PRELIMINARY AGREEMENTS AS CONTRACTS: FACILITATING SOCIALLY DESIRABLE TRANSACTIONS USING THE DOCTRINES OF INJUNCTION, DISGORGEMENT, AND TORTIOUS INTERFERENCE

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I.
INTRODUCTION

For decades, the legal nature of preliminary agreements has been a puzzle for courts, scholars, and practitioners. Even though preliminary agreements are one of the indispensable features of complicated deals, such as mergers and acquisitions, the drafters of preliminary agreements cannot advise their clients with certainty on the legal consequences were a dispute to arise.[1] What is the substance of preliminary agreements? Do preliminary agreements have any legal effect? If they do, what constitutes a breach? And how much in damages

1. For example, Professor Carney points out the unclearness and the danger generating from preliminary agreements, such as letters of intent, in the context of mergers and acquisitions. WILLIAM J. CARNEY, MERGERS AND ACQUISITIONS 96 (2009) ("Disputes can arise after failed negotiations about whether the letter of intent represented a meeting of the minds on all material terms of the contemplated transaction, and that the remaining matters were just 'boiler plate' of lesser importance to a deal."). He cites a famous phrase about the danger of letters of intent: "[I]n most cases, a letter of intent is an invention of the devil and should be avoided at all costs." *Id.*

should a breaching party pay? These questions have yet to be conclusively answered by the courts. Many mistakes in labeling and reasoning have long prevented us from grasping the nature of preliminary agreements. This article attempts to remove the layered misconceptions and uncover the hidden essence of preliminary agreements.

Why is the doctrine of preliminary agreements so indeterminate? The prevailing framework utilized in understanding preliminary agreements is to distinguish between Type I preliminary agreements and Type II preliminary agreements, as introduced in *Teachers Ins. & Annuity Ass'n of Am. v. Tribune Co.*[2] The reason is that two totally different issues have been dealt with under the label of Type II preliminary agreements: agreements to negotiate and agreements with open terms.[3]

Although in practice these two kinds of agreements are sometimes incorporated in a single document, in theory they should be treated differently. While agreements with open terms are incomplete final agreements,[4] agreements to negotiate intend to establish the conditions upon which parties negotiate the final agreements. In essence, the objectives of the two agreements are completely different. An agreement with open terms should not be treated as a preliminary agreement but as a form of final agreement. From the premise that a contract is always incomplete, it follows that a contract's terms are inevitably open to some extent. The striking feature of agreements with open terms is that the parties are conscious of the

2. 670 F. Supp. 491, 498 (S.D.N.Y. 1987).

3. *See, e.g.*, E. Allan Farnsworth, *Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations*, 87 COLUM. L. REV. 217 (1987) (examining both agreements to negotiate and agreements with open terms as preliminary agreements). *See also* Teachers Ins. & Annuity Ass'n of Am. v. Tribune Co., 670 F. Supp. 491, 498 (S.D.N.Y. 1987) (holding that "[the binding preliminary commitment] does not commit the parties to their ultimate contractual objective but rather to the obligation to negotiate the open issues in good faith").

4. Hereinafter, "final agreements" mean those agreements that parties will reach after the negotiations over the transfer of the assets at stake. *See* RESTATEMENT (SECOND) OF CONTRACTS §210 (1) ("An integrated agreement is a writing or writings constituting a final expression of one or more terms of an agreement."). Some scholars refer to this kind of agreement as an ultimate agreement. *See, e.g.*, E. ALLAN FARNSWORTH, CONTRACTS 200 (4th ed. 2004) ("The letter of intent added that if the parties failed to reach ultimate agreement . . . .").

terms to be fixed in subsequent negotiations and intend to fill in the blanks. Thus, when dealing with these agreements, our main concern is whether they are concrete enough to survive the test of indefiniteness.[5] In contrast, the striking feature of agreements to negotiate is that they establish the conditions of future negotiations, rather than allocating resources between the parties.[6] Therefore, the agreements to be discussed under the category of preliminary agreements are only agreements to negotiate, not agreements with open terms.

Why, then, have these two kinds of agreements been categorized together? The first reason is that these two issues are usually presented to courts in a set.[7] The second reason is that both kinds of agreements are made prior to completed final agreements and before further negotiations are scheduled.[8] This superficial but straightforward affinity has induced scholars to lump the two kinds of agreements together.[9] The third reason is that the duty of fair dealing has been deemed the key in connection with these two kinds of agreements.[10]

In the depth of this confusion, Professors Schwartz and Scott took the first step in the right direction.[11] Their analysis

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5. Indeed, Professor Farnsworth deals with agreements with open terms in the section about indefiniteness in his treatise. FARNSWORTH, *supra* note 4, at 210-12. *See also* Ronald J. Gilson et al., *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine,* 110 COLUM. L. REV. 1377 (2010) ("Historically, preliminary agreements such as this would be unenforceable under the indefiniteness doctrine of the common law of contracts.").

6. Alan Schwartz & Robert E. Scott, *Precontractual Liability and Preliminary Agreements,* 120 HARV. L. REV. 661, 666 (2007) ("Preliminary agreements thus commonly are exploratory; that is, the performance of a preliminary agreement sometimes is a necessary condition for parties to pursue an efficient project later.").

7. *See, e.g.,* Brown v. Cara, 420 F.3d 148 (2d Cir. 2005) (holding that the preliminary agreement is enforceable as an obligation to negotiate the open terms in good faith).

8. *See* Farnsworth, *supra* note 3, at 249 (referring to any agreement "that is made during negotiations in anticipation of some later agreement that will be the culmination of the negotiations" as a preliminary agreement).

9. *See, e.g.,* RANDY E. BARNETT, CONTRACTS: CASES AND DOCTRINE 421 (4th ed. 2008) (treating agreements to agree, i.e., agreements to negotiate, in the context of agreements with open terms).

10. *See* Farnsworth, *supra* note 3. The title of the article shows that Professor Farnsworth considers "fair dealing" the key.

11. Schwartz & Scott, *supra* note 6.

identifies that preliminary agreements are utilized in transactions that entail parties' investments before they can negotiate over the divisions of the surplus generated from the deals.[12] Unlike traditional theories, which try to redistribute costs from an ex post perspective according to fairness,[13] the authors find the essence of preliminary agreements in stipulating the sequence of the investments necessary to realize the transaction.[14] In their article, the principal concerns surrounding preliminary agreements switch from ex post equity to ex ante efficiency.[15]

Unfortunately, their analysis remains mired in the prevailing fallacy. The fact that they regard reliance damages as the

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12. *Id.*, at 665 ("Parties make a preliminary agreement because they cannot write a complete contract at the outset: they function in a complex environment in which a profitable project can take a number of forms, and just which form will work, if any, is unknown at the start.").

13. Farnsworth, *supra* note 3, at 219 (stating that the problem addressed in the article is whether "a disappointed party [may] have a claim against the other party for having failed to conform to a standard of fair dealing"). Throughout the article, the perspective of Professor Farnsworth is backward-looking, not forward-looking; he discusses how the cost of failed negotiation should be shared, not how parties should coordinate in order to succeed.

14. *See* Schwartz & Scott, *supra* note 6, at 704 (arguing that "the analysis clarifies that a deviation from the agreed investment sequence is a breach.").

15. *Id.*, at 667 ("It is efficient for contract law to protect the promisee's reliance interest if his promisor deviated from an agreed investment sequence. A reliance recovery will encourage parties to make preliminary agreements and will deter some strategic behavior. Therefore, the new rule governing preliminary agreements—awarding the promisee reliance if the promisor fails to bargain in good faith but not requiring the parties to agree—is a step in the right direction."). Prior to the article of Professors Schwartz and Scott, law and economics scholars had dealt with precontractual liability from the point of efficiency. *See, e.g.*, Lucian Bebchuk & Omri Ben-Shahal, *Precontractual Reliance*, 30 J. LEGAL STUD. 423 (2001); Richard Craswell, *Offer, Acceptance, and Courtship: Cheap Talk Economics and the Law of Contract Formation*, 85, VA. L. REV. 385 (1999); Avery Katz, *When Should an Offer Stick? The Economics of Promissory Estoppel in Preliminary Negotiations*, 105 YALE L.J. 1249 (1996). The significance of the work of Professors Schwartz and Scott, as they claim themselves, is that they deal with three important questions as a set: "Why do parties in this context make preliminary agreements?" "Why do these parties invest after making the preliminary agreement but before uncertainty is resolved?" "If both parties realize that exit is best, how, then, can one of them have a reasonable expectation that the other will reimburse his sunk costs in the absence of a specific promise?" Schwartz & Scott, *supra* note 6, at 665.

sufficient and appropriate compensation for breach[16] shows that they still think the primary function of preliminary agreements is the allocation of costs among parties. However, no examination of the relationship between the parties can give us the truth about preliminary agreements, because the key to understanding many preliminary agreements lies outside the parties—it lies with the third party. The essence of preliminary agreements lies in the allocation of the risks of failure arising from the interference of third parties. A proper understanding of this fact will enable courts and practitioners to facilitate efficient contracting practices.

The first contribution of this article is to construct a model that sheds light on the implications of the risk of interference of third parties. Consider the following example: X Corporation is considering selling its assets to Y Corporation. Roughly speaking, there are two possible cases in which the deal between X and Y will not be closed even though the two companies have made a preliminary agreement and executed investments accordingly. In the first case, if Y values the assets less than X does, the transaction will not be consummated because it does not generate positive value, which is called synergy in the context of mergers and acquisitions. In the second case, even if Y values the assets more than X does, if Z Corporation assesses them higher than Y does, the negotiation between X and Y will also fail, as X will choose Z as its counterparty, not Y.

When we understand the allocation of risks to be the essence of preliminary agreements, we notice that the failure in each case stems from the realization of different risks. In the former case, the failure derives from the common risk that the transaction between X and Y is intrinsically undesirable. In the latter case, by contrast, the failure is the actualization of the risk that a third party will interfere. The distinction between the two scenarios is critically important from the perspective of the risk allocation. Although the transaction between X and Y in the second case turns out to be undesirable ex post, after the more attractive transaction between X and Z becomes available, it is still worth pursuing ex ante (when X is not sure

16. Schwartz & Scott, *supra* note 6, at 702 ("[T]here is no need for a duty to bargain in good faith; awarding reliance interest is sufficient to increase efficiency.").

whether Z would appear or not) because the transaction between X and Y in itself produces some positive value, i.e., generates some synergy.

This is the central theme to be discussed throughout this article. In order to achieve ex ante efficiency, encouraging the transaction between X and Y is indispensable. When Y considers investing in the negotiation with X, it might hesitate in anticipation of Z's interference. If Y's investment is a necessary condition for realizing X's potential transactions (i.e., one with Y and one with Z), relieving Y of the fear of Z's interference and thus encouraging Y's investment is key to facilitating ex ante efficiency. Without Y's investment at the beginning, even the less attractive transaction with Y will not be achieved, not to mention the better one with Z. In this context, preliminary agreements play an important role in facilitating ex ante efficiency by inducing Y's investment.

Equity also matters here.[17] From Y's perspective, the two cases described above are totally different. In the first case, Y has no reason to criticize X because the failure is just the unfortunate realization of the risk in their investments. X, as well as Y, suffers the result. By contrast, Y has good reason to feel it has been treated unfairly in the second case. Without Z's interference, Y would have divided some profit with X. With the interference X enjoys a larger benefit with Z while excluding Y. This sense of unfairness prompts serious consideration.

The second contribution made by this article is its characterization of preliminary agreements as agreements that are different from and independent of final agreements, yet equally deserving of enforcement as contracts.[18] Unlike final agreements, which allocate the resources among parties, preliminary agreements allocate the risks of failure of negotiations among parties. Although Judge Posner once remarked on the possibility of this construction,[19] scholars have failed to

17. The term "equity" is used to mean "justice" in this article, except when otherwise indicated.

18. Professor Knapp introduced the concept of a "contract to bargain." *See generally* Charles L. Knapp, *Enforcing the Contract to Bargain*, 44 N.Y.U. L. REV. 673 (1969).

19. Venture Assocs. Corp. v. Zenith Data Sys. Corp., 96 F.3d 275, 277 (7th Cir. 1996) ("[A]greements to negotiate toward the formation of a contract are themselves enforceable as contracts if the parties intended to be legally bound.").

examine it thoroughly.[20] This paper provides the first comprehensive analysis of this construction, building upon a model introduced by Professors Schwartz and Scott.

