a contributory negligence defense, and why a negligence rule is superior to no liability at all.¹¹¹ Even if we can identify one side as the least-cost avoider in general, we will still benefit by making the other bear the cost of its unreasonable or fraudulent behavior in cases where we can recognize it as such.

The converse of this principle, however, is not true. The mere fact that an offeree's reliance investment was efficient does not imply that it should be protected. Rather, this depends on whether he is otherwise the least-cost avoider. If the offeror has the bargaining power, for instance, then she should pay for reasonable reliance; only then will the offeree have the proper incentive to invest. But if the offeree has the bargaining power, he should pay for his own reliance costs, whether reasonable or not. Placing liability on the offeror in this case would separate responsibility for costs from enjoyment of

109. See Craswell, *supra* note 64 (manuscript at 3, on file with author).

110. *E.g.*, Cooter, *supra* note 65, at 4.

111. Calabresi & Hirschoff, *supra* note 66, at 1068.

benefits. An offeror who sees only the potential costs of reliance will want to reduce her investment below its optimal level by delaying or avoiding negotiations. And the offeree, who sees only the benefits and none of the costs, will have the incentive to boost his reliance in ways that courts may only imperfectly supervise.

The basic lesson of the analysis remains: It is efficient to match the costs of reliance with its benefits wherever possible, and this is best done by looking primarily to the least-cost avoider—usually the party with the bargaining power *ex post*.

V. APPLYING THE ANALYSIS TO PARTICULAR CASES

The previous parts offered a simple and general rule of thumb for allocating the costs of wasted reliance in precontractual negotiations: Other things being equal, the least-cost avoider is the party with the bulk of the bargaining power. A more detailed inquiry, however, is necessary for this rule to be of any help to legal decisionmakers in the diversity of settings they face. Specifically, we need to look more closely at the concrete determinants of bargaining power. In this part, after a brief review of those determinants, I apply the analysis to a variety of actual and hypothetical cases.¹¹²

A. *Determinants of Bargaining Power—A Brief Recap*

Bargaining power in the context of wasted reliance is related but not identical to market power as antitrust law conventionally defines it. In a market with few sellers, many buyers, and barriers to new competition, we expect the sellers to capture a relatively high fraction of the potential gains from trade because they can credibly limit the number of exchanges into which they enter. This artificial restriction in quantity forces the buyers into competition with each other for the scarce supply, bidding up the price. The fewer the sellers, the stronger is their position; a monopolist is in the strongest position of all. Conversely, with few buyers and many potential sellers, the buyers, by limiting their purchases, can force the sellers into competition with one another, thereby bidding down the price. As a result, a monopsonist like General Motors will be able to capture the larger share of the gains from trade with its specialized suppliers. For such reasons, parties with monopoly or monopsony power in the relevant market will be in the better position to capture the benefits of precontractual reliance, other things being equal. As I argued in Section III.C,

112. For a fuller discussion of the determinants of bargaining power, see DOUGLAS G. BAIRD ET AL., *GAME THEORY AND THE LAW* 159–87, 219–67 (1994). A more mathematically formal discussion can be found in ERIC RASMUSEN, *GAMES AND INFORMATION: AN INTRODUCTION TO GAME THEORY* 275–92 (2d ed. 1994). The classic informal discussion is THOMAS C. SCHELLING, *THE STRATEGY OF CONFLICT* 21–52 (2d ed. 1980).

this is the situation of a general contractor with a major government contract in hand, able to play rival subcontractors against each other through bid shopping.

In many cases, however, conventional market power is of secondary importance for the allocation of lost reliance. Recall that the economic test for reliance is whether or not there has been a relationship-specific investment; if the investment is salvageable, there is no lost reliance. Once a promisee has sunk a relationship-specific investment, however, he has a competitive advantage over other potential contractual partners. His costs of going forward are less, and his expected returns from an exchange are higher. It is therefore more profitable *ex post* for the promisor to deal with him as opposed to his competitors; it is also more profitable for him to deal with the promisor. The situation is now one of bilateral monopoly.

An example of such a situation would be a specialized auto parts supplier that retools its production line to produce components for General Motors's new model. In the original negotiations, General Motors can play potential suppliers against each other to obtain a low contract price. After the contract is awarded and the retooling has taken place, however, the supplier's former competitors may have made other plans. They may have sunk specific investments in other relationships, and it will be more costly for them to retool at the last minute. Accordingly, GM would much rather deal with its original subcontractor than with anyone else, and the subcontractor would much rather deal with GM than retool to produce for another purchaser. Because it can no longer play the subcontractor against its competitors, GM's monopoly power *ex ante* has not fully translated into bargaining power *ex post*.

