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## PRECONTRACTUAL LIABILITY AND THE DUTY OF GOOD FAITH NEGOTIATION IN INTERNATIONAL TRANSACTIONS

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I. INTRODUCTION

The most significant changes in contract jurisprudence during the 1980s centered on the development of theories for the expansion of precontractual liability.<sup>1</sup> The emerging jurisprudence stems from a steady increase in claims arising from precontractual negotiations and preliminary agreements.<sup>2</sup> In the wake of several major developments in recent American case law on the subject, and particularly developments arising from the Second Circuit's landmark decision in *Texaco, Inc. v. Pennzoil, Co.*,<sup>3</sup> international traders have become increasingly concerned with the need to identify the circumstances in which liability may arise from negotiations and preliminary agreements.<sup>4</sup>

1. E. Allan Farnsworth, *Developments in Contract Law During the 1980's: The Top Ten*, 41 CASE W. RES. L. REV. 203, 210 (1990).

2. *Id.*

3. 729 S.W.2d 768 (Tex.App.—Houston [1st Dist.] 1987, writ ref'd n.r.e.), *cert. denied*, 485 U.S. 944 (1988).

Pennzoil sued Texaco over the sale of Getty Oil Company stock to Texaco by various Getty entities after Pennzoil had agreed to purchase the same stock. Pennzoil first attempted to sue Getty for breach of contract. When this foray into the Delaware courts proved abortive, Pennzoil shifted its strategy to the Texas courts and sued Texaco there for tortious interference with an alleged contract between Pennzoil and the Getty stockholders. The resulting verdict totaled almost \$11 billion and included an award of punitive damages amounting to \$3 billion.

Farnsworth, *supra* note 1, at 210.

4. E. Allan Farnsworth, *Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations*, 87 COLUM. L. REV. 217, 239-43 (1987) (explaining attempts by several nations to address disputes arising from

Contract law has become more international in recent years.<sup>5</sup> The ratification of the United Nations Convention on Contracts for the International Sale of Goods (CISG)<sup>6</sup> by over thirty nations stands as one of the most significant developments in this area.<sup>7</sup> One of the primary goals of the CISG was to facilitate international transactions through the elimination of inconsistent treatment by different countries in various contractual obligations.<sup>8</sup> However, despite a wide recognition within the international trading community of the problems caused by ambiguities in precontractual rights and liabilities, a draft provision of the CISG concerning fair dealing in contract formation was omitted from the final version.<sup>9</sup> In light of its changing legislative history, it is uncertain to what degree the CISG can be interpreted as governing the resolution of disputes arising from precontractual negotiations and preliminary agreements.<sup>10</sup>

This article will address the duty to negotiate in good faith, the scope of this duty, and the types of liability that can arise from its breach. The article will also address the failure of the CISG to require good faith in negotiations and will argue for an expansive interpretation of the CISG to encompass this duty.

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precontractual negotiations).

5. See generally Farnsworth, *supra* note 1, at 227 (discussing various attempts by countries to promulgate a uniform law for international sales).

6. United Nations Convention on Contracts for the International Sale of Goods, U.N. DOC. A/CONF. 97/18, Annex I (1980) [hereinafter CISG], *reprinted in* UNITED NATIONS CONFERENCE ON CONTRACTS FOR THE INTERNATIONAL SALE OF GOODS, OFFICIAL RECORDS at 178, U.N. DOC. A/CONF. 97/19, U.N. Sales No. E.82.V.5 (1981).

7. U.S. DEP'T OF STATE, TREATIES IN FORCE: A LIST OF TREATIES AND OTHER INTERNATIONAL AGREEMENTS OF THE UNITED STATES IN FORCE ON JANUARY 1, 1993, at 410 (1993).

8. John Honnold, *The United States Uniform Commercial Code: Interpretation by the Courts of the States of the Union*, in INTERNATIONAL UNIFORM LAW IN PRACTICE 181, 183 (International Institute for the Unification of Private Law ed., 1988).

9. ALAN C. SWAN & JOHN F. MURPHY, CASES AND MATERIALS ON THE REGULATION OF INTERNATIONAL BUSINESS AND ECONOMIC RELATIONS, 10 & n.9 (1991). None of the provisions directly address "fair dealing" in formation; however, article 7 of the CISG exhorts that "regard is to be had to . . . the observance of good faith in international trade." CISG, *supra* note 6, art. 7(2) at 178-79.

10. Joseph M. Perillo, *UNIDROIT Principles of International Commercial Contracts: The Black Letter Text and a Review*, 63 FORDHAM L. REV. 281, 287 (1994).

## II. DEFINING PRECONTRACTUAL LIABILITY

The law governing contract formation is typically analyzed in terms of the traditional common and civil law rules of offer and acceptance.<sup>11</sup> Yet, the complex processes that lead to modern contracts are typically articulated in documents that seldom lend themselves to these classical rules.<sup>12</sup> International transactions are frequently completed without clearly discernable offers, counteroffers, or acceptances; instead, agreements usually result from numerous rounds of negotiations and successions of draft agreements.<sup>13</sup>

A variety of problems may arise when negotiations fail and a court determines that no final agreement materialized during the course of those negotiations.<sup>14</sup> For example, questions may develop about possible liability from a party's failure to negotiate in good faith.<sup>15</sup> If damages are available, additional issues may surface concerning the scope of the duty and the appropriate measure of damages.<sup>16</sup> Although the drafters of the CISG intended uniformity in interpretation, the ability of a disappointed party to obtain specific performance, consequential damages, out of pocket expenses, or any remedy at all often depends largely on the perspective of the forum handling the litigation.<sup>17</sup> While civil law jurisdictions have historically proven more receptive to claims based on precontractual liability, common law jurisdictions have shown an increasing willingness to entertain similar complaints in recent years.<sup>18</sup>

The traditional common law view, sometimes referred to as the "aleatory view,"<sup>19</sup> holds that mere participation in precontractual negotiations is not enough to create binding obligations, even if the parties reach a preliminary agreement.<sup>20</sup> As one English jurist expressed, a party to negotiations

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11. Farnsworth, *supra* note 4, at 218.