According to the parties' intention to exclude Z's interference or not, this article introduces three labels for relevant negotiation schemes: the "Auction Method," the "Exclusive Method," and the "Auction Method with Lockup." Under the Auction Method, X is free to negotiate with Z. Under the Exclusive Method, X forgoes the opportunity to contact Z. Finally, under the Auction Method with Lockup, X retains the freedom to negotiate with Z by compensating Y for Y's investment. By choosing one of these three methods in a preliminary agreement, parties can allocate the risk of Z's interference ex ante. It will be shown that respecting the parties' agreed-upon risk allocation by honoring the preliminary agreement can achieve both efficiency and equity simultaneously.

Practitioners use different terminology than that introduced by this article, and their mislabeling has led to confusion within the field. What they call exclusive negotiation is not the Exclusive Method, but is, rather, the Auction Method with Lockup, because the existence of a termination fee and the limitation of the exclusive period suggest that X does not forgo the opportunity to negotiate with Z altogether.[21] This misleading labeling seems to be one source of the confusion. In particular, the reason why termination fees are contracted has often been misunderstood. As this article will show in detail through the model, termination fees are not compensation for the expectation of exclusivity but only for the price of retaining the freedom to engage other buyers. Similarly, courts and scholars have failed to distinguish a case under the Auction Method from one under the Auction Method with Lockup. For example, in the *Brown v. Cara*, the court found the agreement between the parties legally binding as a Type II preliminary agreement.[22] According to the model developed

20. For a thorough criticism of Judge Posner's remark, see Gilson et al., *supra* note 5, at 1442-44.

21. Concerning lockups from the perspective of practitioners, see, for example, Trevor Norwitz & Igor Kirman, *Takeover Law and Practice 2011*, *in* DOING DEALS 2012: THE ART OF M&A TRANSACTIONAL PRACTICE, at 35, 101-05 (PLI Corporate Law & Practice, Course Handbook Ser. No. 1937, 2012).

22. 420 F.3d 148 (2d Cir. 2005).

by this article, readers will realize that the transaction in that case was conducted under the Auction Method and that the court wrongly decided the case.

The third contribution made by this article concerns the remedy for breach of a preliminary agreement. Traditionally, reliance damages have been considered the appropriate remedy for such a breach.[23] The widely accepted basis for rejecting expectation damages is that there are no such interests to be protected.[24] However, if we treat preliminary agreements as contracts, adoption of expectation damages seems the natural consequence.[25] Indeed, we can conceptualize interests distinct from those arising from final agreements: namely, interests the parties expect from future final agreements that would be reached if both of the parties complied with the preliminary agreements.

The practical obstacle to awarding expectation damages is the difficulty of proof. Since both of the two decisive factors—the amount of the surplus issuing from the hypothetical transaction and the parties' bargaining power—are not observable, a breached-against party will surely face extreme difficulty in proving the magnitude of the damages.[26] To circumvent this obstacle, this article suggests that remedies be crafted out of three doctrines: injunction, disgorgement, and tortious interference with punitive damages. Injunction is the simplest way to avoid the problem of proof, but its limitation is that a

23. *See, e.g.*, Farnsworth, *supra* note 3, at 264 ("Reliance damages are particularly appropriate here since a party generally perceives an agreement to negotiate as protecting just that interest, should the other pull out of the negotiations."); *see also* Schwartz & Scott, *supra* note 6, at 667 ("[T]he new rule governing preliminary agreements—awarding the promisee reliance if the promisor fails to bargain in good faith but not requiring the parties to agree—is a step in the right direction.").

24. *See* Farnsworth, *supra* note 3, at 223 (insisting that expectation damages cannot be given to the injured party.); Schwartz & Scott, *supra* note 6, at 667 ("The law cannot protect the promisee's expectation interest because, in the context that we study, there is no complete contract to enforce.").

25. *Cf. Venture Assocs.* 96 F.3d at 278 ("Damages for breach of an agreement to negotiate may be, although they are unlikely to be, the same as the damages for breach of the final contract that the parties would have signed had it not been for the defendant's bad faith.").

26. *See id.* at 278-79 ("The difficulty, which may well be insuperable, is that since by hypothesis the parties had not agreed on any of the terms of their contract, it may be impossible to determine what those terms would have been and hence what profit the victim of bad faith would have had.").

breached-against party must get wind of the breach beforehand; after the breach has occurred, an injunction is useless. On the other hand, in order to justify the invocation of the latter two measures, there must be reproachable behavior on the part of the breaching or interfering parties.[27]

The scheme developed throughout this article simultaneously upholds two fundamental values, efficiency and equity. Although Professors Schwartz and Scott show that awarding reliance damages facilitates ex ante efficiency,[28] the validity of awarding reliance damages seems open to dispute. Professors Schwartz and Scott do not demonstrate that the award of the verifiable reliance damages is *sufficient* to facilitate efficiency, though they certainly succeed in proving that it is *necessary*.[29] The analysis provided in this article will demonstrate that reliance damages are not sufficient, while expectation damages are both necessary and sufficient to facilitate efficiency.

The devices introduced to protect expectation interests, i.e., disgorgement and tortious interference with punitive damages, ensure that prospective breaching parties face significant uncertainty. This uncertainty discourages them from ignoring the preliminary agreements unilaterally and encourages them to try negotiating for modification. By incentivizing them to renegotiate, we can relieve prospective victims from the fear of being deprived of their rights and expectations without consent. This assurance of the equitable outcome encourages prospective parties to decide to invest in profitable opportunities ex ante. Thus, we can accomplish efficiency and equity simultaneously.

The discussion is organized as follows. Part II develops the new model that will be utilized throughout this article. By analyzing the model, this part reveals the intended exchange in a preliminary agreement and defines the substance of a breach

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27. For a discussion of tortious interference, *see* RESTATEMENT (SECOND) OF TORTS §766. *See also* Texaco, Inc. v. Pennzoil, Co., 729 S.W.2d 768 (Tex. App. 1987).

28. Schwartz & Scott, *supra* note 6, at 704 ("Anticipating the availability of a reliance recovery can motivate parties to sink costs in the exploration of possibly profitable ventures and thus will expand the set of efficient contracts that parties can create.").

29. *Id.* They claim that "[t]here is no need to protect the promisee's expectation." However, they do not provide the reasons why there is no need to protect it.

of that agreement. Part III clarifies the problem of existing theories and provides a theoretical solution to the problem, i.e., characterizing preliminary agreements as contracts. Part IV discusses mechanisms for enforcing preliminary agreements, showing that disgorgement and tortious interference with punitive damages will play important roles in enforcing such agreements. The analysis of the two devices sheds light on the utility of uncertainty. Part V applies the analysis of the model to exclusivity agreements, which are used widely in practice. The application of the model peers beneath the label of "exclusivity" and shows that such agreements are really a kind of auction. Part V also analyzes cases in order to demonstrate the validity of the theory developed in this article. Upon the application of the theory to practices and cases, Part V makes some suggestions for practitioners who deal with complicated transactions that entail preliminary agreements. Finally, Part VI summarizes the arguments. This article will enable the reader to see preliminary agreements in a new way, both in theory and in practice, by exposing preliminary agreements' underlying architecture.

II.
Analysis of the Incentive Structure of Parties Negotiating Preliminary Agreements

A. *Introduction of the Model*

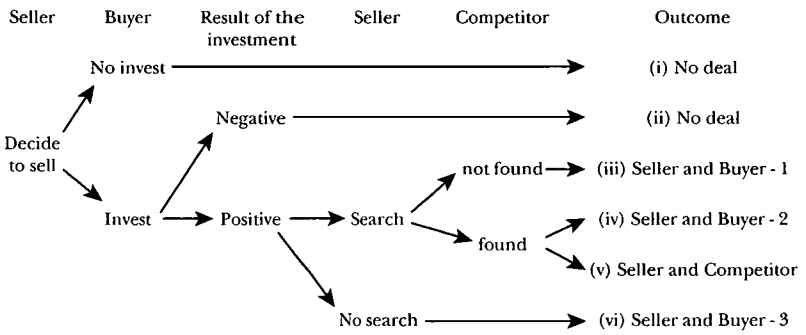
As Professors Schwartz and Scott point out, a preliminary agreement is made when uncertainty makes it impossible to reach a final agreement.[30] So, preliminary agreements are common features in complicated transactions, such as mergers and acquisitions, where the value of the assets to be sold is unknown to the parties, particularly to the buyer, until the parties invest to remove the obstacles to their transaction. Consider the following example:

30. *See supra* note 12 and accompanying text; *see also* Farnsworth, *supra* note 3, at 250 ("[Preliminary] 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.").

Seller Corporation is considering selling its wholly owned subsidiary, Target Corporation.[31] Although Target has no intrinsic value for Seller, it might be worth something to other companies. Seller, however, has trouble finding a prospective buyer; companies hesitate to negotiate with Seller as they do not want to take on the risk of losing time and money only to discover that Target is worthless.[32]

Consider the concerns of Buyer Corporation, a prospective buyer. Buyer is considering investing in the investigation of Target (i.e., due diligence) to reveal its value for Buyer. There are two main concerns for Buyer. Initially, Buyer is worried about the possibility that Target might turn out to be worthless; even if Target turns out to be worth acquiring, Buyer might not be able to profit sufficiently from the transaction because of the interference of its rival company, Competitor. The following tree diagram represents the possible decisions of Seller and Buyer, and their outcomes.

DIAGRAM 1



As you can see from the diagram, if Seller decides to negotiate with Buyer, Buyer's choices are whether or not to in-

31. In this hypothesis, the asset for sale is assumed to be a wholly owned subsidiary rather than the entire Seller corporation. This simplification is intended to limit the analysis to the realm of contract law. If Seller were for sale, fiduciary duties would be implicated. *See, e.g.*, Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003) (holding that a lockup agreement was invalid because it effectively prevented the board of directors from fulfilling its fiduciary duties).

32. Here, the cost of the investigation is assumed to be relation-specific as is the investment in Professors Schwartz and Scott's model. Schwartz & Scott, *supra* note 6, at 677.

vest in acquiring the information about Target. If Buyer decides not to invest, then there will be no deal; thus, both of the parties gain and lose nothing (Case (i) (No Invest Case)). Meanwhile, if Buyer decides to invest, the first bifurcation occurs at the point where Target turns out to be worthwhile or not (Positive or Negative in the diagram). If Target turns out to be valueless to Buyer, then the negotiation between Seller and Buyer terminates. In this case, none of the parties gain anything, but Buyer loses the money invested in the investigation (Case (ii) (Negative Case)). On the other hand, if Target turns out to be valuable to Buyer, Seller has to decide whether it will search for another prospective buyer. If Seller conducts the search, the next question is whether it will find Competitor who will agree to incur the cost of revealing Target's value. If Competitor does not appear, Seller and Buyer will have a deal (Case (iii) (Not Found Case)). If Competitor does appear, the set of parties to the ultimate transaction depends on which buyer values Target more. If Buyer values Target more than Competitor does, Seller and Buyer will have a deal (Case (iv) (Buyer Win Case)). Otherwise, Seller and Competitor will reach an agreement (Case (v) (Competitor Win Case)). Finally, if Seller decides not to conduct the search, Seller and Buyer will make a deal (Case (vi) (No Search Case)).

The diagram makes it clear that Buyer faces three risks. First, Target might turn out to be valueless after Buyer invests to discover Target's value (Case (ii) (Negative Case)). Second, Buyer might gain less profit from the transaction, even if the investment was productive and Target turns out valuable, because of Competitor's interference and the subsequent higher price reached in the bidding contest (Case (iv) (Buyer Win Case)). Last, Buyer might not get any share of the profit from selling a valuable Target because of Competitor's interception (Case (v) (Competitor Win Case)). Whether Buyer will invest in the investigation depends on how Buyer evaluates these risks.

We will start the analysis by setting up parameters and establishing the information structure. In this analysis, we will distinguish the perspective of Seller from that of Buyer and shed light on the changes in the parties' assessments of the parameters according to the information created by Buyer's investment.

The cost to Buyer of the investment necessary to reveal Target's value is C_B. Target's value for Buyer turns out to be positive S with a probability of P, and nothing (zero) with a probability of $(1 - P)$. While the magnitude of S is uncertain ex ante (i.e., before the investigation by Buyer), Seller and Buyer find the magnitude of S simultaneously after the investigation.[33] After the magnitude of S is revealed, Seller decides whether to conduct a search for Competitor (with a cost of C_H), and the search will succeed with a probability of R. If Competitor, who finds Target valuable for Competitor after incurring a cost of investigation (C_C), becomes available, Target's value for Competitor (V) is larger than S with a probability of U. As in the case with S, Seller and Competitor will find the exact size of V simultaneously. The decision of Seller regarding the search depends on the search cost (C_H) and Seller's assessment of R and V,[34] but these are unknown values for Buyer. As Buyer cannot predict ex ante whether Seller will conduct the search, it assumes that Seller will conduct the search with a probability of Q.