Of course, this phenomenon explains why parties like GM (as well as other monopsonists such as the federal government) commonly find it profitable to purchase complicated items from multiple sources.¹¹³ It is worth the extra costs of having two suppliers retool rather than one, even if there are substantial economies of scale, in order to preserve monopsony power in the event that modifications are necessary later on. But for many investments, the costs of duplication exceed the advantages of preserving market power. And for their part, parties who lack market power may be reluctant to make relationship-specific investments without the protection of an exclusive

113. Various provisions of federal law encourage or require second sourcing for U.S. government purchases. See, e.g., 10 U.S.C. § 2304(b)(1) (1994) (allowing exclusion from competitive bidding process of particular sources for military procurement if necessary to establish or maintain alternative source of supply); 41 U.S.C. § 253(b)(1) (1988) (same for public contracts). For discussions of second sourcing in the private sector, see Shantanu Dutta & George John, *Combining Lab Experiments and Industry Data in Transaction Cost Analysis: The Case of Competition as a Safeguard*, 11 J.L. ECON. & ORGANIZATION 87 (1995); Joseph Farrell & Nancy T. Gallini, *Second-Sourcing as a Commitment: Monopoly Incentives to Attract Competition*, 103 Q.J. ECON. 673 (1988). For a similar argument concluding that licensing a proprietary technology to competitors may be profit-maximizing, see Andrea Shepard, *Licensing to Enhance Demand for New Technologies*, 18 RAND J. ECON. 360 (1987).

arrangement, for fear that their efforts will be expropriated. For all these reasons, disputes over reliance will usually involve some degree of bilateral monopoly.

In general, market power under bilateral monopoly will often be asymmetric. Such bilateral monopoly will often be less than complete, for it may be easier *ex post* for one party to find substitute partners than for the other to do so. This can depend on the specific market involved, but it also depends on the nature of the reliance itself. For instance, when a buyer's reliance takes the form of turning away substitute suppliers, he weakens his negotiating position relative to a seller who keeps open her option of dealing with other purchasers. Reliance in the form of complementary investments such as a retooled plant, in contrast, does not have the same strategic effect, because it lessens competition symmetrically on both sides of the transaction. Similarly, the parties' relative monopoly power depends on how appropriate the reliance investment is—that is, the extent to which the relying party can block others from appropriating its benefits in the absence of a final agreement. Investments in information, for instance, such as an expert's appraisal, an engineer's design, or an entrepreneur's marketing concept, are notoriously difficult to monopolize without the protection of law, and it may be relatively easy to find competitors willing to free ride on such endeavors after the fact.

Even in the case of complete and symmetric bilateral monopoly, however, bargaining power is not necessarily equal. Asymmetries in bargaining power can come from a host of other asymmetries in the parties' situation, some of which have already been discussed. For instance, one side may be more impatient than the other to reach an early deal. Such impatience may result from a higher per period cost of delay before a bargain is reached, as in the case of a criminal defendant who must remain in jail during plea bargaining. It may arise because one party discounts future profits at a higher rate than her counterpart, who faces a lower interest rate in financial markets and can therefore more cheaply borrow against a favorable but delayed agreement. A party may also be impatient because there may be some significant chance that he or she will be unable to enjoy the benefits of a delayed agreement at all, as in the case of a buyer on the verge of bankruptcy or a partnership on the verge of dissolution. In all these events, the impatient party's greater desire to reach an early deal will lead him or her to offer earlier and larger concessions.¹¹⁴

Similarly, one side may be more averse to risk than the other, due to differences in taste, size, or opportunities to diversify. A risk-averse party will rationally make softer demands in bargaining as insurance against failing to

114. See MARTIN J. OSBORNE & ARIEL RUBINSTEIN, BARGAINING AND MARKETS 51–52 (1990); Ariel Rubinstein, *Perfect Equilibrium in a Bargaining Model*, 50 *ECONOMETRICA* 97 (1982) (offering mathematical analysis).

reach a deal altogether.¹¹⁵ Bargainers with more of a taste for risk will be less willing to pay for such insurance, will make tougher demands, and will garner a larger share of the gains,¹¹⁶ other things being equal.