12. *Id.* at 218-19.

13. *Id.*

14. *Id.* at 219-20.

15. *Id.* at 239.

16. *Id.* at 219-20 (posing questions that may implicate these issues).

17. *Id.* at 239-40.

18. *Id.* at 264-67 (citing cases where courts have been asked to enforce agreements to negotiate).

19. *Id.* at 221.

20. *Id.*

“undertakes this work as a gamble, and its cost is part of the overhead expense of his business which he hopes will be met out of the profits of such contracts as are made.”<sup>21</sup> The parties’ freedom to negotiate is preserved at the risk that their efforts will go uncompensated if negotiations fail.<sup>22</sup> Another objective of the common law view is to avoid finding the existence of a contract based on perceived reprehensible conduct rather than on the traditional benchmark of mutual expectation.<sup>23</sup>

Nonetheless, the trend in the United States is to impose precontractual liability in certain circumstances.<sup>24</sup> Courts are becoming more aware that preliminary agreements serve a valuable function in the marketplace.<sup>25</sup> In *Schwanbeck v. Federal-Mogul Corp.*,<sup>26</sup> the Massachusetts Court of Appeals noted:

Reaching a definitive, binding agreement soaks up time, effort, and intimidating professional fees. When they memorialize key elements of a deal, parties may be in a position to decide that enough is agreed upon to risk the substantial resources which will be consumed in contract formation. The letter of intent focuses attention; it has certain moral force in pressing parties to proceed toward a conclusion of the transaction on the terms outlined; and it assists in obtaining loan financing and capital investment in that the proposed transaction has progressed beyond “just talk.”<sup>27</sup>

These sentiments have become more common in recent years as American courts seek to enforce and preserve preliminary agreements that the parties intended to be binding.<sup>28</sup> Without judicial enforcement, parties are left with the prospect of expending large sums of money negotiating every detail into the final contract before they may rely on their agreements.<sup>29</sup>

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21. *Id.* (quoting *William Lacey (Hounslow) Ltd. v. Davis*, [1957] 1 W.L.R. 932, 934 (Q.B. 1957)).

22. Farnsworth, *supra* note 4, at 221.

23. *See id.*

24. *Id.* at 222.

25. *See id.* at 221–23.

26. 578 N.E.2d 789 (Mass. App. Ct. 1991).

27. *Id.* at 793.

28. Farnsworth, *supra* note 4, at 265–66.

29. *See id.* at 221.

In some ways, the modern approach of enforcing precontractual agreements may seem to be a complete reversal from the previous approach. The traditional view seeks to protect negotiating parties from involuntary, judicially imposed contracts.<sup>30</sup> It also preserves the parties' freedom to negotiate, as well as the corollary freedom not to negotiate, by providing contractual remedies only when a completed contract exists.<sup>31</sup> The modern view primarily focuses on the intent of the parties and creates contractual obligations only if the parties intend to be bound to the duty of good faith by the preliminary agreements.<sup>32</sup> However, the two views are not entirely incompatible. Given the proper framework, both views may support the proposition that "the law of contracts attempts the realization of reasonable expectations that have been induced by the making of a promise."<sup>33</sup>

### III. THE SCOPE AND EFFECT OF THE DUTY TO NEGOTIATE IN GOOD FAITH

Although "precontractual liability" as a term of art holds a certain superficial appeal in its apparent homogeneous treatment of preliminary obligations, the concept encompasses a variety of distinct scenarios. In recognizing the complexity of modern negotiations, E. Allan Farnsworth suggests that the resolution of disputes caused by the failure of negotiations is best analyzed by classifying the controversies according to the stage that the negotiations had reached before the failure.<sup>34</sup> The first two of these stages, negotiation and preliminary agreement, are discussed here in detail. The third and final stage, the ultimate agreement, is a creature of ordinary contract law and therefore is beyond the scope of this paper.

#### A. *The Negotiation Stage*

Farnsworth suggests that in the initial stage of negotiation, the traditional aleatory view should remain the rule:

30. *Id.*

31. *Id.*

32. *See generally id.* at 265-66 (explaining the willingness of courts to enforce the intention of parties, including the intention to deal in good faith).

33. ARTHUR L. CORBIN, CORBIN ON CONTRACTS § 1, at 2 (1952).

34. Farnsworth, *supra* note 4, at 219-20.

There is no reason to believe that the imposition of a general obligation of fair dealing would improve the regime under which [these] negotiations take place. The difficulty of determining a point in the negotiations at which the obligations of fair dealing arise would create uncertainty. An obligation of fair dealing might have an undesirable chilling effect, discouraging parties from entering into negotiations.<sup>35</sup>

Most U.S. courts have been reluctant to find a general obligation of fair dealing or a duty to negotiate in good faith during the preliminary stages of contractual negotiation.<sup>36</sup> This reluctance is supported by the prevailing view that the American Uniform Commercial Code (UCC) and the Restatement (Second) of Contracts do not apply to the negotiation stage.<sup>37</sup> However, these limitations do not necessitate the conclusion that a disappointed party is completely without remedy. Rather, they merely preclude parties from claiming expectation damages or the specific performance of their agreements.<sup>38</sup> In the proper circumstances, liability may still be imposed based on unjust enrichment, detrimental reliance, misrepresentation, or any combination of these theories.<sup>39</sup>

## B. *The Preliminary Agreement Stage*

### 1. The Use and Effects of Preliminary Agreements in International Transactions

When parties use preliminary agreements to allocate the risks of negotiation, the prudence of imposing a general obligation of fair dealing becomes a far more complicated question. Serious interpretive problems may arise because of ambiguities

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35. *Id.* at 242-43.

36. *Id.* at 239.

37. "Every contract . . . imposes an obligation of good faith in its performance or enforcement." U.C.C. § 1-203 (1989); RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981) (using the same language); Farnsworth, *supra* note 4, at 239 (concluding that these provisions of the U.C.C. and the Restatement imply that the duty of good faith and fair dealing does not apply to negotiations).