The following assumptions are included in the information structure. First of all, Seller and Buyer will adjust their assessments of the parameters as new information is produced by the investigation. In particular, Seller's assessments of R and V will change according to information it acquires about S. We call Seller's evaluations of R and V before the investigation R_{S0} and V_{S0}, and those after the investigation R_{S1} and V_{S1}. Second, Seller utilizes the information produced by Buyer's investment in searching for Competitor because Seller's search

33. It is assumed here that the information about Target's value for Buyer (S) is revealed to Seller and Buyer simultaneously. The justification for this assumption is that Seller and Buyer work together to reveal the value. In practice, Buyer obtains information about Target from Seller. So, the assumption that Seller knows Target's value for Buyer is not unrealistic. If this assumption is relaxed, Buyer will have incentive to pretend that Buyer evaluates Target less than in reality to obtain a larger share of the surplus. *See infra* p. 399. It is also assumed that the magnitude of S is uncertain ex ante. If the magnitude of S is fixed, then the parties can make a final agreement even before the investigation, and do not have to make a preliminary agreement. This is why the magnitude of S should be assumed to be uncertain in this context.

34. As we will discuss later, we assume that all the parties have the same bargaining power. *See infra* p. 387. So, the magnitude of U is irrelevant to Seller's decision.

without the information will be always futile. In the hypothesis discussed here, Buyer is the only prospective buyer who decides to negotiate with Seller. It is a fundamental assumption in the hypothesis that Seller cannot find another prospective buyer without utilizing the information revealed by Buyer; therefore, if Seller conducts such a search, it does so with this information.

Proceeding from the premises set up above, we will calculate the expected returns on Buyer's investment in each case from the ex ante perspective of Buyer. In Case (ii) (Negative Case), Buyer's net loss is C_B and the probability of this outcome is $(1 - P)$.

(ii) Buyer's expected return: $- C_B$, Probability: $1 - P$

Next, after it is revealed that Target has some value for Buyer, Seller conducts a search for Competitor by utilizing the information, the product of Buyer's investment, in Cases (iii) (Not Found Case), (iv) (Buyer Win Case), and (v) (Competitor Win Case). In Case (iii) (Not Found Case), since Competitor is not found, Seller and Buyer will make a deal and each will gain half of the value of Target, S, assuming that the parties have equal bargaining power and thus neither can demand more than an equal share. In this situation, we must subtract C_B from Buyer's profit of $S/2$, because Buyer's investment is already a sunk cost.

(iii) Buyer's expected return: $S/2 - C_B$, Probability: $PQ(1 - R)$

In Case (iv) (Buyer Win Case), where Competitor is available but Buyer wins the contest, Seller's opportunity cost of doing business with Buyer, i.e., Target's value for Competitor (V_s: smaller than S)[35] is considered in the negotiation between Seller and Buyer, while Buyer's investment (C_B) is already a sunk cost and is not considered. So, V_s becomes the bargaining chip of Seller as Seller's next-best option. Now the surplus produced by the transaction between Seller and Buyer is only ($S - V_s$) instead of S. Therefore, Buyer will split this reduced sur-

35. V_s is the conditional expected value of V. Because the situation changes thoroughly depending on whether V is larger or smaller than S, we have to set V_s as the expected value of V on the condition that V is smaller than S.

plus equally with Seller,[36] and the initial cost of C_B will be subtracted from Buyer's profit.

(iv) Buyer's expected return: $(S - V_s)/2 - C_B$, Probability: $PQR(1 - U)$

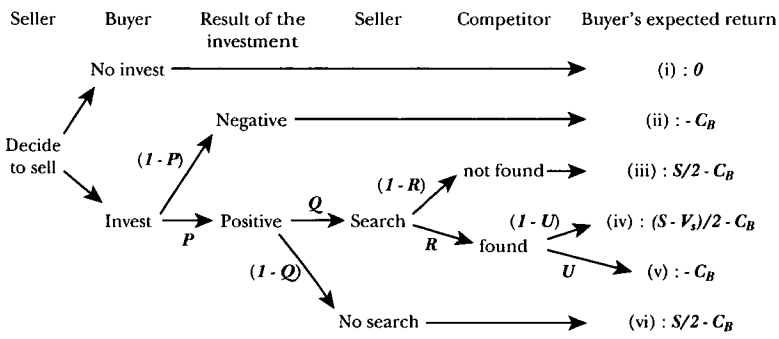
In Case (v) (Competitor Win Case), when Competitor is available and it values Target more than Buyer does, Buyer will gain nothing. So, Buyer incurs the net loss of its investment.

(v) Buyer's expected return: $- C_B$, Probability: $PQRU$

In Case (vi) (No Search Case), when Seller decides not to conduct a search for Competitor, Seller and Buyer will reach an agreement to share the value of Target at the price of $S/2$ as in Case (iii) (Not Found Case).[37]

(vi) Buyer's expected return: $S/2 - C_B$, Probability: $P(1 - Q)$

DIAGRAM 1-2
FROM THE PERSPECTIVE OF BUYER BEFORE THE INVESTMENT



Following the above calculation of Buyer's expected return in each case, the expected value of Buyer's return (*EVB*)

36. Provided that the both parties are equally patient, according to Nash bargaining, the parties will split the surplus equally. So, the price of Target will be agreed at $V_s + (S - V_s)/2$, or $(S + V_s)/2$. The expected return to Buyer is S less $(S + V_s)/2$, or $(S - V_s)/2$.

37. In this analysis, Buyer's expected return in Case (vi) (No Search Case) is the same with that in Case (iii) (Not Found Case). If we consider time value of money and the time necessary to conduct the investigation, then Buyer's expected return decreases in Case (iii).

at the time Buyer considers investing can be expressed as follows:

$$\begin{aligned} EVB &= -C_B(1-P) + (S/2 - C_B)PQ(1-R) + ((S-V_s)/2 \\ &\quad - C_B)PQR(1-U) - C_BPQRU + (S/2 - C_B)P(1-Q) \\ &= S/2*P\,(1-QRU) - V_s/2*PQR(1-U) - C_B \end{aligned}$$

This expression shows that, from Buyer's perspective, ***EVB*** increases as ***S*** or ***P*** increase, or as ***Q***, ***R***, ***U***, or V_s decrease. In other words, Buyer hesitates to invest if it considers ***S*** or ***P*** small or ***Q***, ***R***, ***U***, or V_s large.

B. *Commitment Strategy*

Buyer invests to reveal the value of Target only when it considers the expected return to the investment (***EVB***) to be positive. Thus, Seller's concerns are that Buyer may hesitate to invest because it believes ***S*** or ***P*** to be small or believes ***Q***, ***R***, ***U***, or ***V*** to be large and that, consequently, the sale of Target will not be realized. What, then, can Seller do to prompt Buyer to invest? Seller has two strategies it can use to influence Buyer's judgment. It can change the parameters, or add another parameter. We will discuss the latter in Section F.[38] In this section, our attention will focus on the former.

The first thing to consider is which parameters Seller can influence. We assumed that ***S***, ***P***, ***R***, ***U***, and ***V*** are out of Seller's control. However, Seller can influence the magnitude of ***Q***, which is Buyer's assessment of the probability that Seller will conduct the search, by promising not to search. If Seller promises not to search, and if Buyer believes this promise, Seller can increase Buyer's assessment of ***EVB*** by fixing ***Q*** at zero and thus encourage Buyer to decide to invest.[39] See the tree diagrams below.

38. *See infra* p. 395.

39. *See* Venture Assocs., 96 F.3d at 278 ("The parties may want assurance that their investments in time and money and effort will not be wiped out by the other party's foot-dragging or change of heart or taking advantage of a vulnerable position created by the negotiation.").

DIAGRAM 2

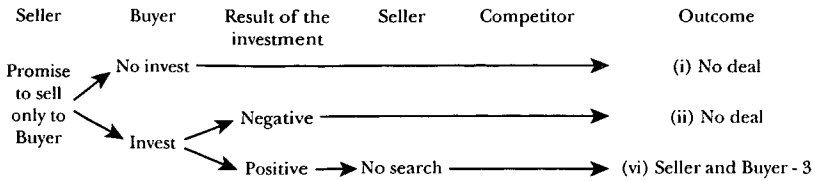
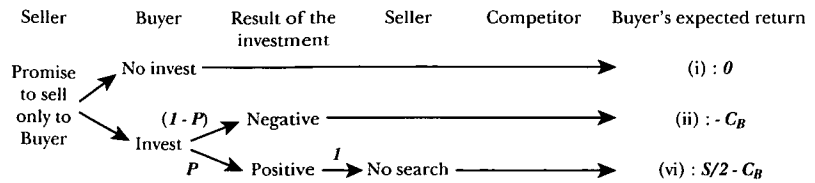


DIAGRAM 2-2



If Buyer believes Seller's promise and fixes Q at zero,[40] Buyer's assessment of EVB in this scenario ($EVB_{Q=0}$) can be expressed as follows:

$$EVB_{Q=0} = - C_B(1 - P) + (S/2 - C_B)P = S/2 * P - C_B$$

$EVB_{Q=0}$ can be positive even when EVB is negative. Thus, Seller has a strong incentive to promise not to search for Competitor in order to induce Buyer's investment, which is a necessary condition for the sellout of Target. This promise is the essence of a preliminary agreement.[41]

40. Although Professors Schwartz and Scott argue that Seller cannot commit not to defect the agreement, the analysis in this article does not follow their argument. The reason is that this article does not accept their assumption that the parties cannot contract on the timing or level of investment. Schwartz & Scott, *supra* note 6, at 686 ("[T]he parties cannot contract on the timing or level of investment."). In the model developed here, even though parties cannot contract on the division of S, which will be revealed after the investment, one of the investments of the parties is specific and easy to observe: Seller's investment. What Seller should do is just not to search for another potential buyer.

41. By contrast, Professors Schwartz and Scott argue that the essence of a preliminary agreement lies in stipulating the sequence of investments: "[A] preliminary agreement—an intention to make a binding preliminary agreement—should be found when the parties have agreed, albeit imprecisely, on the nature of the project; on the categories of action, such as marketing or construction, into which their investments are to fall; and on the order in which they are to act." Schwartz & Scott, *supra* note 6, at 690.

C. *Preliminary Agreements as Parties' Selection of the Dealing Method*

The analysis above shows that, in general terms, there are two methods of conducting a transaction. Under the first, Seller is permitted to search for Competitor, utilizing the Buyer-generated information to demonstrate that Target is valuable (Diagram 1-2). This article refers to this method as the "Auction Method" since either Buyer or Competitor—whoever values Target higher—will acquire Target. Under the second method, Seller forgoes the opportunity to search for Competitor after Buyer invests in revealing Target's value (Diagram 2-2). This article calls this method the "Exclusive Method" since Buyer is entitled to negotiate with Seller exclusively.

Using this terminology, a preliminary agreement can be expressed as an agreement concerning the parties' selection of their dealing method. Through a preliminary agreement that stipulates that Seller should not search for Competitor, parties choose the Exclusive Method. Under the Auction Method, Buyer assumes the risk of Competitor's interference; while under the Exclusive Method, Seller gives up the opportunity to find Competitor. These methods each allocate differently the risk of an appearance by Competitor.

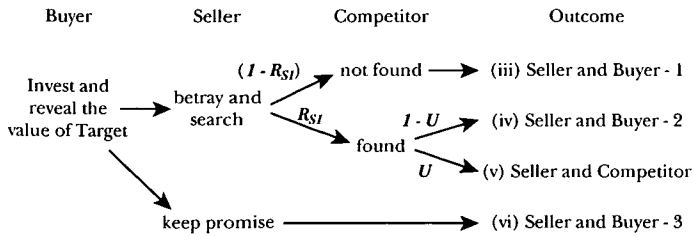
D. *The Possibility of Seller's Betrayal*

As we have already determined in Section B, Seller has good reason to commit to not searching for Competitor when it tries to persuade Buyer to invest. Seller, however, has a strong incentive to betray Buyer's reliance on Seller's commitment (fixing Q at zero) once Buyer has invested and the information about Target has become available, because searching for Competitor is likely to increase the expected price of Target[42] since the cost of the search (C_H) is usually small compared to the amount at stake.[43]

42. Schwartz & Scott, *supra* note 6, at 666 ("The promisor has an incentive to defect from any such agreement by delaying her decision whether to invest until after the promisee has invested.").

43. Generally speaking, once Seller finds out what assets can generate synergy, searching for a prospective buyer who values the same assets becomes much easier.

DIAGRAM 3
FROM THE PERSPECTIVE OF SELLER AFTER THE INVESTMENT



Since Buyer's cost of investigation (C_B) is a sunk cost, it will not be considered during the negotiation of Target's price. Keeping this fact in mind, we will examine how Seller assesses its expected return in each case at the time it decides whether to betray. If Seller keeps its promise and does not search for Competitor (Case (vi) (No Search Case)), as we determined in Section B, Seller and Buyer will reach an agreement at price of $S/2$.[44] Since the price of Target is the same as Seller's profit, its profit is $S/2$.