Informational asymmetries also affect the parties' relative bargaining power. Recall that if one is uncertain about the other side's eagerness to enter into a deal, it is worthwhile to hedge on one's settlement demand, balancing the benefit of getting a larger share of the surplus if one's counterpart is eager to reach settlement against the risk of delay or bargaining failure if he or she is not. Therefore, a party desperate to reach a deal may nonetheless obtain a significant share of the gains from trade if the other side is unaware of the extent of his or her desperation; conversely, a nonchalant party cannot benefit from nonchalance unless he or she can credibly communicate it. For this reason, negotiators commonly find it advantageous to conceal their reservation prices and go to great efforts to make the other side believe that they are willing to conclude a bargain only on favorable terms. An opponent who can see through such subterfuge will have a significant advantage.

Finally, parties who are better able to commit to their negotiating strategies in advance will have a strategic advantage. Commitment by one bargainer raises the other's cost of holding out for a better deal; the clearest case of this is the take-it-or-leave-it offer. If one is faced with such an offer in a negotiation that is not going to be repeated and believes that the underlying threat to end the bargaining is credible, it pays to accept, even if one knows that other more favorable deals are potentially available. The offeror's commitment enables her to garner a larger share of the surplus. On the other hand, if it is unclear whether this is really the final offer, it may pay to call the offeror's bluff and see if she will back down; or, if similar negotiations are expected on some other occasion, it may pay to force the offeror to act on her threat in the hope of deterring similar threats in the future. Since it does not pay to issue take-it-or-leave-it offers to those who can be expected to reject them, an offeree's commitment to rejecting such threats will, over time, increase the share of surplus he is able to obtain. Parties who can establish a credible reputation for stubbornness, spite, or even irrationality will increase their bargaining power, and those who are repeat players or who are engaged in many negotiations simultaneously will find it easier and cheaper to do so.

In sum, the distribution of bargaining power depends on: (1) the number of *ex post* competitors on both sides; (2) the appropriability of the reliance investment; (3) the parties' attitudes toward delay; (4) the parties' attitudes toward risk; (5) the parties' information about each other's willingness to enter

115. See *supra* Section IV.A.

116. See Alvin E. Roth, *A Note on Risk Aversion in a Perfect Equilibrium Model of Bargaining*, 53 *ECONOMETRICA* 207 (1985) (presenting mathematical demonstration that more risk-averse negotiators get smaller share of bargaining surplus).

into a deal; and (6) the parties' ability and incentive to establish and maintain a reputation.

B. *Relative Bargaining Power—A Selection of Examples*

The foregoing list of factors suggests some straightforward empirical generalizations. For instance, as between a monopolist and a firm on the competitive fringe, the former is likely to have more bargaining power, other things being equal. More importantly, as between a larger party and a smaller one, the larger is likely to have more bargaining power. Large size usually provides greater opportunity to spread and diversify risk and also makes it easier to establish a reputation. Similarly, long-lived parties have more bargaining power than short-lived ones; they not only have greater opportunities to spread risk and to establish a reputation, but they also can more easily borrow against expected future earnings and will likely attach a lower discount rate to delay. For the same reasons, wealthy parties have an advantage over poor ones, commercially experienced parties have an advantage over newcomers, and governmental entities have an advantage over individual citizens, other things being equal. Apart from these broad generalizations, however, the distribution of bargaining power depends upon the specific features of the business context, making it likely that different sectors and regions of the economy and different markets and submarkets within those sectors and regions will find different legal rules to be efficient. It will necessarily fall to individual groups of contracting parties, therefore, to choose the regime best suited to their situations. The following examples illustrate the sort of analysis such parties will need to conduct in order to so choose.

1. *Franchise Relationships*

Both *Hoffman v. Red Owl Stores* and *Goodman v. Dicker* involved disputes between franchisors engaged in business across a national or regional market and individual applicants for a local franchise who made franchise-related investments before having a franchise in hand. The general rule of thumb favors the applicants. Other things being equal, franchisors are in a superior bargaining position relative to potential franchisees. There are many more franchise applicants than there are franchisors, since an established and reputable trademark is necessary to make franchising an economically valuable enterprise. General business experience and access to a modest amount of capital, in contrast, are sufficient to qualify an applicant to be a franchisee. Additionally, franchisors typically impose limits on the number of franchises they grant in order to provide each individual franchisee with an exclusive market. The franchisors' relatively large size and geographically diversified operations make them better able to bear risk and to establish a reputation for

firm dealing. They are likely to have better information about franchisees' financial situation than franchisees have about franchisors', if only on the basis of the franchisees' applications. On the basis of their experience, franchisors also will have better information about the business as a whole. Moreover, the franchisors draft the language of the franchise agreement, usually in standardized form. For these reasons, there is a strong argument for construing franchise contracts in favor of protecting franchisees and their reliance investments once the franchise contract is signed.¹¹⁷ All the same arguments apply to the precontractual setting. The behavior of the Hoffmans notwithstanding, rational franchise applicants will be reluctant to make investments specific to the franchise relationship. Optimal precontractual reliance, then, will ordinarily require holding the franchisor liable for precontractual representations and offers.