38. See Farnsworth, *supra* note 4, at 223 (explaining that precontractual liability cannot support expectation damages because no agreement has been reached).

39. *Id.* at 222.

concerning each party's intent to be bound at this early stage.<sup>40</sup>

Preliminary agreements have a variety of names, including "letters of intent," "commitment letters," "binders," "agreements in principle," and "memoranda of understanding."<sup>41</sup> Regardless of the terminology, all preliminary agreements reduce to writing the parties' basic agreement at the completion of some level of negotiation.<sup>42</sup> Yet, the intended use of these documents may vary considerably.<sup>43</sup> The agreement may be a letter for future reference, a framework agreement governing only the negotiation process, a memorialization of partial agreements arising during negotiation, or a document reflecting the substance of a binding agreement.<sup>44</sup>

Recent changes in modern international transactions have led to an increased reliance on precontractual instruments.<sup>45</sup> Commercial transactions are increasingly consummated between parties of diverse cultural and legal traditions.<sup>46</sup> Parties are often unfamiliar with the ethical rules and legal ramifications of the negotiating process in other countries, which may lead the parties to write out their goals at a relatively early stage of the negotiation.<sup>47</sup> Furthermore, recent technological advances in computers and facsimile machines has decreased personal contacts between international traders.<sup>48</sup> This decrease in face to face dealings impedes the development of personal trust, thus increasing the perceived need for written protection.<sup>49</sup>

40. *See id.* at 256.

41. *Id.* at 250.

42. *See id.*

43. *See id.* at 250-51.

44. Ralph B. Lake, *Letters of Intent: A Comparative Examination Under English, U.S., French, and West German Law*, 18 GEO. WASH. J. INT'L L. & ECON. 331, 331-32 (1984).

45. *Id.* at 332.

46. *Id.*

47. *Id.*

48. John Klein, *Good Faith in International Transactions*, XV(2) LIVERPOOL L. REV. 115, 115 (1993).

49. This situation has been described as follows:

While parties to international transactions may save a few guilder by forgoing the proverbial business lunch in Rotterdam, the benefits of technology do not come without a price . . . . [International traders can] lose valuable opportunities to weigh the trustworthiness of prospective business associates and to signify with a closing handshake their intent to deal fairly with each other.

Therefore, preliminary agreements are frequently used in international transactions, especially in deals involving acquisition and disposition agreements, construction contracts, long-term supply contracts, and technical assistance agreements.<sup>50</sup> These contracts are characterized by the complexity of their negotiation stages, which may last for months and sometimes years.<sup>51</sup> During protracted negotiation phases, the parties often generate preliminary agreements to obtain documentation for third parties for financing, insurance, and other purposes.<sup>52</sup> As Farnsworth has noted,

Such agreements are particularly common in situations in which the investment of at least one party becomes substantial in relation to the deal as a whole and cannot be spread over other similar deals, and yet the parties cannot escape from the regime of negotiation by moving to that of ultimate agreement.<sup>53</sup>

Recognizing the special role of preliminary agreements in complex negotiations, the court in *Teachers Insurance & Annuity Ass'n v. Tribune Co.*<sup>54</sup> suggested that binding preliminary contracts may be used in two distinct scenarios.<sup>55</sup> First, the contracts may be used when the parties have reached complete agreement on all issues perceived to require negotiation.<sup>56</sup> The court treats the parties as if a completed contract exists, and a breach of contract may result in remedies such as specific performance or expectation damages.<sup>57</sup> The second scenario arises where the parties have expressed their mutual commitment to the major terms of the agreement, while recognizing that open terms remain for future negotiation.<sup>58</sup> This type of binding preliminary agreement does not commit the parties to an ultimate contractual objective, but rather to an obligation to

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*Id.*

50. Ugo Draetta, *The Pennzoil Case and the Binding Effect on the Letters Intent in the International Trade Practice*, 2 *Revue de Droit des Affaires Internationales* [R.D.A.I.] 155, 156 (1988).

51. *Id.*

52. Lake, *supra* note 44, at 334.

53. Farnsworth, *supra* note 4, at 250.

54. 670 F. Supp. 491 (S.D.N.Y. 1987).

55. *Id.* at 498.

56. *Id.*

57. *See id.*

58. *Id.*

continue their negotiations in good faith.<sup>59</sup> Although the agreement is unenforceable on its own terms, the court imposes on each party a duty to continue negotiations in good faith.<sup>60</sup> The obligation to continue negotiating provides no guarantee that the parties will reach a final agreement, "as good faith differences in the negotiations of the open issues may prevent a reaching of a final contract."<sup>61</sup> The good faith duty does, however, prevent the parties from refusing to negotiate or offering only unreasonable proposals.<sup>62</sup>

## 2. The Binding Effect of Preliminary Agreements: Factors to Consider

Most U.S. courts believe the intent of the parties is the ultimate test in determining whether to uphold preliminary agreements, in that the parties are held to the agreement if they intended it to be binding.<sup>63</sup> However, because the test is cast simply in terms of intent, resolution of the issue tends to be fact specific and highly discretionary.<sup>64</sup> Nevertheless, the courts have identified a number of factors relevant to the legal recognition of preliminary agreements: 1) the language of the preliminary agreement; 2) the context of the negotiations; 3) the existence of open terms; 4) partial performance; and 5) express demands for a finalized contract.<sup>65</sup>

### a. The Language of the Preliminary Agreement

Precatory or vague language may serve as evidence that the parties do not intend to be bound by a preliminary agreement.<sup>66</sup> For example, in *Beck v. American Health Group Int'l*,

59. *Id.*

60. *Id.* at 499. A party may demand only that "his counterpart negotiate open terms in good faith toward a final contract incorporating the agreed terms." *Id.* at 498.

61. *Id.* at 498.

62. *Id.*

63. *Reprosystem, B.V. v. SCM Corp.*, 727 F.2d 257, 261 (2d Cir. 1984), *cert. denied*, 469 U.S. 828 (1984) (explaining that intent determines whether a document constitutes a binding agreement).