If Seller breaks its promise and searches for Competitor, the outcome depends on whether Competitor is found and, if Competitor is found, on how much Competitor values Target. (Note that the cost of the search (C_H) is a sunk cost whether or not the search is fruitful.) In Case (iii) (Not Found Case), where Competitor is not found, Seller and Buyer will reach an agreement at a price of $S/2$.

(iii) Seller's expected return: $S/2 - C_H$, Probability: $1 - R$

In Case (iv) (Buyer Win Case), since Target's value for Competitor (V)[45] is smaller than Target's value for Buyer (S), Seller and Buyer will make a deal. However, as we determined

44. Throughout this article, we assume that Target has no value for Seller for simplicity. In reality, Target always has some value for Seller. If Seller finds some value in Target, the agreed price will be that value plus $S/2$ here.

45. When calculating Seller's expected return, we do not have to distinguish V_s from V because Seller's situation does not change which bidder will win. Note that this assumption applies only because we assume here that all the parties have the same level of patience. If we loosen this assumption, of course, we have to distinguish V_s (or V_i: expected V on the condition that V is larger than S) from V.

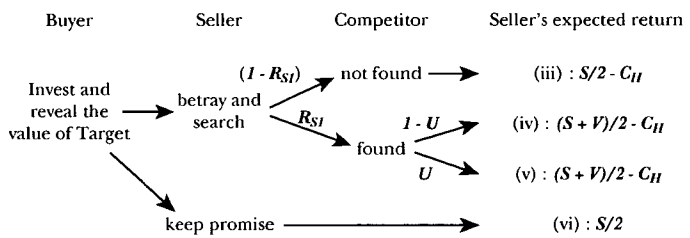
in Section A, utilization of information about V increases Seller's bargaining power, so the parties will reach an agreement at price of $(S + V)/2$.[46]

(iv) Seller's expected return: $(S + V)/2 - C_H$,
Probability: $R(1 - U)$

In Case (v) (Competitor Win Case), since Target's value for Competitor (V) is larger than Target's value for Buyer (S), Seller and Competitor will make a deal. Because Seller's next-best option is S, the parties will reach an agreement to divide the surplus of $(V - S)$ equally at the price of $(S + V)/2$.[47]

(v) Seller's expected return: $(S + V)/2 - C_H$,
Probability: RU

DIAGRAM 3-2
FROM THE PERSPECTIVE OF SELLER AFTER THE INVESTMENT



Following the above calculation of the expected return of Seller's search in each case, the expected value to Seller of Seller's betrayal after Target is found valuable ($EVS_{P=1}$) can be expressed as follows:

$$EVS_{P=1} = S/2(1 - R) + (S + V)/2*R(1 - U)+(S + V)/2*RU - C_H$$
$$= S/2 + V/2 * R - C_H$$

46. If Seller can utilize the information that the value of Target for Competitor is V, its next-best option is V. So, the surplus produced from the transaction between Seller and Buyer is $(S - V)$ here. Provided that both parties are equally patient, the parties will split the surplus equally. So, the price of Target will be agreed at $V + (S - V)/2$, or $(S + V)/2$.

47. In this case, Seller's next-best option is S. So, the surplus produced from the transaction between Seller and Competitor is $(V - S)$ here. Provided that both parties are equally patient, the parties will split the surplus equally. So, the price of Target will be agreed at $S + (V - S)/2$, or $(S + V)/2$.

Whether it is advantageous for Seller to betray Buyer depends on the relationship between ($V/2 * R$) and C_H. As long as Seller considers ($V/2 * R$) larger than C_H, Seller will decide to breach in order to seek a higher price. Thus, from Seller's perspective, as Seller's assessment of V or R increases, so does the strength of its incentive to betray Buyer.[48]

E. *The Essence of Betrayal*

If we understand a preliminary agreement as an agreement regarding the parties' choice of dealing method, Seller's betrayal can be understood as a unilateral conversion from the Exclusive Method to the Auction Method. Buyer decided to invest, relying on Seller's agreement to conduct their transaction under the Exclusive Method, because it judged that the investment opportunity under that method was attractive. For Seller, committing not to search for Competitor means promising to utilize the information revealed by Buyer only for the purpose of closing a deal between Seller and Buyer. When Seller betrays Buyer and utilizes the information in a search for Competitor,[49] Seller and Competitor free-ride on the information generated by Buyer.

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48. In this model, the only cause for Seller to hesitate to betray Buyer is the cost of the search (C_H). Seller might have another incentive to comply with the agreement in the model of Professors Schwartz and Scott because it incorporates the concept of time. Since the time value of money is considered, Seller might have incentive to comply with the agreement in order to accelerate the realization, or closing, of the transaction. *See* Schwartz & Scott, *supra* note 6, at 685.

49. In other words, Seller utilizes Buyer as a "stalking horse" to find a Competitor who can beat Buyer. The court's decision in *Quantum Communications* provides a good example of such an attempt. Quantum Commc'ns v. Star Broad., 473 F. Supp.2d 1249, 1260-61 (S.D. Fla. 2007). In *Quantum*, the defendant breached an agreement to sell the assets of an FM radio station to the plaintiff; instead, the defendant induced the plaintiff's rival to purchase the assets at a higher price. *See also* NACCO Indus., Inc. v. Applica Inc., 997 A.2d 1, 19 (Del. Ch. 2009) ("Parties bargain for provisions in acquisition agreements because those provisions mean something. Bidders in particular secure rights under acquisition agreements to protect themselves against being used as a stalking horse and as consideration for making target-specific investments of time and resources in particular acquisitions. Target entities secure important rights as well. It is critical to our law that those bargained-for rights be enforced, both through equitable remedies such as injunctive relief and specific performance, and, in the appropriate case, through monetary remedies including awards of damages."). Note that this case does not

F. *The Third Choice of Dealing Method: The Auction Method with Lockup*

Beyond the aforementioned Auction Method and Exclusive Method is a third dealing method, the Auction Method with Lockup. As we determined above, the advantage of using the Exclusive Method is that it can increase the expected value of the return to Buyer on its investment (from ***EVB*** to $\boldsymbol{EVB_{Q=0}}$) and can encourage Buyer to invest even if it might hesitate under the Auction Method. ($\boldsymbol{EVB_{Q=0}}$ can be positive when ***EVB*** is negative.) The reasons for Buyer's hesitation under the Auction Method are that the information Buyer gathers has positive externalities and that Seller (and Competitor) may get a free ride on Buyer's investment. Due to the externality and the risk of the free ride, potentially attractive investment opportunities might not be pursued.[50] The key, then, to encouraging these socially desirable investments is preventing the free ride and assuring Buyer that it will get rewarded for its investment. The Exclusive Method solves this problem by prohibiting others from utilizing the information, i.e., eliminating the externality.

Another answer to the problem is to make Seller (and Competitor) pay for the information if they want to utilize it. To this end, it is a reasonable option for the parties to agree that Seller pays some money (***X***) from the value of Target in compensation for the utilization of the information.[51] In other words, Seller tries to influence the magnitude of ***EVB*** by adding another parameter (***X***) through a preliminary agreement. Therefore, we assume here that ***X*** is determined before Buyer invests in the investigation, and ***X*** is payable when ***S*** turns out to be positive after the investigation.[52] If this option is

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involve breach of a preliminary agreement but that of a merger agreement, especially no-shop clause.

50. GUHAN SUBRAMANIAN, NEGOTIAUCTIONS 42 (2010) ("[S]ome bidders might not participate in auctions because other bidders can get a free ride off their expertise.").

51. Marcel Kahan & Michael Klausner, *Lockups and the Market for Corporate Control*, 48 Stan. L. Rev. 1539, 1540 (1996) ("Target firms grant lockups in friendly deals in order to ensure the bidder a return on the investment it makes in evaluating and implementing the deal . . . .").

52. Since ***S*** is uncertain at the time ***X*** is fixed, ***S*** might turn out to be smaller than ***X***. In such a case, Seller would suffer a loss from the transaction due to its own misjudgment. If Seller considers this risk too large, Seller

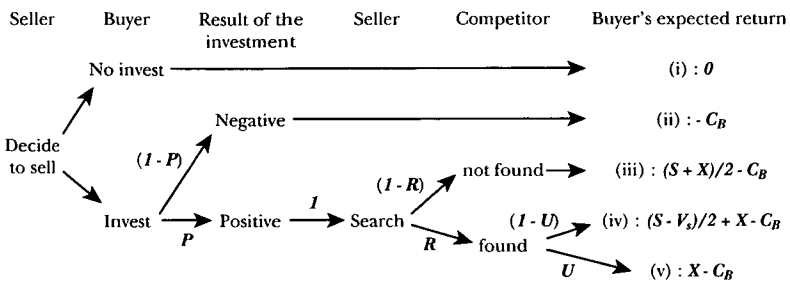
adopted, Buyer's return in each of Cases (iii) (Not Found Case),[53] (iv) (Buyer Win Case),[54] and (v) (Competitor Win Case) changes as follows:[55]

(iii) Buyer's expected return: $(S + X)/2 - C_B$, Probability: $P(1 - R)$

(iv) Buyer's expected return: $(S - V_s)/2 + X - C_B$, Probability: $PR(1 - U)$

(v) Buyer's expected return: $X - C_B$, Probability: PRU

DIAGRAM 1-3
FROM THE PERSPECTIVE OF BUYER BEFORE THE INVESTMENT



should insist that X be reduced to S in such a case. In order to adopt this option, it must be assumed that the magnitude of S is revealed to both parties simultaneously after the investigation.

53. In this case, Buyer received X when the value of the Target (S) turned out to be positive and Seller conducted the search. As the value of Target becomes smaller by X, the parties will split the surplus of $(S - X)$ equally. So, the expected return will be $(X + (S - X)/2)$, or $(S + X)/2$.

54. In this case, the next-best option for Seller is $(V_s - X)$. So, the surplus produced from the transaction between Seller and Buyer is again $(S - V_s)$ here. Since the parties will split the surplus equally, they will agree at the price of $(V_s - X) + (S - V_s)/2$. Thus, Buyer's expected return will be $(S - V_s)/2 + X$ less C_B. Note that this calculation does not apply in a precise sense because there is a presumption that $(V_s - X)$ is positive. If V_s is below X, this calculation is not correct. In that case, Competitor will lose interest in Target. *See also infra* note 55.

55. The payment of X does not change U because it does not affect who will win the bidding contest because the value of Target for both Buyer and Competitor reduces by the same amount, X. In a precise sense, R might be changed because of the payment of X since Competitor who values Target less than X will lose interest in it. *See* Kahan & Klausner, *supra* note 51, at 1548.

Thus, the expected value of Buyer's investment ($EVB_{Q=1, \text{ with } X}$)[56] is expressed as follows:

$$\begin{aligned} EVB_{Q=1, \text{ with } X} &= (S+X)/2*P(1 - R)+((S - V_s)/2+X)PR(1 - U) \\ &\quad +X*PRU - C_B \\ &= S/2*P(1 - RU)+X/2*P(1+R) - V_s/2*PR(1 - U) - C_B \end{aligned}$$

These calculations show that EVB increases by ($X/2 * P(1 + R)$) as a consequence of the change from the Auction Method to the Auction Method with Lockup. Thus, this method can induce Buyer to invest where it might hesitate under the Auction Method. The advantage of using this method is that it encourages Buyer to invest while Seller retains its freedom to search for Competitor. The Auction Method with Lockup combines the advantages of the Auction Method with those of the Exclusive Method.

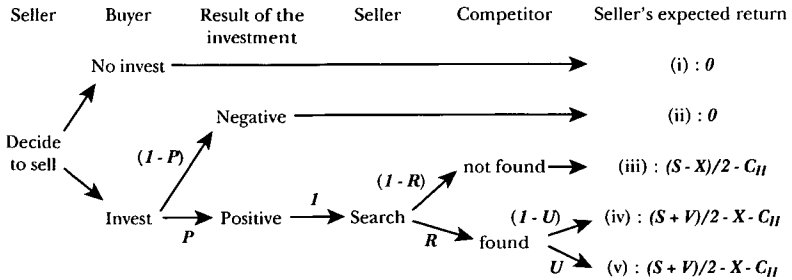
G. *The Advantages and Disadvantages of Using the Auction Method with Lockup*

The Auction Method with Lockup can encourage Buyer's investment while allowing for the possibility that a Competitor will emerge that evaluates Target higher than Buyer does. However, it does not necessarily follow that the Auction Method with Lockup is always the most desirable option for the parties. First, consider Seller's situation. If Seller fails to find Competitor, it will be forced to negotiate with Buyer without a bargaining chip. In this case, the agreed price will be lower than the one that would be agreed upon through the Exclusive Method.[57] In addition, the cost of the search (C_H) will be deducted from the profit generated by the transaction. For Seller, the Auction Method with Lockup is preferable only when Seller is confident that it can find a Competitor that will value Target substantially high enough. The diagram below describes the set of possible expected returns for Seller.