2. *Lender-Borrower Disputes*

In a number of recent cases,¹¹⁸ courts have held banks and other lenders liable for informal promises made in the course of loan negotiations that ultimately concluded in a failure to extend credit. To the extent that it is important to give credit applicants incentives to sink reliance investments or to turn down other business opportunities before credit is actually extended, these decisions appear efficient. Because of the information required of most credit applicants, lenders generally have better information about borrowers' willingness to accept stringent terms than borrowers do about lenders. Because of their access to wholesale credit markets, lenders face a lower rate of interest and thus can afford to apply a lower discount rate to the returns from a delayed agreement. Borrowers also have a higher discount rate for delay than do lenders because they face a greater risk of going out of business.

On the other hand, borrowers may be less risk-averse than lenders by virtue of their limited resources. It is generally recognized that firms and individuals on the edge of insolvency have an incentive to behave in a risk-preferring fashion, since they capture the upside gains of a gamble while being protected from the downside losses by limited liability.¹¹⁹ This attitude toward risk, produced by having nothing to lose, will translate into a more aggressive bargaining posture and may provide borrowers with an edge in

117. See Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 STAN. L. REV. 927, 984-90 (1990).

118. See, e.g., *Zimmerman v. First Fed. Sav. & Loan Ass'n*, 848 F.2d 1047 (10th Cir. 1988) (upholding jury award in favor of appellees on estoppel claim); *Johnston v. State Bank*, 195 N.W.2d 126 (Iowa 1972) (holding that bank is liable to builder pursuant to bank's letter advising existence of loan commitment to property owner); *Bixler v. First Nat'l Bank*, 619 P.2d 895 (Or. 1980) (upholding jury verdict in favor of appellant on promissory estoppel claim but modifying damages award).

119. See, e.g., Michael Bradley & Michael Rosensweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992).

negotiations. Furthermore, borrowers can engage in various sorts of misbehavior if lenders become unilaterally bound to extend them credit in advance of a final agreement. They can withdraw assets from the underlying enterprise, dilute the value of the loan by issuing more debt to other lenders, or divert the enterprise to more risky projects.¹²⁰ This may deter or reduce precontractual investments on the lender's part, and it reduces the lender's incentive to spend resources to evaluate the borrower's application in the first place. On balance, then, the efficient rule for precontractual liability may depend on whether it is more important to encourage borrowers or lenders to make early reliance investments and on how close the debtor is to insolvency.

3. *Broker-Customer Disputes*

In *Marchiondo v. Scheck*,¹²¹ the court used promissory estoppel to protect a real estate broker who relied on the seller's offer to pay a commission upon finding a buyer, even though the deal was never concluded. This decision is consistent with the general rule of thumb. While the large number of potential buyers, sellers, and real estate brokers prevents any single one of them from gaining substantial market power, the central problem here is appropriability of the reliance investment. The product of the broker's efforts is largely informational; it is his job to discover and disclose the existence of a buyer willing to pay the seller's price. Once this information is revealed, the broker has given up most of the value of his work, and most of his bargaining power. Even if the buyer's name has not yet been revealed to the seller, the parties will now find each other more easily and the temptation to get together behind the broker's back and cut him out of his commission will be significant. This will, of course, undercut the broker's incentive to look for a willing buyer in the first place. It is for this reason that real estate brokerage contracts often provide the broker with exclusive agency rights for some nontrivial period of time,¹²² and it is for this reason that promissory estoppel is appropriate to protect reasonable reliance by brokers before such contracts are signed.

4. *Employer-Employee Disputes*

The strongest case for applying promissory estoppel to precontractual negotiations may be in the context of labor contracts—specifically, the case of the prospective employee who quits a previous job in reliance on a new employer's offer, as in *Hunter v. Hayes* and *Grouse v. Group Health Plan*.

120. See Daniel R. Fischel, *The Economics of Lender Liability*, 99 YALE L.J. 131, 133–35 (1989).

121. 432 P.2d 405 (N.M. 1967).

122. See *Real Estate Listing Serv. v. Connecticut Real Estate Comm'n*, 425 A.2d 581, 584–85 (Conn. 1979) (discussing and comparing open-listing, exclusive-agency, and exclusive-right-to-sell arrangements).