64. Matthew Hodel and Benjamin A. Nix, *Avoiding Traps in the Letter of Intent*, CAL. LAW., July 1991, at 54.

65. *Teachers Ins.*, 670 F. Supp. at 499-505.

66. Hodel & Nix, *supra* note 64, at 54.

*Inc.*,<sup>67</sup> the court held that a notation stating that "it is a pleasure to draft the outline of our future agreement" did not create a binding agreement.<sup>68</sup> However, in *Texaco, Inc. v. Pennzoil, Co.*,<sup>69</sup> the court indicated that the use of more definitive syntax may indicate an intent to be bound.<sup>70</sup>

#### b. The Context of the Negotiations

When a court focuses on the context of the negotiations to reveal the parties' intent, the primary question is whether the relevant business community would accord binding force to the type of preliminary agreement at issue.<sup>71</sup> In *Teachers Insurance*, the court upheld the agreement because preliminary commitments were generally regarded as binding in the local financial community.<sup>72</sup>

Courts also consider the complexity and scope of the agreement in determining intent.<sup>73</sup> In *Reprosystem, B.V. v. SCM Corp.*,<sup>74</sup> the court noted that the greater the complexity and importance of the transaction, the more likely it is that informal communications are intended to be preliminary.<sup>75</sup> However, although the court in *Texaco* acknowledged that a signed writing is usually expected in a complex transaction, it held that the absence of a writing is not determinative of the parties' intent.<sup>76</sup>

The course of performance or course of dealing between the parties is also important in determining the parties' intent to

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67. 260 Cal. Rptr. 237 (Cal. Ct. App. 1989).

68. *Id.* at 242.

69. 729 S.W.2d 768 (Tex. App.—Houston [1st Dist.] 1987, writ ref'd n.r.e.), *cert. denied*, 485 U.S. 944 (1988).

70. *Id.* at 790 (noting that a press release issued prior to the onset of the litigation was worded "as a whole . . . in indicative terms, not in subjunctive and hypothetical ones").

71. See *Teachers Ins. and Annuity Ass'n v. Tribune Co.*, 670 F. Supp. 491, 503 (S.D.N.Y. 1987). The court upheld a preliminary agreement because "legal recognition to preliminary binding commitments serves a valuable function in the marketplace, particularly for relatively standardized transactions like loans." *Id.* at 499.

72. *Id.* at 500.

73. See *Texaco*, 729 S.W.2d at 790.

74. 727 F.2d 257 (2d Cir. 1984), *cert. denied*, 469 U.S. 828 (1984).

75. "[T]he magnitude and complexity of the deal . . . reinforce[s] the parties' stated intent not to be bound until written contracts were signed." *Id.* at 262.

76. *Texaco*, 729 S.W.2d at 795.

be bound.<sup>77</sup> In *Banking & Trading Corp. v. Floete*,<sup>78</sup> the court noted that parties who have exhibited a high level of interest in contractual formalities during the negotiation process should be regarded as having contemplated a final written contract.<sup>79</sup> Likewise, if two parties have dealt with each other in similar transactions involving preliminary agreements, their prior course of dealing may be an important indication of their intent to be bound.<sup>80</sup>

### c. The Existence of Open Terms

U.S. courts interpret the presence of open terms differently, depending on what the court focuses on as an indication of the parties' intent.<sup>81</sup> The court in *Teachers Insurance* stated that if the issue is whether the parties have reached a final agreement, the presence of open terms indicates that the parties are still negotiating.<sup>82</sup> If the issue is "whether a preliminary expression of commitment was intended to bind the parties to negotiate the open terms in good faith," the presence of open terms is less indicative that the parties did not intend to be bound.<sup>83</sup> The open terms may simply indicate that side issues or documentation matters that require negotiation and approval remain to be resolved.<sup>84</sup> If the parties mutually intend to be bound by a preliminary commitment, the presence of open terms will not permit a party to avoid the transaction.<sup>85</sup>

77. RESTATEMENT (SECOND) OF CONTRACTS § 273(i) (1981). In determining the meaning of agreements, a "course-of-dealing is a sequence of previous conduct between the parties to an agreement which is fairly regarded as establishing a common basis of understanding for interpreting their expressions and other conduct." *Id.*

78. 257 F.2d 765 (2d Cir. 1958).

79. *Id.* at 765 (finding that where a government agency required a written contract, preliminary agreements and negotiations were not binding).

80. *May Metro. Corp. v. May Oil Burner Corp.*, 290 N.Y. 260, 264-65 (N.Y. App. 1943) (finding there was a question for the jury as to an intent to be bound based on eight previous renewals of distributorship agreement).

81. See *Teachers Ins. and Annuity Ass'n v. Tribune Co.*, 670 F. Supp. 491, 502 (S.D.N.Y. 1987).

82. *See id.*

83. *See id.*

84. "Such an agreement is preliminary only in form—only in the sense that the parties desire a more elaborate formalization of the agreement." *Id.* at 498.

85. *See id.* at 502.

A strong presumption against a binding obligation exists if the agreement contains significant open terms.<sup>86</sup> Some courts evaluate how far the parties have progressed toward agreement on the essential terms of the contract.<sup>87</sup> In *Winston v. Mediafare Entertainment Corp.*,<sup>88</sup> the court found that the presence of terms that remain to be settled may be a factor indicating that the parties did not intend to be bound.<sup>89</sup>

#### d. Partial Performance

Acquiescence to the other party's actions with respect to a preliminary agreement also supports enforcement of the agreement.<sup>90</sup> However, partial performance by a party does not necessarily indicate that the parties believe they are bound to a preliminary agreement.<sup>91</sup> "A party may make some partial performance [of a preliminary agreement] merely to further the likelihood of consummation of a transaction."<sup>92</sup>

#### e. Express Demands for a Finalized Contract

Certain types of documents and language within agreements may indicate that the parties do not intend to be bound by a preliminary agreement.<sup>93</sup> Express disclaimers often serve as persuasive evidence that the parties intended to be bound only by a formal, written contract.<sup>94</sup> Contracts of preliminary commitment usually contain language reserving rights of approval

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86. "The more terms the parties leave open, the less likely it is that they have intended to conclude a binding agreement." RESTATEMENT (SECOND) OF CONTRACTS § 33 cmt. c (1981).