56. In this scenario, for simplification, it is assumed that Q is fixed at 1 because Seller will surely search for Competitor since it paid X in order to retain the freedom to do it.

57. In this scenario, Seller and Buyer will divide (S - X) equally as the value of the lockup (X) is already paid to Buyer upon the search. Thus, the price will be (S - X)/2.

DIAGRAM 1-4
FROM THE PERSPECTIVE OF SELLER BEFORE THE INVESTMENT



Second, consider Buyer's concerns. When Buyer thinks that Competitor is likely to interfere with the negotiation, the Auction Method with Lockup is not attractive for Buyer. There is a high possibility of a price increase as a consequence of the bidding contest, and in the worst case, Buyer will lose the contest and be forced to walk away with X. Thus, to be compensated for these risks, Buyer will demand substantial X if Seller insists on the Auction Method with Lockup. One can understand this by comparing $EVB_{Q=1,\ with\ X}$ with $EVB_{Q=0}$.

$$EVB_{Q=0} - EVB_{Q=1,\ with\ X} = S/2 * PRU - X/2 * P(1 + R) + V_s/2 * PR(1 - U)^{58} = P/2(S * RU - X * (1 + R) + V_sR(1 - U))$$

This expression shows that Buyer's assessments of P, S, R, U, V_s, and X determine which method is most advantageous. While this calculation is very complicated, we can still make a conjecture about the magnitude of the X Buyer will surely demand. Under the Auction Method with Lockup, Buyer does not expect much more of a return than X when Buyer assumes that R and V are large. In that case, Buyer pays attention to the relationship between P and C_B in negotiating the size of X because Buyer incurs the net loss of C_B with a probability of $(1 - P)$. Since Buyer insists on being compensated for the risk of the net loss in exchange for accepting the Auction Method with Lockup, Buyer will demand at least C_B/P, which is necessarily larger than C_B.[59] When Buyer considers P small, Buyer

58. Note that 1 is assigned to Q here.

59. In the worst assumption, in which R is 1 and V is as large as S, Buyer gains only $(X - C_B)$ with a probability of P while incurring the net loss of C_B with a probability of $(1 - P)$. In order to make the expected return of Buyer

will demand a substantially large X. An X acceptable to Buyer might be too large for Seller to accept. This shows the difficulty of determining the appropriate X.

In addition, there seems to be a practical reason that Buyer will not appreciate the idea of negotiating over the amount of X. In the model presented by this article, it is assumed that the magnitude of S is revealed to Seller and Buyer simultaneously only after the investigation and that there is no information asymmetry. In reality, however, Buyer will sometimes have a conjecture about S and will always try to conceal its evaluation of Target and to pretend that S is small, because it will want to enjoy a larger share of the real S.[60] Therefore, it might be difficult for Buyer to demand a sufficient X in making the preliminary agreement. If Buyer demands an increase of X, this request necessarily reveals its expectation that S will be large. This unavoidable disclosure might have a negative impact on Buyer's position when it is negotiating over the division of S because it would not be able to insist that S and the appropriate price be low. In order to avoid this undesirable situation, Buyer has no choice but to claim that S is low when negotiating over X, which, in turn, results in an inadequate X.

Under the Auction Method with Lockup, Seller pays X to retain its freedom to search for Competitor. For Seller, the desirability of both the Exclusive Method and the Auction Method with Lockup depends on the prospect of success of search (R), the expected Competitor's evaluation of Target (V),[61] and the magnitude of the X Buyer will accept. We cannot say that the Auction Method with Lockup is intrinsically superior to the Exclusive Method. Indeed, the parties are likely to choose the Exclusive Method when Seller is not confident in finding a good Competitor, or when Buyer is afraid of the risk of Competitor's interference. In other words, risk-averse parties will choose the Exclusive Method, not the Auction Method with Lockup. The point is that each party will exercise its own judgment in deciding which method is

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positive, X must be larger than C_B/P, which is necessarily larger than C_B because P is smaller than 1.

60. *See supra* note 33 (discussing the assumption that the information about the value of S is simultaneously revealed to both Buyer and Seller, and that the actual value of S is uncertain ex ante).

61. *See supra* Diagram 3-2 (showing that in our hypothesis, whether V is larger than S or not is irrelevant to Seller).

favorable for it, and it will incur the consequences of its own judgment. Each party must be responsible for its own assessment of the risks, and, accordingly, we need a rule that respects parties' own decisions.

III.
CHARACTERIZING PRELIMINARY AGREEMENTS

A. *What It Means to Breach a Preliminary Agreement*

In Part II we saw that parties to a complicated transaction have three options: the Auction Method, the Exclusive Method, and the Auction Method with Lockup. In light of this categorization, Seller's breach of a preliminary agreement can be understood as a unilateral attempt to convert the dealing method from the Exclusive Method to the Auction Method, despite the fact that Buyer has invested on the basis of the Exclusive Method.

Why is this unilateral change so problematic? The answer to this question rests on analysis from the perspectives (both ex ante and ex post) of both efficiency and equity.

Let us begin with an efficiency analysis. First of all, from an ex post perspective, the unilateral change from the Exclusive Method to the Auction Method might be justifiable because it provides the potential for increase in efficiency. If Competitor values Target more than Buyer does, Competitor's interference is socially desirable. However, the unilateral change can disturb efficiency. For one thing, the search for Competitor cannot be conducted for free, as Seller has to incur the cost of search (C_H). Second, when a prospective Competitor decides to interfere with the transaction, it must incur the cost of the investigation (C_C). These costs can be justified from the perspective of efficiency only when the difference between S and V is larger than the sum of C_H and C_C.[62]

62. Although the model of this article does not take into account the time value of money, the timing of realization matters in considering the validity of the unilateral change. Professors Schwartz and Scott shed light on the timing. Schwartz & Scott, *supra* note 6, at 665–666 ("The parties invest in the interim period because early investment accelerates the realization of returns."). Seller's search and subsequent Competitor's investigation will surely delay the closing of the transaction. In other words, the realization of the synergy from the transaction will be suspended by the unilateral change. If Seller finds Competitor who values Target less than Buyer does, there will

On the other hand, from an ex ante perspective, the unilateral conversion impairs efficiency and is not justifiable. If there is a possibility of Seller's betrayal, Buyer will surely anticipate it and might hesitate to invest from the outset if it considers the investment under the Auction Method too risky.[63] Therefore, the possibility of the unilateral change by Seller may preclude a potentially profitable investment opportunity that could be pursued through the Exclusive Method.[64]

Next, we will analyze Seller's betrayal from the perspective of equity between the parties. First, from an ex post perspective, Seller tries to deprive Buyer of its expectation under the Exclusive Method without its consent. If Seller wants to change the method, it should ask Buyer for its consent. Buyer is robbed of the opportunity to negotiate with Seller over the conditions of the conversion. Moreover, from an ex ante perspective, if Seller wants to retain its freedom to search for Competitor, it should negotiate with Buyer accordingly. Since Buyer has rational grounds to hesitate to invest under the Auction Method, Buyer should be awarded the opportunity to consider whether it is profitable for it to invest under such a method. If Buyer considers the Auction Method too disadvantageous or too risky, it will demand some lockup (X) as the compensation for the risks. If the dealing method is changed unilaterally and the amount of X is determined ex post, Buyer is deprived of the opportunity to negotiate over the amount of the lockup (X). The analysis above shows that the unilateral conversion of the method by Seller can be supported only from the perspective of the ex post efficiency. However, since this change cannot be a Pareto improvement but only be a Kaldor-Hicks improvement, it has, at best, weak validity.[65]

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be only a transfer of resources from Buyer to Seller at the expense of delayed realization and the costs of Seller's search and Competitor's investigation. From the perspective of society as a whole, it is just waste of resources.

63. In other words, if Buyer anticipates Seller's betrayal, Q will not be fixed at zero. *See* discussion *supra* Part II, Section D.

64. Professors Schwartz and Scott call this problem the ex post holdup problem. Schwartz & Scott, *supra* note 6, at 686.

65. Concerning the Pareto principle, *see, e.g.*, STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 611 (2004) ("if all individuals prefer one situation to a second, the first should be socially preferred"). Concerning Kaldor-Hicks efficiency, *see, e.g.*, Guido Calabresi, *The Pointlessness of Pareto: Carrying Coase Furrther*, 100 YALE L. J. 1211, 1221 (1991) ("[The Kaldor-Hicks test] states that a move is efficient whenever the winners win

B. *Problems with Existing Theories: Are Reliance Damages Enough?*

Currently, it is widely held that reliance damages should be awarded for a breach of a preliminary agreement.[66] As the analysis in Part II shows, a breach of a preliminary agreement is Seller's attempt to convert the dealing method from the Exclusive Method to the Auction Method. The traditional theory can be understood to refuse this unilateral change from the perspective of ex post equity and to try to allocate to Seller some of the costs Buyer has incurred by awarding verifiable reliance damages. In other words, utilizing the terminology introduced in Part II, the traditional theory characterizes a transaction with a preliminary agreement as one under the Auction Method with Lockup, on the ground of ex post equity, assigning verifiable reliance damages (αC_B: α is the verifiable fraction of C_B)[67] to X. Alternatively, although Professors Schwartz and Scott adopt reliance damages as the appropriate remedy,[68] their justification is based on ex ante efficiency rather than the ex post equity basis of traditional theory.[69] Awarding reliance damages for a breach of a preliminary agreement, thereby enforcing it, might be supported as promoting efficiency. From the ex ante perspective, it encourages Buyer to invest where it might otherwise hesitate to do so. In addition, from the ex post perspective, it does not prohibit Seller from searching for Competitor, which might be efficiency-enhancing activity. Moreover, it can be justifiable from the perspective of equity because letting Seller betray Buyer's reliance on its promise is inequitable.

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more than the losers lose, in the sense that, if the winners compensated the losers to their satisfaction, the winners would still be better off than they were before the change.").

66. *See, e.g.*, sources cited *supra* note 23.

67. α is likely to be substantially below 1 because the most important component of the reliance interest is the lost opportunity, which is very difficult to prove. *See* Schwartz & Scott, *supra* note 6, at 687 ("In some cases, the verifiable portion of the buyer's reliance will be too small to sustain his incentive to make a preliminary agreement.").

68. *Id.* at 704 ("These goals are advanced by awarding the faithful party her verifiable reliance costs if the other has wrongfully delayed investment.").

69. *Id.* at 687 ("Awarding reliance in both cases will encourage buyers to make efficient preliminary agreements and will sometimes deter strategic behavior by sellers.").

As was discussed in Part II, Section D, since Seller has an incentive to defect from an agreement to conduct a transaction under the Exclusive Method, the agreement is not always self-enforcing.[70] Thus, awarding some damages to a victim of a breach is necessary to enforce the method. Existing theories[71] can be interpreted as insisting that we enforce preliminary agreements by awarding reliance damages, thereby mitigating the free-riding on the information Buyer created.[72]

However, the analysis of the model in this paper suggests that there are problems with the existing theories' approaches. First, it is unclear whether the parties realized that they would conduct their transaction under the Auction Method with Lockup. In particular, it must be examined whether Buyer decided to invest in revealing the information under the method. If it decided to invest upon the understanding that the transaction was under the Exclusive Method, as we have discussed in Section A, then imposing the Auction Method with Lockup on Buyer is inequitable. To justify the conversion from the Exclusive Method to the Auction Method with Lockup, Buyer should have accepted the possibility of conversion. Moreover, if the transaction is to be conducted under the Auction Method with Lockup, Buyer should have been given an opportunity to negotiate over the amount of X ex ante, because whether Buyer accepts the method depends on the magnitude of X.[73] Given that Buyer's expected value of the return under the Exclusive Method ($EVB_{Q=0}$) is different from the reliance damages, it is unjustifiable to require Buyer to accept the reliance damages as compensation for the unilateral change of the dealing method, or X.

Since the difference between the expected value of the return under the Exclusive Method ($EVB_{Q=0}$) and the reliance

70. Only when Seller considers the cost of the search and the delay of the closing of the transaction too burdensome, will an agreement to conduct a transaction under Exclusive Method be self-enforcing. *See supra* note 48 and accompanying text.

71. Both the traditional theory and the theory presented by Professors Schwartz and Scott will be referred to as existing theories below. Although they have different justifications, they have common feature in awarding reliance damages to a breach of a preliminary agreement.