Except when the employee has some unique skill or professional knowledge, the employer is much more likely to hold the bargaining power. After the employee has given up the source of his livelihood, he will have limited financial resources on which to draw. A period of unemployment may also make it harder for him to find work in the future. Employers, in contrast, generally have lower short-term costs of doing without an agreement and can afford to be more patient. Because they deal with many employees while a worker deals with relatively few employers, moreover, employers have both the incentive and the ability to commit to an uncompromising reputation. They can more easily claim the excuse of bureaucratic inflexibility and can more credibly assert that a concession in one instance will cost them similar concessions in the future. For all these reasons, holding employers to their offers will most likely promote optimal reliance in employment negotiations.

C. *Summary*

In the foregoing examples, my suggested rule of thumb generally implies holding large, informed, wealthy repeat players to their precontractual offers and representations, while excusing small, uninformed, liquidity-constrained novices from theirs. This favoring of weak parties over strong ones comports with the traditional norms of equity out of which the estoppel doctrine originally grew and may for some readers seem appealing for that reason. It is important to remember, however, that my analysis here is not focused on distributional fairness, but on allocative efficiency. Whether or not it is fairer to favor weak parties over strong ones, it is necessary to do so in order to give the weak appropriate incentives to make reliance investments—investments that increase the social value of exchange for strong and weak alike. It is in the private interests of the strong to enter into contractual arrangements whereby they bind themselves not to use their bargaining power to expropriate the investments of the weak. Who is strong and who is weak, however, and whose investment incentives need protection, may be a matter for individualized and decentralized determination.

VI. CONCLUSIONS AND CAVEATS

In summary, the doctrine of promissory estoppel does not merely protect the expectations of those who follow social and legal conventions. It also has regulatory consequences, since it helps to set those conventions, and not all conventions have similar effects. Specifically, by altering the costs and benefits of reliance, promissory estoppel influences parties' decisions to make offers and to rely on them at the proper time and in the proper amount. The traditional approach to the doctrine, however, reflecting what I have labeled convention maintenance, focuses on interpreting the context of the dispute to

see what convention the parties agreed to follow. In so doing, this approach neglects the regulatory consequences of promissory estoppel.

To give the traditional approach its due, convention maintenance may be the only sensible policy if contracting parties cannot adapt their expectations to the legal regime. For instance, individuals who have infrequent contact with the legal system will find it costly and difficult to learn legal rules and to adjust their behavior to them. They may rely inefficiently, notwithstanding any regulatory incentives the law provides. For this reason, the analysis I recommend will be more persuasive in some situations than in others. I am inclined to think that parties in cases like *Baird* and *Drennan* can adjust their expectations to the legal default rule fairly easily. Less experienced negotiators, like the disappointed applicants in *Hoffman*, may have more trouble adjusting, though a few costly mistakes might help to speed up the learning process.

Even in situations in which some parties are unsophisticated about what the law provides, however, it is still useful for policymakers and planners to consider a regulatory perspective, if only to understand what consequences would follow from changing expectations. Only then will it be possible to determine whether the better policy would be to defer to the expectations of the untutored, to impose on them the burden of adjustment, or to require those who deal with them to instruct them in the ways of the law.¹²³ Moreover, in most of the cases that are close enough to make it into court, the regulatory and interpretive approaches will overlap, since any reasonable interpretation will be guided by the recognition that the legal system has been set up under some rational regulatory scheme.

From the regulatory perspective, the key criterion in applying promissory estoppel is whether or not it promotes efficient reliance. With regard to the specific question of whether offers should be revocable, this means optimally timed reliance—comparing the incremental value of waiting a little longer to resolve some uncertainty with the incremental cost of delaying a productive reliance investment. As I have argued above, the best way to promote optimal reliance is to allocate the costs of wasted reliance to the least-cost avoider. Other things being equal, this will be the party who holds the bulk of the bargaining power. Sometimes this is the offeror, as when a large organization revokes an offer of employment made to a liquidity-constrained worker who has given up his previous source of income, as was arguably the case in *Hunter v. Hayes*. But sometimes it is the offeree, as when a general contractor controls access to a lucrative construction project and can play bidding

123. For a discussion of these switching costs from the economic viewpoint, how seriously they should be taken, and who ought to bear them, see Louis Kaplow, *An Economic Analysis of Legal Transitions*, 99 HARV. L. REV. 509 (1986). For a critique from the liberal position of the economic approach to the problem, see Ronald M. Dworkin, *Is Wealth a Value?*, 9 J. LEGAL STUD. 191 (1980); Ronald Dworkin, *Why Efficiency? A Response to Professors Calabresi and Posner*, 8 HOFSTRA L. REV. 563 (1980).

subcontractors against one another, as was arguably the case in *Baird* and *Drennan*.