87. See 729 S.W.2d 768, 792 (Tex. App.—Houston [1st Dist.] 1987, writ ref'd n.r.e.), cert. denied, 485 U.S. 944 (1988) (describing agreement on essential terms as a "factor showing intent to be bound").

88. 777 F.2d 78 (2d Cir. 1985).

89. *Id.* at 80.

90. See, e.g., *Dawson v. General Motors Corp.*, 977 F.2d 369, 374 (7th Cir. 1992) (noting that a letter expressing an intent to rely on assurances demonstrates acquiescence to the reliance since the party giving the assurances remained silent for a year after receiving the letter).

91. *Teachers Ins. and Annuity Ass'n v. Tribune Co.*, 670 F. Supp. 491, 502 (S.D.N.Y. 1987).

92. *Id.*

93. See *Reprosystem, B.V. v. SCM Corp.*, 727 F.2d 257, 261–62 (2d Cir. 1984), cert. denied, 469 U.S. 828 (1984).

94. See *Arcadian Phosphates, Inc. v. Arcadian Corp.*, 884 F.2d 69, 72 (2d Cir. 1989); *Doll v. Grand Union Co.*, 925 F.2d 1363, 1369 (11th Cir. 1991).

of the final contract.<sup>95</sup> Furthermore, references to a final written agreement to be drafted and approved by counsel or a corporate board of directors indicate an intent not to be bound.<sup>96</sup> In addition, the parties may incorporate language into the preliminary agreement indicating that the terms of the contract do not become effective until some time in the future.<sup>97</sup>

However, in *Texaco, Inc. v. Pennzoil, Co.*<sup>98</sup> and *Seaman's Direct Buying Service, Inc. v. Standard Oil Co. of California*,<sup>99</sup> express language indicating that the parties would be bound only to a final contract was not held to be controlling.<sup>100</sup> Similarly, the court in *Teachers Insurance* found that while these reservations standing alone indicate that the parties intend to be bound only under a final contract, they do not necessarily require such a conclusion.<sup>101</sup> In addition, the court in *Dawson v. General Motors Corp.*<sup>102</sup> also took a restrictive view of the effects of express limitations, noting that the anticipation of a formal written document is not a sufficient basis on which to preclude the enforcement of a specific preliminary promise.<sup>103</sup>

An agreement conditioning a party's obligation on the occurrence of a future event does not permit a party to discontinue negotiations for no reason.<sup>104</sup> The grounds for a termina-

95. *Reprosystem*, 727 F.2d at 262.

96. *A/S Apotekernes Laboratorium for Specialpraeparater v. I.M.C. Chem. Group, Inc.*, 873 F.2d 155, 157-58 (7th Cir. 1989).

97. In *Chrysler Capital Corp. v. Southeast Hotel Prop.*, the court found that a letter stating that its terms would only become effective when certain conditions were met showed the writer's intent not to be bound unconditionally. *Chrysler Capital Corp. v. Southeast Hotel Prop.*, 697 F. Supp. 794, 801 (S.D.N.Y. 1988), *aff'd*, 888 F.2d 1376 (2d Cir. 1989). Moreover, in both *Reprosystem* and *R.G. Group, Inc. v. Horn & Hardart Co.*, the courts reasoned that a provision stating that a preliminary agreement would become effective only upon execution indicated the parties did not intend to be bound prior to execution. *Reprosystem*, 727 F.2d at 262; *R.G. Group, Inc. v. Horn & Hardart Co.*, 751 F.2d 69, 75 (2d Cir. 1984).

98. 729 S.W.2d 768, 790 (Tex. App.—Houston [1st Dist.] 1987, writ ref'd n.r.e.), *cert. denied*, 485 U.S. 944 (1988).

99. 686 P.2d 1158, 1161-63 (Cal. 1984).

100. *Id.* at 1164; *Texaco*, 729 S.W.2d at 790.

101. "Such terms are by no means incompatible with intention to be bound." *Teachers Ins. and Annuity Ass'n v. Tribune Co.*, 670 F. Supp. 491, 500 (S.D.N.Y. 1987).

102. 977 F.2d 369 (7th Cir. 1992).

103. *Id.* at 374.

104. *See, e.g., Teachers Ins.*, 670 F. Supp. at 499 (rejecting defendant's

tion in negotiations should be clearly expressed or acknowledged by the parties to avoid problems.<sup>105</sup> Thus, a party cannot terminate contract negotiations by insisting on a condition that was not within the scope of the agreement.<sup>106</sup> Although the courts are willing to look to a variety of factors to determine the parties' intent to be bound by their preliminary agreements, no bright-line test for determining intent has been successfully formulated.<sup>107</sup> The absence of a primary or even controlling factor to determine intent, combined with the ambiguity of the terms that define the factors themselves, leaves the trier of fact much discretion.<sup>108</sup> The fact-specific nature of the inquiry is further exacerbated by a change in circumstances that renders the original transaction significantly less attractive to one of the parties.<sup>109</sup> For example, interest rates go down,<sup>110</sup> the market for a specific product or raw material changes radically,<sup>111</sup> or one of the parties receives a higher bid for its corporate stock.<sup>112</sup> The change in circumstances usually leads to reprehensible conduct, a common denominator in many cases in which a party does not want to be held to a preliminary agreement.<sup>113</sup> Unfortunately, similar commonality is nowhere to be found in the case law on preliminary agreements; the fact-specific nature of the intent analysis has instead left a stream of contradictory decisions and, consequently, a lack of predictability in precontractual liability.

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contention that its reservation of the right of approval to its Board of Directors left it free to abandon the transaction).