72. In other words, Professors Schwartz and Scott intend to solve the ex post holdup problem by awarding reliance damages. *See supra* note 64.

73. *See* discussion *supra* Part II, Section F.

damages is critically important for the following analysis, we will examine it by utilizing the model. In our hypothesis, by adopting the Exclusive Method, Seller agrees to give up the freedom to search for Competitor when Target turns out to be valuable after the investigation. This forgone opportunity, C_S, is the cost Seller agrees to incur in the agreement. As was discussed in Part II, Section D, C_S is $(V/2 * R - C_H)$.[74] For Buyer, it agrees to invest in the investigation of Target, and the cost of this investigation is C_B.

As we have already seen, awarding the betrayed Buyer reliance damages in effect denotes their transaction as a kind of Auction Method with Lockup, assigning Buyer's verifiable reliance damages (αC_B) to X as a lockup. This means that Seller is given an option to change the dealing method unilaterally from the Exclusive Method to the Auction Method with Lockup of αC_B. To determine whether this option is justifiable, we must examine the substance of this option.

By exercising the option, Seller increases its expected return by $(V/2 * R - X/2 * (1 + R) - C_H)$, hereinafter, Δ.[75] This expression shows that Seller regains C_S, which was forgone in the agreement, by paying $(X/2 * (1 + R))$. The reason why the change should be characterized as an option is that the assessment of the magnitude of Δ changes as uncertainty about R and V reduces through investigation. At the time the preliminary agreement is made, Seller judges that Δ is negative, i.e., $(V_{S0}/2 * R_{S0} - C_H)$ is smaller than $X/2 * (1 + R_{S0})$. (This X is hypothetical one that Buyer would accept.) However, after the investigation, Seller's assessment of Δ changes as that of R and V changes from R_{S0} and V_{S0} to R_{S1} and V_{S1} according to the information Buyer created. If Δ is positive, Seller has incentive to breach the agreement according to the new assessment. This hindsight is the source of the option's value.

This option is problematic for two reasons. First, the exercise price of the option is too low. As we discussed in Part II, Section G, Buyer would demand X, which is larger than C_B, in

74. *See supra* Part II, Section D. More precisely, Seller's assessment of C_S at the time of the agreement is $(V_{S0}/2 * R_{S0} - C_H)$.

75. After Seller finds that Target is valuable for Buyer, the expected return for Seller under Exclusive Method is $S/2$. On the other hand, the expected return for Seller under Auction Method with Lockup is $(((S - X)/2 - C_H)(1 - R) + ((S + V)/2 - X - C_H) R)$. Therefore, the difference between the two expectations is $(V/2 * R - X/2 * (1 + R) - C_H)$.

order to be compensated for the risk Buyer bears, i.e., the risk of the net loss with a probability of $(1 - P)$. Therefore, αC_B, which is necessarily smaller than C_B as α is between 0 and 1, is too small to be assigned to X. Second, Seller does not pay for the option; Seller is given this option for free. For these reasons, awarding reliance damages to a breached-against Buyer is not justifiable. Such small damages cannot sufficiently compensate for Buyer's expected interests under the Exclusive Method.

On the other hand, enforcing a preliminary agreement through awarding reliance damages can be a surprise for Seller.[76] Where the parties did not specify the dealing method they would follow, Seller might have thought that it was under the Auction Method.[77] Moreover, as Buyer did not demand a lockup in the transaction ex ante, it should be questioned whether it is justifiable to give Buyer what it did not bargain for.[78]

Finally, awarding reliance damages is likely to distort Buyer's decision regarding the investment. In the first place, Buyer might have the incentive to invest too many resources in order to threaten Seller from breaching the preliminary agreement.[79] If the verifiable reliance interests (αC_B) are artificially increased, Seller might hesitate to breach because it would be forced to compensate more. The increased compensation

76. In *Teachers*, the court stated that "[a] primary concern for courts in such disputes is to avoid trapping parties in surprise contractual obligations that they never intended." Teachers Ins. & Annuity Ass'n of Am. v. Tribune Co., 670 F. Supp. 491, 497 (S.D.N.Y. 1987).

77. Professor Farnsworth insists that "[i]f a party has not agreed to negotiate exclusively, . . . it seems unlikely that that party can reasonably be expected to forgo the opportunity to conclude a deal with a third party before impasse has been reached." Farnsworth, *supra* note 3, at 283. The existence of the agreement to negotiate exclusively seems critically important to justify the change of the default rule. Additionally, he points out that "parallel negotiations are so common in practice and so important to competition that it is hard to see how there can be such a requirement [not to negotiate with others] in the absence of an undertaking that negotiations will be exclusive." *Id.* at 279.

78. *See id.*, at 231 ("[U]nder the aleatory view of negotiations, a court may treat benefit as well as loss as being at risk in the negotiations.").

79. If reliance damages are awarded, Buyer might have incentive to invest too much because some of its investments might be transferred to Seller. Concerning the danger of overinvestment, see, for example, Schwartz & Scott, *supra* note 6, at 688.

might make a search unprofitable and cause over-deterrence. In addition, Buyer might have incentive to spend resources in a way that can make its reliance damages more verifiable. In other words, Buyer might choose an expensive but verifiable way of investigation rather than an inexpensive but non-verifiable one. For example, it is possible that Buyer would decide to hire more expensive outside professionals even if it has an internal staff fit for the task, because the cost of internal human resources is difficult to prove in front of a court while the cost of outside professionals is easily verifiable. As this example shows, the rule awarding reliance damages has the potential to distort Buyer's investment decision.

In addition, the prevailing theories, except that of Professors Schwartz and Scott, are problematic due to their unpredictability. They define preliminary agreements broadly, and then select legally binding ones.[80] In this process, they examine whether failed negotiations should be characterized as those under the Auction Method with Lockup in light of ex post equity. Since this decision is made from an ex post comprehensive standpoint, not only the preliminary agreement itself, but also the relationship between the parties and the process of the negotiation are considered.[81] Therefore, whether a court will regard a preliminary agreement as legally binding is

80. Generally, preliminary agreements are discussed within the context of precontractual liability. *See, e.g.*, Farnsworth, *supra* note 3. This article deals with only preliminary agreement, not precontractual liability in general. Concerning precontractual liability, see, for example, Omri Ben-Shahar, *Contracts Without Consent: Exploring a New Basis for Contract Liability*, 152 U. PA. L. REV. 1829 (2004) (developing the "no-retraction" principle which controls contract formation process. Under this principle, liability emerges gradually as negotiation progresses, rather than arising upon mutual assent of the parties.); Jason Scott Johnston, *Investment, Information, and Promissory Liability*, 152 U. PA. L. REV. 1923 (2004) (criticizing Professor Ben-Shahar's "no-retraction" regime.); Omri Ben-Shahar, *Mutual Assent Versus Gradual Ascent: The Debate Over the Right to Retract*, 152 U. PA. L. REV. 1947 (2004) (responding to the criticism by Professor Johnston.).

81. *Teachers Ins. & Annuity Ass'n of Am. v. Tribune Co.*, 670 F. Supp. 491, 498 (S.D.N.Y. 1987) ("The second and different sort of preliminary binding agreement is one that expresses mutual commitment to a contract on agreed major terms, while recognizing the existence of open terms that remain to be negotiated."). *See also* Schwartz & Scott, *supra* note 6, at 675-76 ("The cases endorse a multifactor analysis that invokes the language of the agreement; the existence, number, and character of open terms; the extent of any reliance investments or partial performance; and the customary prac-

highly unpredictable ex ante. This unpredictability can cause conflicts between parties and thus increases litigation costs. Additionally, this may create chilling effects on complicated transactions because mere participation in negotiation can constitute causes of liability against parties' expectations.[82] These are the problems from the perspective of efficiency. On the other hand, a party who intended to conduct a negotiation under the Auction Method faces the risk of having liability imposed under the Auction Method with Lockup. This is a problem of equity because a party might be deemed liable without its consent. Such an imposition of liability is a fundamental breach of contract law.[83]

The analysis above shows that the rule of awarding reliance damages to a victim of a breach of a preliminary agreement is not the optimal one. Reliance damages are not sufficient compensation for the unilateral change from the Exclusive Method to the Auction Method. They might inappropriately interfere with parties who started their negotiation under the Auction Method, and they might have distorting effects on Buyer's investment decision. Especially concerning the former problem, the rule does not succeed in en-

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tice regarding formalities. The court is to consider, in addition, the context of the negotiations resulting in the preliminary agreement.").

82. Such a rule may have a chilling effect on complicated negotiations. Professors Schwartz and Scott succeed in solving this problem by requiring the agreement as a basis of liability. *See* Schwartz & Scott, *supra* note 6, at 690. Therefore, the author cannot support the criticism by Professor Kostritsky. Juliet P. Kostrinsky, *Uncertainty, Reliance, Preliminary Negotiations and the Holdup Problem*, 61 SMU L. REV. 1377 (2008). Professor Kostrinsky puts promissory estoppel in the context of preliminary agreement. *Id.* at 1418 ("Promissory estoppel does and should play an important role in these contexts."). From the perspective of this article, the most important accomplishment of Professors Schwartz and Scott is that they carve out an agreement from the mired doctrine of precontractual liability. Professor Kostrinsky's argument seems to spoil it.

83. The default rule of contract law is that no liability exists prior to the acceptance of the offer. As Professor Farnsworth pointed out, courts have traditionally accorded parties the freedom to negotiate without risk of precontractual liability. Farnsworth, *supra* note 3, at 221. In *Teachers*, the court held that "[i]t is fundamental to contract law that mere participation in negotiations and discussions does not create binding obligation, even if agreement is reached on all disputed terms. More is needed than agreement on each detail, which is overall agreement (or offer and acceptance) to enter into the binding contract." Teachers, 670 F. Supp. at 497.

couraging the investment of a Buyer who invests only under either the Exclusive Method or the Auction Method with Lockup with X larger than αC_B. Awarding reliance damages is not sufficient to facilitate ex ante efficiency.[84]

C. *Preliminary Agreements as Contracts*

The most important reason why the existing theories assert that reliance damages are the appropriate remedy is that expectation damages are excluded from consideration.[85] Many have pointed out that expectation damages cannot be awarded because a final agreement has not been reached.[86] It might be argued that expectation damages, which put the breached-against party in the position it would have been had the agreement been performed, should not be awarded when the parties never reached an agreement. Expectation damages are not meant to position the party as if the agreement had been reached.

However, if we can conceptualize a preliminary agreement as an independent contract different from a final agreement, it seems possible to identify expectation interests that are different from the expectation interests rooted in the final agreement. The expectation from such a preliminary agreement is that the party can negotiate with the counter-party through the dealing method on which they agreed.[87] There-

84. It is true that awarding reliance damages contributes to efficiency. As Professors Schwartz and Scott claim, awarding reliance damages can encourage some buyers to make preliminary agreements which otherwise would have been rejected. *See* Schwartz & Scott, *supra* note 6, at 686. However, this rule cannot encourage a buyer to make a preliminary agreement whose expected return with reliance damages is still negative while that with the seller's commitment is positive. This is why the author claimed in Part I that the award of the verifiable reliance damages does not sufficiently facilitate efficiency. Indeed, Professors Schwartz and Scott admit that "[i]n some cases, the verifiable portion of the buyer's reliance damages will be too small to sustain his incentive to make a preliminary agreement." *Id.* at 687. In short, their proposal solves the ex post holdup problem only partially.

85. *See supra* note 23.

86. *E.g.,* Farnsworth, *supra* note 3, at 263 ("[T]here is no way of knowing what the terms of the ultimate agreement would have been, or even whether the parties would have arrived at an ultimate agreement, so there is no possibility of a claim for lost expectation under such an agreement.").

87. Judge Posner stated that damages for breach of an agreement to negotiate are theoretically not limited to reliance damages. *See* Venture Assocs. V. Zenith Data Sys., 96 F.3d 275, 278 (7th Cir. 1996) ("[I]f the plaintiff can

fore, it seems straightforward to characterize a preliminary agreement that stipulates the dealing method as a contract[88] distinct from the final agreement.[89]

Indeed, such an agreement fulfills the requirements of a contract by providing consideration for each of the promises. Buyer promises to invest in the investigation in order to induce Seller to promise to negotiate with it exclusively. Seller promises not to engage in a search for another buyer (Competitor) in order to induce Buyer to promise to invest.[90] Both of the promises are bargained for—each is exchanged for the other.[91]

Characterizing a preliminary agreement as a contract will contribute to the delineation of a clearer rule regarding negotiations, which will reduce conflicts between parties. Currently, we have a rule that awards reliance damages for a breach of a preliminary agreement. Under this rule, it is unclear when a court will find a legally binding preliminary agreement, a breach of which serves as the basis for the claim for the reliance damages.[92] In most of the cases concerning preliminary

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prove that had it not been for the defendant's bad faith the parties would have made a final contract, then the loss of the benefit of the contract is a consequence of the defendant's bad faith, and, provided that it is a foreseeable consequence, the defendant is liable for that loss.").