The basis for this conclusion is that the party with the bargaining power captures the bulk of the gains from reliance. If the same party is made to bear the costs of reliance, including the costs of waste when the exchange cannot be completed, she will have the proper incentives to weigh costs against benefits. This will lead her to choose the timing of the transaction to maximize the potential value of the exchange. If, however, the law places the costs of reliance on a party who cannot capture its benefits, the incentives will be inefficient. If it is the potential offeree who bears the costs of reliance but cannot capture the benefits, he will want to delay reliance or avoid it altogether. If instead it is the potential offeror who bears the costs without being able to capture the benefits, she will want to delay or avoid an offer. The argument needs to be modified when other complications such as asymmetric information are introduced, but its underlying logic continues to hold. In general, persons without bargaining power will be reluctant to enter relationships requiring specific investments, for fear that their investments will be expropriated. The proper allocation of contract and property rights, however, can provide them with the necessary protection.

The rule of thumb I advocate here is best suited to questions of timing: When should reliance take place, when should promises be communicated, and when should an offer stick? Both parties to a transaction have good control over its timing because of the sequential link between their actions. The offeree can always avoid or delay reliance until the underlying uncertainty is resolved or until the parties conclude a mutually binding agreement. Similarly, the offeror can prevent premature reliance by delaying her offer and by avoiding advance representations that an offer is forthcoming. Thus, either party, if given the incentive to do so, can coordinate the optimal decision. If the problem is not the timing of reliance but its amount, however, the offeror may not have the same degree of control as the offeree; for that reason, the suggested rule of thumb will not by itself produce a fully efficient outcome. Instead, we will need to supplement it with other legal doctrines such as misrepresentation, contributory negligence, unforeseeability, and the duty to mitigate damages. The same is true if multiple reliance investments are possible, if information about costs and benefits is not symmetrically distributed, if the parties face different costs in bearing risks, or if they can take precautions in advance to reduce the chances of a failed exchange. I have focused here on timing because these other issues have been more thoroughly covered in the existing literature, but maximizing the gains from exchange will require trading off incentives along all the dimensions of efficiency.

From a purely legal standpoint, I have abstracted from some doctrinal differences among the cases I have discussed, in order to focus on their strategic structure. While the essence of the incentive problem is the same in

the franchise, construction, and employment contexts, contracting parties may be able to protect themselves more easily in some business and legal settings than in others. If the reliance-inducing statement is specific enough to be classified as an offer, for instance, as in the construction cases, the offeree can protect himself by accepting, especially if there is room to condition the acceptance on the award of the primary contract. But this tactic will not suffice to protect the individual recipient of a job offer in a jurisdiction that recognizes employment at will, since the employer retains the right to terminate for any reason. And the franchise applicant who has not yet received any formal offer, as in *Hoffman*, cannot accept at all. Similarly, it may be easier for the parties to control reliance—either their own or the other side’s—in some settings than in others.¹²⁴

The basic lessons of the analysis, however, go beyond the confines of *Restatement (Second)* sections 87 and 90, and apply to any analogous rules of offer and acceptance. For example, the doctrine of indefiniteness, which holds that an agreement leaving too many terms open cannot be enforced notwithstanding the parties’ actual intentions,¹²⁵ presents a similar economic problem. Early in the negotiating process, the parties have relatively poor information about what terms of exchange are best. Thus, they face a trade-off: They can transact using terms that run the risk of later turning out to be inappropriate, or they can leave things open-ended until they know more details. Waiting to be bound until everything is known forfeits the benefits of reliance, if the relying party lacks bargaining power. If the legal regime requires the parties to choose relatively specific terms in order to create an enforceable bargain, as the common law traditionally did, they may get these terms wrong; if the cost of wrong terms is too high, the parties may abstain from the transaction entirely. On the other hand, if courts are prepared to fill in gaps in the contract or to rewrite terms that turn out to be inappropriate, as more modern doctrines and statutory provisions allow, early reliance may become more worthwhile.¹²⁶ The obvious disadvantage of the modern, more liberal approach is that courts may misunderstand the transaction and enforce wrong and possibly inefficient terms. The analysis above suggests that if courts are not in a position to regulate the substantive terms of the bargain or if the parties are unable to supply such terms in the early stages of their negotiations, they can at least promote efficient reliance by assigning the costs in the event of waste to the least-cost avoider.¹²⁷

124. For instance, when reliance takes the form of contracting with a third party, as in the construction cases, optimal reliance will require a second set of costly negotiations. The third party’s own reliance also becomes an issue.