105. Hodel & Nix, *supra* note 64, at 57.

106. *Teachers Ins.*, 670 F. Supp. at 506.

107. "It is unlikely there will ever be a bright-line test for determining intent." Hodel & Nix, *supra* note 64, at 56.

108. *See supra* note 64 and accompanying text.

109. *See infra* notes 109-11 and accompanying text.

110. *Teachers Ins.*, 670 F. Supp. at 496.

111. *Arcadian Phosphates, Inc. v. Arcadian Corp.*, 884 F.2d 69, 71 (2d Cir. 1989).

112. *Texaco, Inc. v. Pennzoil, Co.*, 729 S.W.2d 768, 786 (Tex. App.—Houston [1st Dist.] 1987, writ ref'd n.r.e.), *cert. denied*, 485 U.S. 944 (1988).

113. *See, e.g., Seaman's Direct Buying Serv., Inc. v. Standard Oil Co. of Cal.*, 686 P.2d 1158, 1161-62 (Cal. 1984). Standard Oil considered its preliminary agreement with Seaman's binding, but when market condition changes made the deal less attractive, Standard Oil began denying that a binding agreement existed. *Id.* Standard Oil adopted a "stonewall" or "see you in court" posture which the court said "offends accepted notions of business ethics." *Id.* at 1167.

IV. A COMPARISON OF THE COMMON AND CIVIL LAW  
APPROACHES TO PRECONTRACTUAL LIABILITY AND THE DUTY  
TO NEGOTIATE IN GOOD FAITH

A primary distinction between the civil and common law approaches to the duty of good faith is that the latter generally imposes no good faith obligation prior to the execution of the contract.<sup>114</sup> In the absence of a formal contract, English courts generally refuse to recognize the terms of a precontractual agreement.<sup>115</sup> Only a preexisting valid contract may impose a subsequent obligation to negotiate in good faith.<sup>116</sup> The duty to negotiate in good faith is best viewed under the rubric of a "contract to make a contract," or a "contract to attempt to make a contract," which is generally unenforceable at common law.<sup>117</sup>

Although civil law systems generally recognize and enforce a duty of good faith negotiation, the underlying rationales for the obligation may vary.<sup>118</sup> Precontractual liability in France is based not on contract law, but rather on tort principles.<sup>119</sup> If the parties have manifested an intent not to be bound until the execution of a formal document, they will not be bound before that event; therefore, neither party is liable if they cannot complete the contract.<sup>120</sup> Notwithstanding the absence of contractual liability, the obligations of honesty and good faith nevertheless exist during the negotiation stage.<sup>121</sup> The duties stem from a theory of tortious misrepresentation, which demands that when one makes misrepresentations that cause damage to another, the one who made the misrepresentation is obligated to remedy the harm.<sup>122</sup> However, this good faith obligation requires only that the parties "conduct the negotiations fairly; it does not obligate them to conclude a final contract."<sup>123</sup>

114. See Lake, *supra* note 44, at 346-47.

115. *Id.*

116. *Id.* at 347.

117. See CORBIN, *supra* note 33, § 29.

118. See Lake, *supra* note 44, at 346.

119. *Id.* at 350.

120. *Id.*

121. *Id.*

122. *Id.* at 350-51 (citing CODE CIVIL [C. CIV.] arts. 1382-83 (Fr.)).

123. *Id.* at 351.

In contrast, the good faith obligation under German law is based more squarely on contract theory.<sup>124</sup> German law provides contractual remedies for damages caused by reprehensible conduct during either the negotiation or the performance of the contract.<sup>125</sup> The doctrine of *culpa in contrahendo*, loosely translated as "fault in negotiating," imposes liability on the party "whose blameworthy conduct invalidates a contract or prevents its completion."<sup>126</sup> Although the obligation is implicit, the parties are nevertheless bound to negotiate in good faith.<sup>127</sup> The overriding rule is that "[one] must not create the expectation that a contract will be forthcoming unless [one] so intends."<sup>128</sup>

The primary point of divergence between the civil and common law approaches to good faith negotiation stems from certain fundamental differences between their general philosophies of contract law:

The civil law concept of contract focuses on the relationship between the parties. The formal contract is not the dramatic event in civil law countries that it is in common law countries; as a result, the courts in civil law jurisdictions are more likely to declare the parties legally bound at an earlier stage of the negotiation process than courts in common law countries.<sup>129</sup>

Common law systems are inclined to attach greater significance to the economic consequences of the contractual agreement, making them more likely to stress contractual formality as a requisite condition to enforceability.<sup>130</sup> The traditional English common law emphasis on the economic aspects of the contractual relationship influenced the development of U.S. common law.<sup>131</sup> The American system continues to emphasize

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124. *See id.* at 351-52.

125. *Id.*

126. *Id.* at 352.

127. *See id.*

128. *Id.*

129. *Id.* at 342.

130. Draetta, *supra* note 50, at 160.

131. "Economic, rather than strictly moral, considerations of good faith fit well with the individualistic, 'manifest destiny' philosophy that characterized the American mindset in the late nineteenth and early twentieth centuries." Klein, *supra* note 48, at 118-19.

the economic aspects of good faith in the contract relationship.<sup>132</sup>

Evaluating the *Texaco, Inc. v. Pennzoil, Co.*<sup>133</sup> decision from the perspective of European civil law provides an interesting basis for comparison between the two systems.<sup>134</sup> If the case had been heard in a civil law system, Pennzoil could also have sought recourse against Getty, the only other major party to the transaction.<sup>135</sup> Pennzoil could have grounded its claim against Getty on either breach of a preliminary agreement (as Pennzoil did in this case) or breach of a judicially established duty to negotiate in good faith.<sup>136</sup> In a European civil law system, Texaco's breach of the preliminary agreement would have provided Pennzoil a remedy for expectation damages, but punitive damages would not have been available.<sup>137</sup> In contrast, damages for the breach of duty of good faith negotiation would have been limited to Pennzoil's expenses in negotiating and perhaps an allowance for "lost opportunity."<sup>138</sup> As Farnsworth observes, "[i]t would have been possible to give Pennzoil adequate relief without going to the extreme of the actual verdict upheld by the Texas courts. Under the common law's all or nothing approach, there was no such middle ground."<sup>139</sup> It is thus somewhat ironic that the common law system, finding such ample cause to trumpet the freedom of negotiation, might nevertheless provide more recognition of the duty of good faith negotiation than is typically afforded by its civil counterpart.<sup>140</sup>

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132. *Id.*

133. 729 S.W.2d 768 (Tex. App.—Houston [1st Dist.] 1987), *cert. denied*, 485 U.S. 944 (1988); *see also supra* text accompanying note 2.