88. As previously mentioned, Judge Posner characterizes an agreement to negotiate as a contract. In fact, the court used the term "preliminary contract." *See id.*

89. Professors Schwartz and Scott advocate that the law should encourage parties to make efficient preliminary agreements as "the law encourages parties to invest and trade efficiently by enforcing contracts they make." Schwartz & Scott, *supra* note 6, at 690. This article intends to further their argument by enforcing preliminary agreements as contracts.

90. Professors Schwartz and Scott introduce a good example of this kind of transaction. *Id.* at 698 ("In this situation, the buyer invests in information costs by undertaking due diligence, and he will be protected if he negotiates for an exclusive dealing clause according to which the seller agrees not to shop for a better deal during the negotiations. Thus, the seller makes an opportunity cost investment.") (quoting Tan v. Allwaste, No. 96 C 3558, 1997 WL 337207 (N.D. Ill. June 11, 1997)); *see also* Gilson et al., *supra* note 5, at 1440.

91. Professor Farnsworth also admits that preliminary agreements rarely raise questions under the classic rules of offer and acceptance. Farnsworth, *supra* note 3, at 252.

92. In *Teachers*, the court held that there are two kinds of binding preliminary agreements. One "occurs when the parties have reached complete agreement on all the issues perceived to require negotiation." The other

agreements, the issue has been whether there was a preliminary agreement mature enough to justify reliance damages. Much time and money have been spent on inquiries into the existence of legally meaningful preliminary agreements.[93] By contrast, if we adopt the rule proposed in this section, a preliminary agreement will never become a basis of liability except when it fulfills the requirements of a contract. This approach is consistent with the traditional aleatory view of contracts. In principle, both of the parties spend time and money at their own risk during negotiation.[94] If they find this default rule inappropriate for their situation, they can contract out of the default rule, i.e., the Auction Method. Without a contract stipulating that their transaction is under the Exclusive Method or the Auction Method with Lockup, neither of the parties should incur any liability.

The existence of a contract is obviously much easier to identify than that of a legally meaningful preliminary agreement. A court should focus on the agreement itself and should not consider other factors like the negotiation process.[95] Under the proposed rule, there would be fewer conflicts

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"expresses mutual commitment to a contract on agreed major terms, while recognizing the existence of open terms that remain to be negotiated." Teachers Ins. & Annuity Ass'n of Am. v. Tribune Co., 670 F. Supp. 491, 498 (S.D.N.Y. 1987). Since the first type of agreement is a traditional contract, only the second type of agreement is what should be classified as a preliminary agreement. As previously mentioned, a preliminary agreement is necessary when the parties cannot contract on major terms because of uncertainty. So, such a rule cannot sufficiently facilitate efficiency by encouraging investment. In addition, there are several elements to be considered under the rule stipulated in the case. When several elements are weighed, it is difficult to predict the conclusion. The court itself admitted this difficulty by stating that "[i]t may often be difficult for a court to determine whether a preliminary manifestation of assent should be found to be a binding commitment." *Id.*

93. Professors Schwartz and Scott point out that "[f]or courts, the real issues are when an agreement will be found and how the nature of the agreement will determine the type of damages a promisee can recover." Schwartz & Scott, *supra* note 6, at 668.

94. *See supra* note 78.

95. *See, e.g., Itek Corp. v. Chicago Aerial Indus.*, 248 A.2d 625, 629 (Del. 1968) ("We think the first issue to be resolved in this case is the existence or non-existence on January 15, 1965 of an enforceable agreement. If there was none, then obviously Itek's case falls. Under Illinois law, this decision is to be reached after consideration of the surrounding circumstances and what the parties intended and believed to have been the result.").

among parties over the existence of a legally binding preliminary agreement, and, even if a conflict were to occur, the task of a court would be much easier.[96]

IV.
THE ENFORCEMENT OF PRELIMINARY AGREEMENTS AND THE REMEDY FOR BREACH

A. *The General Principle Regarding Remedy for Breach of Contract: Expectation Damages*

If the proposed rule is accepted, the remedy for breach of a preliminary agreement as a contract should generally be expectation damages. By awarding expectation damages instead of reliance damages, we can put breached-against Buyer in the position in which it would have been had the contract, i.e., the agreement to negotiate under the Exclusive Method, been performed.

Awarding expectation damages is superior to awarding reliance damages because it can avoid undesirable side effects. As we have already discussed in Part III, Section B, the rule of awarding reliance damages might have distorting effects on Buyer's investment decision. These effects result from the relationship between the amount of the damages and the costs of the investigation. Adopting expectation damages as the appropriate remedy eliminates the relationship between Buyer's decision on the investment and the damages Buyer would receive if Seller breaches. So, under this rule, Buyer will have an incentive to spend the most appropriate amount in the most effective way. It no longer needs to consider the verifiability of its expenses.

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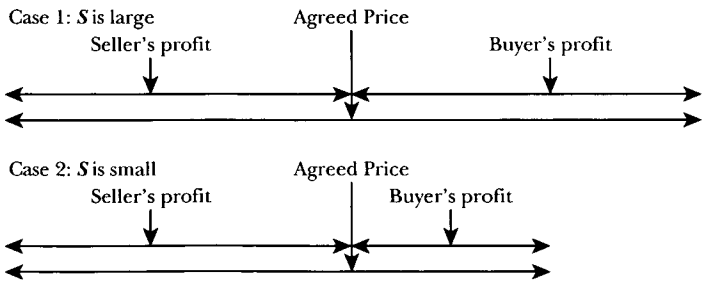
96. Professor Farnsworth does not recognize a specific duty resulting from an agreement to negotiate but argues that the parties to an agreement to negotiate undertake a general obligation of fair dealing. Farnsworth, *supra* note 3, at 263. The author of this article disagrees with his argument. By distinguishing the parties' agreement over the dealing method from the elusive concept of fair dealing, we can realize the parties' intentions and lessen the possibility of conflict. As long as we honor the intentions of the parties, the duty of fair dealing does not play any meaningful role. As Professors Schwartz and Scott point out, the parties must reach an agreement when the transaction between them produces positive value. *See* Schwartz & Scott, *supra* note 6, at 667 ("[I]t is unnecessary to require parties to bargain in good faith . . . [r]ational parties will pursue efficient projects and abandon inefficient projects.").

However, there is a substantial obstacle in seeking expectation damages: the difficulty of proving damages. If Seller had complied with the preliminary agreement, Seller and Buyer would have divided *S* (Surplus generating from the deal) without the interference of Competitor, but we cannot know how they would have divided *S* or how large *S* would be. Although the division of *S* depends on the bargaining power of the parties, bargaining power is not observable or determinable. Furthermore, it is extremely difficult to prove the magnitude of *S* generated by a transaction that never progressed past its early stages.

The next question, then, is how to respond to the uncertainty of proving damages. One argument might be that this difficulty shows that a contract to choose a dealing method is too uncertain to enforce. However, such an argument misses the point because the uncertainty of a contract is a matter of degree. To comprehend this problem, compare the situation at hand with the one in which the parties have already reached a final agreement. Even if the parties have reached a final agreement, we cannot observe the magnitude of *S* because *S* is the subjective value of Target for Buyer. The following diagram shows that we cannot observe the magnitude of *S* even when we know the agreed price.

DIAGRAM 4



In both cases, the agreed price is the same, but Buyer's profit from the transaction varies.[97] As this diagram shows, the agreed price tells us Seller's profit but not Buyer's. When deal-

97. That is why we utilize specific performance in such a case. Concerning the role of specific performance, *see, e.g.*, Alan Schwartz, *The Case for Specific Performance*, 89 YALE L. J. 271 (1979).

ing with complicated transactions, the difficulty of proving expectation damages becomes a matter of degree.[98] The next step of the analysis is overcoming this problem.

B. *How to Circumvent Evaluation by Courts: Monetary Appraisal Through Renegotiation*

As discussed in Section A, when Seller breaches a preliminary agreement in which the parties have agreed to conduct their transaction under the Exclusive Method, a monetary remedy awarded by a court cannot be effective because of the difficulty of proof. There are two ways to circumvent this obstacle. The first way, as we have discussed in Part II, is choosing the Auction Method with Lockup. The problem with this measure is that the parties must have agreed upon the magnitude of the lockup (*X*) ex ante. This avenue is not available after the parties have started their negotiation under the Exclusive Method.[99] The second way is for Seller and Buyer to negotiate over the conditions upon which Buyer agrees to convert their

98. Judge Posner has pointed out the same thing. *Venture Assocs.*, 96 F.3d at 278-79 ("The difficulty, which may well be insuperable, is that since by hypothesis the parties had not agreed on *any* of the terms of their contract, it may be impossible to determine what those terms would have been and hence what profit the victim of bad faith would have had. But this goes to the practicality of the remedy, not the principle of it.").

99. There are two additional obstacles in utilizing Auction Method with Lockup. First, it may be difficult for parties to find an acceptable lockup price (*X*) because *S* is uncertain at the time of a preliminary agreement. Secondly, a court may invalidate lockup if the lockup is considered to be a penalty clause. One of the typical instances of lockup is a breakup fee. Courts treat breakup fees as liquidated damage clauses and enforce a breakup fee as long as it reflects a reasonable estimate of the buyer's costs. *See, e.g.*, *Brazen v. Bell Atl. Corp.*, 695 A.2d 43 (Del. 1997). Professors Schwartz and Scott claim that parties do not utilize liquidated damages clause because "courts will probably treat such clauses as penalties." Schwartz & Scott, *supra* note 6, at 689. If their argument is correct, the parties lose one of the options, leaving only Exclusive Method and Auction Method remain available. Thus, invalidating a liquidated damages clause in this context on the ground of a penalty test is against ex ante efficiency. Additionally, it is likely that forms of lockup other than a breakup fee are enforceable even though a court is likely to invalidate liquidated damages clauses. If a lockup takes the form of a purchase of some valuable asset at a low price, a court is unlikely to invalidate it. Indeed, in the context of a merger or acquisition, a lockup worth substantially more than the cost of the prospective buyer is widely utilized. *See also* Kahan & Klausner, *supra* note 51 (discussing lockups in general).

dealing method from the Exclusive Method to the Auction Method ex post. If Seller and Buyer can reach an agreement over an acceptable price for Buyer's right to negotiate exclusively, they do not need to go to a court to ask a judge to appraise the expectation damages.

What then should be the mechanism that encourages the parties, especially Seller, to renegotiate? If such a mechanism gives Seller enough incentive to renegotiate voluntarily with Buyer and not unilaterally proceed to the Auction Method, Buyer's right to negotiate exclusively will be protected. Thus, Buyer can decide to invest without fear of losing the fruit of its investment. This facilitates ex ante efficiency given that the number of socially desirable transactions will increase. At the same time, Seller might realize that conversion to the Auction Method is profitable even after it pays for the change of the method—if such a change is not prohibited. This possibility of renegotiation contributes to ex post efficiency. Finally, since both of the parties gain only what they bargained for and lose nothing without their consent, this solution is equitable.[100] We will now proceed to discuss the mechanisms that can incentivize the parties to renegotiate.

C. *Forcing Renegotiation: Injunction*

The most straightforward way to encourage Seller to renegotiate with Buyer would be through an injunction.[101] By issuing an injunction that prohibits Seller from contacting Competitor, a court can force Seller to negotiate with Buyer over the conversion. Although equitable remedies are awarded only when legal remedies are insufficient,[102] as we have already discussed in Section A, monetary damages are obviously insuffi-

100. In *Teachers*, the court pointed to the importance of awarding what the parties bargained for by stating that "if that is what the parties intended, courts should not frustrate their achieving that objective or disappoint legitimately bargained contract expectations." Teachers Ins. & Annuity Ass'n of Am. v. Tribune Co., 670 F.Supp.491, 499 (S.D.N.Y. 1987).

101. Although Professor Farnsworth denies the award of expectation damages for the breach of an agreement to negotiate, he admits that "a court might enjoin a party that had undertaken to negotiate exclusively from negotiating with others." Farnsworth, *supra* note 3, at 264.

102. *See* RESTATEMENT (SECOND) OF CONTRACTS §359-(1) ("Specific performance or an injunction will not be ordered if damages would be adequate to protect the expectation interests of the injured party.").

cient because of the difficulty of proof.[103] So, an injunction could be warranted.