125. See 1 FARNSWORTH, *supra* note 5, §§ 3.27–30; RESTATEMENT (SECOND), *supra* note 4, § 33.

126. See, e.g., *Lee v. Joseph E. Seagram & Sons*, 552 F.2d 447, 454 (2d Cir. 1977) (enforcing promise to grant liquor distributorship despite indefiniteness of location).

127. Similar arguments could be made in cases dealing with preliminary agreements or equivocal acceptances, and regarding the rules governing parties who negotiate through correspondence, who need

Since I have selected common law cases as my main examples, it might be thought that my analysis is primarily directed toward courts and judges. But this is not so. The intended audience is whatever legal decisionmaker might be setting the framework that governs negotiations; depending on the circumstances, this could be a court, a legislature, a trade association, or the parties themselves through a letter of intent at the outset of their dealings. Who should set the framework is a question of relative institutional competence—one that I do not attempt seriously to address here. There are good institutional arguments to be made for and against each of these possible lawmakers. Courts have the advantage of deciding cases in hindsight, after all the facts are revealed, and have no obvious economic stake that would bias them toward one rule or another, but they lack expertise in the particular subject of the exchange. Furthermore, it is questionable whether basing legal outcomes on facts that are known only in hindsight can have much of a regulatory influence on the actual incentives of the parties *ex ante*, who after all must make their decisions based on the limited facts available to them at the time.¹²⁸ For their part, the individual parties know the subject of their bargain well, but they may not find it worthwhile to spend the time and effort required to establish an efficient legal regime for the sake of a single exchange. Parties engaged in repeated dealing, in contrast, may find it worthwhile to invest in an efficient legal framework and to embody it in their standard form contract, but they also have an incentive to include inefficient one-sided terms in order to take advantage of smaller contractual partners who trade less frequently and who find it costly to read and interpret standard forms.¹²⁹ Private organizations such as trade associations may be knowledgeable, concerned with transactional efficiency, and best positioned to promulgate rules among their membership, but they are also inevitably tempted to tailor their rules in the interests of restricting competition, and earning oligopoly profits. The institutional implementation of a regulatory regime, however, is a separate issue from its substantive content. In this Article, I have focused on the latter issue rather than the former, subsidiary one.

Similarly, I have skipped over a number of other important issues relating to implementation. I have not discussed whether disputes involving lost reliance should be decided on a case-by-case basis or according to bright-line

to worry not just about the possibility that a revocation is forthcoming but also that one has already been sent. For an economic discussion of this last doctrinal category, see Beth A. Eisler, *Default Rules for Contract Formation by Promise and the Need for Revision of the Mailbox Rule*, 79 KY. L.J. 557 (1991) (analyzing rules from convention maintenance perspective); Avery Katz, *Bargaining at a Distance: The Economics of the Mailbox Rule* (Aug. 28, 1991) (unpublished manuscript, on file with author) (analyzing rule from regulatory perspective). For a fuller doctrinal survey of contract formation doctrines, focusing on reliance incentives, see Craswell, *supra* note 64 (manuscript at 40–96, on file with author).

128. See generally Guido Calabresi & Alvin K. Klevorick, *Four Tests for Liability in Torts*, 14 J. LEGAL STUD. 585, 600 (1985) (discussing appropriateness of liability rules that incorporate hindsight).

129. See Katz, *supra* note 1, at 272–93.

rules. I have not analyzed the process by which private individuals might contract around the legal framework set by courts and legislatures. Nor have I discussed whether the framework should be made mandatory or merely presumptive. The choice of substantive regulatory incentives, however, is necessarily prior to such institutional discussions. Both Judge Hand in *Baird*¹³⁰ and Justice Traynor in *Drennan*¹³¹ made it clear that parties could depart from standard interpretational conventions by being sufficiently explicit in their communications, and I have assumed the same. As a general rule, however, contracting around the legal convention is costly; it requires the offeror to draft special language and to invest time and effort calling that language to the offeree's attention. In cases in which the standard rule is highly inefficient, these costs will be worth bearing, and it will be necessary to take account of them when setting the proper background rule.