134. Farnsworth, *supra* note 1, at 211.

135. *Id.*

136. *Id.*

137. *Id.*

138. *Id.*

139. *Id.* at 212.

140. *Id.* at 211–12.

## V. THE CISG AND PRECONTRACTUAL LIABILITY

The omission of any language in the CISG addressing the legal obligations created by precontractual negotiations and preliminary agreements was not an oversight on the drafter's part, but rather the result of a purposeful deletion.<sup>141</sup> Article 5 of the Draft Convention on the Formation of Contracts for the International Sale of Goods included the following provision, which was later dropped from the final version: "In the course of the *formation* of the contract the parties must observe the principle of fair dealing."<sup>142</sup> The reasons given for omission of the provision include:

1. "Good Faith" or "Fair Dealing" are moral principles which should not be elevated to the status of a legal obligation. Such an "elevation" necessitates the delineation of the scope and application of the terms, a determination likely to elude the courts of the various member states. Were the provision to be adopted, the risk of non-uniform interpretation would be exacerbated as the national courts turned to their respective legal and social traditions to construe the Convention's provisions.<sup>143</sup>
2. Because the proposed provision on good faith negotiation failed to specify the consequences of failures to comply with its demands, remedial measures would be left to the national courts and, consequently, would subject the Convention to further non-uniformity.

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141. See Swan & Murphy, *supra* note 9, at 10.

142. Peter Winship, *Commentary on Professor Kastely's Rhetorical Analysis*, 8 NW. J. INT'L L. & BUS. 623, 631 (1988) (quoting *Report of the Working Group on the International of Goods on the Work of Its Ninth Session*, para. 70, U.N. Doc. A/CN.9/142 (1977)).

143. *Commentary on the Draft Convention on Contracts for the International Sale of Goods*, Prepared by the Secretariat, U.N. Doc. A/CONF. 97/5, reprinted in *Official Records of the UNITED NATIONS CONFERENCE ON CONTRACTS FOR THE INTERNATIONAL SALE OF GOODS*, U.N. DOC. A/CONF. 97/19 (1981) [hereinafter *Draft Convention*].

3. Since the requirement of "good faith" is implicit in all laws regulating business activity; it is therefore unnecessary to include the requirement in a specific provision.

4. Provisions on good faith are more appropriate with respect to contract validity than contract formation.<sup>144</sup>

The drafting history also contains arguments for including a provision that requires parties to negotiate in good faith:

1. The principle of good faith is universally recognized, so there is no harm in including it in the Convention. Furthermore the extension of such a provision into an instrument regulating international trade would be a valuable extension of a norm of conduct which is widely recognized as necessary in international trade.

2. The inclusion of the provision would promote the development of a body of case law which could eventually overcome any of the problems with non-uniformity that might be raised initially by the adoption of the provision.

3. The explicit inclusion of the principle of good faith in negotiation would serve to remind both the courts and the parties that a high standard of behavior is expected in international trade transactions.<sup>145</sup>

Despite the exclusion of the provision addressing the duty to negotiate in good faith, Article 7 could be read expansively to impose legal obligations based on precontractual negotiations and preliminary agreements.<sup>146</sup> Article 7(1) of the Convention reads: "In the interpretation of this Convention, regard is to be had to its international character and to the need to promote uniformity in its application and the observance of good faith in

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144. *Id.* CISG Article 4 states that it governs "only formation of the contract and the rights and obligations of the parties to the contract." CISG, *supra* note 6, art. 4, at 178. It does not govern the validity of the contract. The drafting history suggest that this article also excludes issues arising out of fraud, duress, illegality and mistake. Whether issues arising out of unconscionability and good faith are also excluded is debated by the authorities. If this article is interpreted as leaving precontractual liability and a duty to negotiate in good faith out of the Convention then they remain issues governed by the domestic law. Winship, *supra* note 142, at 633-34.

145. Draft Convention, *supra* note 143.

146. Perillo, *supra* note 10, at 287.

international trade.<sup>147</sup> Professor Michael Bonell asserts that under Article 7(1), good faith may be viewed as one of the general principles underlying the CISG; therefore, the article may be invoked to impose additional duties during the negotiation process.<sup>148</sup>

Article 7 was drafted to assist the national courts in interpreting the Convention itself instead of contracts governed by the CISG.<sup>149</sup> In interpreting the CISG provisions, the national courts are expected to focus on the international character of the Convention and minimize reliance on domestic practice or precedent.<sup>150</sup> The CISG's preference for international standards is further stressed by its directive that the national courts should promote uniformity in the application of its provisions.<sup>151</sup>

Article 7(2) continues in the same vein with regard to supplementary principles of law that the Convention does not expressly settle.<sup>152</sup> Supplementary legal principles may be based on the general principles of the Convention, private international law, and any body of law which is applicable under normal choice of law rules, respectively.<sup>153</sup> Furthermore, both the Convention and any applicable principles of private international law should be given broad interpretation to pro-

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147. CISG, *supra* note 6, art. 7(1) at 178-79.

148. Perillo, *supra* note 10, at 287.

149. Amy H. Kastely, *Unification and Community: A Rhetorical Analysis of the United Nations Sales Convention*, 8 NW. J. INT'L L. & BUS. 574, 601 (1988).

150. *Id.*

151. *Id.*

152. Article 7(2) of the Convention reads,

Questions concerning matters governed by this Convention which are not expressly settled in it are to be settled in conformity with [sic] the general principles on which it is based or, in the absence of such principles, in conformity with [sic] the law applicable by virtue of the rules of private international law.

CISG, *supra* note 6, art. 7(2) at 179.

153. Fritz Enderlein, *Uniform Law and Its Application by Judges and Arbitrators*, in INTERNATIONAL UNIFORM LAW IN PRACTICE, 329 (1988).

Given the need to promote the greatest possible uniformity in the application of each convention, it is only too clear that the ultimate aim towards which uniform laws . . . are directed, i.e., the setting-up of internationally uniform legal regimes in respect of the subject matters covered by them, would be seriously compromised if these same uniform laws, once accepted by the contracting States, were then applied differently within the different national legal systems.

*Id.*

note uniformity.<sup>154</sup> Consequently, recourse to the idiosyncracies of the various national legal systems should be rare.<sup>155</sup>

Nevertheless, a danger remains in that national courts may narrowly interpret the Convention so as to find unsettled areas of law.<sup>156</sup> In that case, courts may dismiss the general principles of the Convention and private international law as being inadequate and apply local law to supplement the Convention.<sup>157</sup> One commentator notes that a tendency among the national courts to resort to local law may be inevitable.<sup>158</sup>

Although the Convention does not expressly state that parties are bound to precontractual agreements, Article 8 may be interpreted as allowing the court to bind the parties based on their intent. Article 8(3) states:

In determining the intent of a party or the understanding a reasonable person would have had, due consideration is to be given to all relevant circumstances of the case including the negotiations, any practices which the parties have established between themselves, usages and any subsequent conduct of the parties.<sup>159</sup>

At least one U.S. court has used language similar to the language in Article 8 to outline the relevant factors in determining the parties' intent to be bound to their preliminary agreement.<sup>160</sup>

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154. *Id.* See also, Kastely, *supra* note 149, at 601.

155. *Id.*

156. Kastely, *supra* note 149, at 603-07, 621.

157. Note, *Unification and Certainty: The United Nations Convention on Contracts for the International Sale of Goods*, 97 HARV. L. REV. 1984, 1988 (1984).

158. *Id.*

159. CISG, *supra* note 6, art. 8(3) at 179.

160. See generally *Teachers Ins. and Annuity Ass'n v. Tribune Co.*, 670 F. Supp. 491, 497-507 (S.D.N.Y. 1987) (discussing the relevant factors in determining the parties' intent to be bound to their preliminary agreement).

The courts charged with the interpretation of the CISG also may rely on general principles of private international law.<sup>161</sup> Among these principles, arbitration decisions may be especially instructive since arbitrators frequently turn to international jurisprudence.<sup>162</sup>

International arbitrators confronting preliminary agreements requiring corporate director approval have concluded that the promoters of these agreements are subject to several implied good faith obligations.<sup>163</sup> Promoters must provide good faith recommendations to the board, insure the approval process is as expedient as possible, and inform all parties to the agreement of the progress of the directors' deliberations.<sup>164</sup> Parties are impliedly forbidden from withdrawing from the negotiation process while the approval process is pending and from entering into any third-party agreements that could jeopardize the pending agreement.<sup>165</sup> Other arbitration decisions have dealt with the question of whether negotiators who exceed their authority can nevertheless bind their principles via agency theories<sup>166</sup> or a general obligation to negotiate in good faith.<sup>167</sup> In sum, private international law provides an ample supply of general principles for use in defining the scope of a duty to negotiate in good faith.

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161. CISG, *supra* note 6, art. 7(2) at 179.

162. Anne-Marie S. Burley, *International Law and International Relations Theory: A Dual Agenda*, 87 AM. J. INT'L L. 205, 231-32 (1993).

163. See Draetta, *supra* note 50, at 170-71.

164. See *id.*

165. See *id.*

166. *Id.* at 171 n.16.

167. *Id.*

The CISG member states could provide a framework for the development of the legal obligations in international preliminary agreements through transnational legal principles and international trade usages.<sup>168</sup> This would undoubtedly require the national courts to remain true to the overall purpose of the Convention, the harmonization of laws, even if it means going beyond the literal meaning of isolated provisions.<sup>169</sup> Finally, since rules pertaining to legal obligations arising out of preliminary agreements can only be developed through case law, a provision requiring an accurate and timely case reporting system would be necessary.<sup>170</sup>

Future jurisprudence governing these arrangements will likely continue to develop haphazardly because no CISG member state has attempted to develop a systemic approach to evaluate the legal status of the preliminary agreement.<sup>171</sup> Although courts may easily recognize culpable conduct in negotiating and fulfilling contracts, reliance on judicial decisions remains an ineffective means of establishing law because of unpredictable decisions.<sup>172</sup> Unless a body of case law is developed to support its interpretation, the CISG's historic inability to define the scope of precontractual liability and the obligation of good faith negotiation will likely continue unabated.

Undoubtedly, the uncertainties surrounding precontractual liability in international transactions have had deleterious effects on international trade.<sup>173</sup> The ambiguities surrounding the current state of precontractual liability inject untold transactional costs into the international marketplace.<sup>174</sup> These costs are amplified by overly cautious attitudes about the use of preliminary agreements and unpredictable litigation over the scope of the duty to negotiate in good faith.<sup>175</sup> The role of the CISG member states in resolving these problems depends largely on their readiness to adopt a more expansive view of the good faith obligation provided for in the Convention. The CISG's

168. See *supra* notes 148-54 and accompanying text.

169. See *supra* notes 148-54 and accompanying text.

170. See generally, Farnsworth, *supra* note 4.

171. See *supra* notes 153-55 and accompanying text.

172. See *supra* notes 153-55 and accompanying text; Farnsworth, *supra* note 4., at 239-43.

173. See *supra* notes 45-49 and accompanying text.

174. See *supra* notes 45-49 and accompanying text.

175. See *supra* notes 45-49 and accompanying text.

survival as a primary international trade agreement likely hinges in large part on the successes or failures of member states in confronting these issues.