Furthermore, there is nothing in my analysis that would restrict it to judicially enforced contracts. I assumed for the sake of concreteness that the court-imposed liability and damage rules were actually effective in governing the parties' relationship, and I ignored nonlegal incentives. But the analysis is more general than this and could apply to any system of sanctions, private or public. In many actual contexts, private sanctions may be more important to the parties than public ones. Offerors who revoke after the offeree relies, for instance, may find themselves the subject of a whispering campaign and may suffer a loss of reputation. They may lose repeat business, miss out on referrals, be hauled before arbitration tribunals, or face suspension of their privileges within trade associations.¹³² The substantive rules enforced by such private contract regimes, furthermore, may differ from those enforced by the public legal system. In this case, what courts or the drafters of the *Restatement (Second)* do will make less of a regulatory difference. But my analysis would still be useful in describing and evaluating the regulatory effects of whatever private regime happened to be in force.¹³³ If those who design private contract regimes want to promote efficient reliance, they should pay attention to the factors identified above.

In practice, the actual implementation of any regulatory regime will be imperfect. It is often difficult and costly to enforce one's legal rights after the fact, even in the private arena. If offerees cannot prove the existence of an offer or the fact of reliance at reasonable cost, they will not get in practice the

130. 64 F.2d 344, 346 (2d Cir. 1933).

131. 333 P.2d 757, 759 (Cal. 1958).

132. See, e.g., Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115, 117-30 (1992).

133. See, e.g., Robert C. Ellickson, *A Hypothesis of Wealth-Maximizing Norms: Evidence from the Whaling Industry*, 5 J.L. ECON. & ORGANIZATION 83, 94-96 (1989) (making similar argument with reference to whaling industry).

protection that promissory estoppel affords them in theory.¹³⁴ In this case, the regulatory effects of the legal regime will be less than my analysis would suggest; and contracting parties may then want to arrange for alternative commitment devices that help to enforce their promises by shifting the burdens of enforcement, such as deposits, bonding, escrows, letters of credit, and direct financing of reliance.

Additionally, courts or other third-party enforcers will tend to err in applying liability rules and in measuring damages. To the extent that measured damages systematically fall short of the theoretical ideal, the consequences can easily be forecast by a straightforward extension of the basic analysis. If reliance is less than fully protected, then parties who cannot capture its benefits will underrely. Partial protection, however, is still better than none at all. Conversely, overprotection and the resultant moral hazard may lead weaker offerors to avoid preliminary negotiations, distorting or delaying reliance by offerees. On the other hand, uncertainty in the measurement of damages or the assignment of liability blurs the incentive effects of the various regulatory regimes. Depending on the nature of the uncertainty, the parties may be led either to take too many precautions to protect themselves against legal error, or to take too few.¹³⁵ All these difficulties, of course, are what motivate the least-cost avoider approach in the first place as a way of conserving administrative costs and reducing judicial error.

Notwithstanding these qualifications, the basic lesson is a robust one. The rules of contract formation in general, and of promissory estoppel in particular, affect reliance decisions through a common strategic pattern. At the outset, the parties' background rights are established by the legal framework—specifically, whether an offer or promise is binding as an option. In a second stage, the parties choose whether and when to make relationship-specific investments. In a third stage, after the uncertainty has been resolved, the parties decide how to divide any productive surplus that results. The initial background rules matter because they set the framework for the bargaining in the final stage, which, along with the parties' relative bargaining power, determines the incentives for specific investments in the interim. The exact process of bargaining is inessential, as is the classification of the parties as offeror and offeree, which may be a matter of arcane legal categories and in practice is often an accident of the mails. Instead, what matters is who makes specific investments, how productive they are, and who has bargaining power and

134. For economic discussions of the consequences of costly enforcement for the regulatory effects of legal rules, see A. Mitchell Polinsky & Daniel L. Rubinfeld, *The Welfare Implications of Costly Litigation for the Level of Liability*, 17 J. LEGAL STUD. 151 (1988).

135. For a fuller discussion and formal analysis of the problem of uncertain enforcement, see SHAVELL, *supra* note 91, at 79–83; Richard Craswell & John E. Calfee, *Deterrence and Uncertain Legal Standards*, 2 J.L. ECON. & ORGANIZATION 279 (1986); Marcel Kahan, *Causation and Incentives to Take Care Under the Negligence Rule*, 18 J. LEGAL STUD. 427, 437–39 (1989).

information. These factors will determine which side is the least-cost avoider, best able to weigh the costs of reliance against its benefits.

In sum, the protection of specific investments under conditions of uncertainty has generally been understood to be an important function of the law of contract. Many legal doctrines, such as duress, unconscionability, the preexisting-duty rule for modifications, and the implied duty of good faith, help to serve this purpose by regulating the opportunistic exercise of bargaining power once negotiations are completed. The doctrine of promissory estoppel, and other rules governing the effect of preliminary communications, promote a similar purpose in the precontractual setting. Properly applied, they can help to increase the potential surplus from exchange.