However, the practical problem with injunction is that it can be utilized only before Seller contacts Competitor; if Seller has already breached the preliminary agreement and has obtained the information about Competitor's evaluation of Target (*V*), injunctive relief is useless.[104] In other words, Buyer can rely on an injunction to prevent Seller's unilateral conversion only so long as it gets wind of Seller's intention to breach before the breach is accomplished. Otherwise, this device does not work to ensure the renegotiation. Therefore, in order to utilize an injunction, Buyer must incur the cost of monitoring Seller's behavior, but this monitoring cost might be too large for Buyer to bear.[105]

Thus, we need a mechanism that ensures that Seller observes the agreement and negotiates with Buyer voluntarily, i.e., without Buyer's monitoring. We turn to disgorgement and tortious interference in the following sections.

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103. *See* RESTATEMENT (SECOND) OF CONTRACTS §360-(a) ("In determining whether the remedy in damages would be adequate, the following circumstances are significant: the difficulty of proving damages with reasonable certainty . . . .").

104. If Seller knows the magnitude of *V*, it can utilize this information in the negotiation over the division of *S* because Seller knows that it can make a deal with Competitor after the termination of the negotiation with Buyer. It is true that this scenario is different from the one in which Seller deals with Buyer and Competitor simultaneously: after termination Seller cannot utilize *S* in the negotiation with Competitor because Buyer has already walked away. Seller and Competitor will reach an agreement at the price of *V/2*. Therefore, after Seller learns the magnitude of *V*, the surplus from the transaction between Seller and Buyer changes from *S* to *(S - V/2)*. Even if Seller is prohibited from contacting Competitor again, Seller can take advantage of the information of *V*. (Note that it is assumed here that the preliminary agreement between Seller and Buyer loses its legal effect once the parties reach a conclusion that their transaction is not mutually beneficial.)

105. This monitoring cost is a sunk cost in the negotiation over the division of *S*. Moreover, such a monitoring cost is a waste of resources from society's perspective.

D. *The Danger of Undercompensation: Disgorgement as an Appropriate Remedy*

1. *The General Requirements of Disgorgement as a Remedy for Breach of Contract*

Although disgorgement of profit is not widely accepted as an appropriate remedy for breach of contract, it is worth considering here. Professor Farnsworth once proposed that disgorgement should be adopted as a remedy where a promisor pursues its own interests while putting a promisee in danger of undercompensation.[106] As he pointed out elsewhere, a breach of a contract is justifiable only as long as the expectation damages are fully compensated and the position of the breached promisee is not worsened by the breach.[107] If the expectation damages are not fully compensated, the aggravation of the promisee's position is inevitable, so the breach cannot be justified as facilitating ex post efficiency; such a change is not a Pareto improvement. Professor Farnsworth correctly insisted that disgorgement should be accepted as a remedy in such a situation. If the usual remedy cannot compensate for the damages the promisee suffers, the promisor should not be permitted to gain profits from its wrongdoing.

If Professor Farnsworth's proposal is accepted, a breach of a preliminary agreement seems to be a good example of an appropriate situation that should trigger disgorgement. When the promisor, or Seller, breaches its promise not to search for Competitor, it seeks to benefit itself at the expense of the

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106. E. Allan Farnsworh, *Your Loss or My Gain? The Dilemma of the Disgorgement Principle in Breach of Contract*, 94 YALE L. J. 1339 (1985). Concerning disgorgement, *see, generally*, Ernest Weinrib, *Punishment and Disgorgement as Contract Remedies*, 78 CHI.-KENT L. REV. 55 (2003) (arguing that disgorgement is an inapt remedy); Melvin A. Eisenberg, *The Disgorgement Interest in Contract Law*, 105 MICH. L. REV. 559 (2006) (advocating that there are strong moral and efficiency reasons for protecting the disgorgement interest); Andrew Botterell, *Contractual Performance, Corrective Justice, and Disgorgement for Breach of Contract*, 16 LEGAL THEORY 135-160 (2010) (arguing that disgorgement damages for certain breaches should be available under a certain view of the nature of contractual performance).

107. Farnsworth, *supra* note 4, at 736 ("The party in breach may gain enough from the breach to have a net benefit, even though that party compensates the injured party for resulting loss, calculated according to the subjective preferences of the injured party. If this is so, nonperformance and the consequent reallocation of resources is socially desirable, and economic theory not only sanctions but encourages breach.").

promisee, or Buyer, which puts it in danger of significant undercompensation. Buyer will surely face the difficulty of proving its expectation or reliance damages.[108] Since this risk of undercompensation discourages Buyer from investing in the investigation, such a breach harms ex ante efficiency. Therefore, we cannot support this kind of breach as an efficient breach.

On the other hand, from the perspective of equity, the unilateral conversion from the Exclusive Method to the Auction Method can be considered blameworthy because Seller attempts to transfer to Buyer the disadvantage generated from its own misjudgment.[109] This article aims to deepen our understanding of the blameworthiness of Seller's betrayal through the model in the following subsection.

2. *Analysis Through the Model*

As we have discussed in Part III, Section B, what Seller agrees to incur in the preliminary agreement is C_S. The magnitude of C_S is uncertain at the time of the agreement.[110] During the negotiation of the preliminary agreement, Seller evaluates C_S depending on R_{S0} and V_{S0}, Seller's assessment of R and V before the revelation of S. Why did Seller decide to accept the Exclusive Method when it entered into the preliminary agreement and thus relinquished its freedom to search for Competitor? The reason must be that Seller determined that C_S would be small and could be forgone. In other words, it judged that R_{S0} or V_{S0} would be negligible. On the other hand, why does Seller want to deviate from the agreement after Buyer has invested in the investigation? On this occasion, Seller believes

108. Professor Farnsworth points out the difficulty of proving reliance damages, such as opportunity costs, as follows: "if the reason for choosing reliance damages is that it is too difficult to measure expectation, the same difficulty will inhere in an attempt to count lost opportunities." Farnsworth, *supra* note 3, at 227.

109. *Venture Assocs.*, 96 F.3d at 279 ("It would be a paradox to place a lower ceiling on damages for bad faith than on damages for a perfectly innocent breach, though a paradox that the practicalities of proof may require the courts in many or even all cases to accept.").

110. In the model of Professors Schwartz and Scott, the level of actual investment is supposed to be private information, not uncertain. Schwartz & Scott, *supra* note 6, at 677. In the model of this article, the level of investment of Seller (C_S) is unknown not only to Buyer but also to Seller itself.

that C_S is too large to be forgone. Put differently, it now believes that R_{SI} and V_{SI} are substantial according to the information Buyer created.

As we have already discussed in Part II, Section D and in Part III, Section B, Seller's expected return (*EVS*) grows by ($V/2 * R - C_H$) through the search and ($V/2 * R - C_H$) is the very substance of C_S which was thrown away in their preliminary agreement. If Seller judged that C_S would be large and forgoing it would be too disadvantageous, it should have negotiated with Buyer to retain its freedom to search for Competitor. That is, Seller should have sought the Auction Method with Lockup instead of the Exclusive Method. Seller attempts to recoup the forgone opportunity, motivated by the reassessment of C_S, through changing the dealing method unilaterally. This is the blameworthiness in Seller's attempt. Seller refuses to accept the responsibility of its own misjudgment and instead tries to shift the loss to Buyer. We can see that the uncertainty of C_S plays a significant role in a preliminary agreement. It is Seller's misjudgment in assessing C_S that causes a breach of a preliminary agreement.[111]

3. *Calculating the Interests to be Disgorged*

As the analysis above demonstrates, a breach of a preliminary agreement is reprehensible because the promisor shifts the responsibility of its own misjudgment to the promisee. By converting from the Exclusive Method to the Auction Method unilaterally, the promisor seeks to benefit itself at the expense of the promisee, who is now in danger of undercompensation. Disgorgement is the appropriate remedy for such a breach.

How should we calculate the interests to be disgorged? Concerning this problem, Professor Farnsworth pointed out that the promisor should have negotiated with the promisee

111. In *Teachers*, 67 F. Supp. 491, one of the important causes of the defendant's decision to walk away is that the transaction with the plaintiff is no longer advantageous for it. As the court pointed out, the defendant would not have entered into the agreement with the plaintiff with the benefit of two months' hindsight. The passage of two months revealed that the opportunity cost for the defendant is larger than it thought. In other words, C_S turned out to be large in this case, and the defendant's error in the judgment of C_S is the cause of the conflict.

terms of release from the agreement.[112] The interests to be disgorged are therefore what the promisor saved by avoiding the renegotiation - the price for the release that would have been reached in the hypothetical renegotiation.

There is a clue to the price the parties would have reached. If the transaction method is converted from the Exclusive Method to the Auction Method, Buyer will gain smaller profit by $V_S / 2$ with a probability of $R(1 - U)$ (Case (iv) (Buyer Win Case)), and will lose all of the expectation of $S / 2$ with a probability of RU (Case (v) (Competitor Win Case)). Therefore, Buyer will accept the change from the Exclusive Method to the Auction Method only if Buyer is compensated more than its expected value of loss (*EVL*) resulting from the conversion.

$$EVL = V_S/2 * R(1 - U) + S/2 * RU$$

Therefore, Seller and Buyer will reach an agreement over the price within the range from Buyer's assessment of *EVL* as a minimum to Seller's assessment of C_S as a maximum.

Undoubtedly, courts are required to make a hard judgment if we accept the presumptive price of the modification as the interests to be disgorged. Although we conceptually have some clues to the price, it is almost impossible to prove them; the most parties can do is prove the range discussed above. If a court decides a specific amount of money should be disgorged, such a decision inevitably entails the exercise of some discretion. Thus, the adoption of disgorgement as a remedy involves uncertainty.

Is it the case, though, that this uncertainty should be avoided? From the ex ante perspective, this uncertainty is desirable. If the amount of the disgorgement is unpredictable, Seller will face the risk resulting from the uncertainty when it decides to breach the agreement. This risk will give Seller a

112. In his article, Professor Farnsworth cites Lord Denning's words as follows: "If the wrongdoer had asked the owner for permission to use the goods, the owner would be entitled to ask for a reasonable remuneration as the price of his permission. The wrongdoer cannot be better off because he did not ask permission. He cannot be better off by doing wrong than he would be by doing right." Following this citation, he states that the appropriate approach is to measure a gain in terms of saving the cost of modification. Farnsworth, *supra* note 106, at 1345-46.

strong incentive to renegotiate with Buyer over the modification rather than changing the dealing method unilaterally.[113] Thus, the uncertainty entailed in disgorgement has the potential to make a preliminary agreement self-enforcing, and a court can be released from the heavy burden of deciding the amount of the remedy, whether it is expectation damages or disgorgement. At the same time, Buyer will be freed from the danger of undercompensation.[114]

This analysis shows that accepting disgorgement as a remedy can be a solution to the difficult problem of the enforceability of a preliminary agreement. However, it is highly likely that courts will reject this proposal. We cannot rely solely on the use of disgorgement to encourage Seller to renegotiate. Our attention turns to a more feasible solution: punitive damages awarded under the doctrine of tortious interference.

E. *Preventing Competitor from Being an Accomplice to the Betrayal: Tortious Interference*

A preliminary agreement to conduct a transaction under the Exclusive Method is irreparably broken when Seller finds Competitor and learns its evaluation of Target (***V***). The argument discussed in Section D focuses on how to prevent Seller from breaching a preliminary agreement; we discovered a theoretical way to decrease the likelihood that Seller will *decide to search for Competitor* (***Q***). The alternative solution is to discourage Competitor from participating in Seller's betrayal. Since Competitor is an indispensable component of Seller's scheme, we can foil the scheme by eliminating the intervention of Competitor. In other words, we need a way to reduce the likelihood that Seller will *find Competitor* (***R***).

To incentivize Competitor not to interfere with the transaction between Seller and Buyer, the threat of punitive damages awarded under the doctrine of tortious interference is an

113. Benjamin E. Hermalin et al., *Contract Law*, *in* HANDBOOK OF LAW AND ECONOMICS 3, 116 (A. Mitchell Polinsky & Steven Shavell eds., 2007) ("A rationale sometimes articulated in favor of disgorgement damages is that, by removing any incentive for unilateral breach, they encourage a party who would like to escape performance to approach the counterparty and negotiate a modification or release.").

114. Thus, Buyer would not have to incur the monitoring cost to utilize injunction. *See supra* p. 415.

effective mechanism.[115] Indeed, there has been at least one case in which a Competitor was held liable on the basis of tortious interference.[116] If it is not held liable in this way, Competitor will gain $((V - S)/2 - C_C)$[117] when its assessment of the value of Target (V) is larger than Buyer's assessment (S).[118]

(v) Successful Competitor's expected return: $(V - S)/2 - C_C$, Probability: U

(iv) Failed Competitor's expected return: $- C_C$, Probability: $1 - U$

Thus, the expected value of Competitor's interference (EVC) is expressed as follows.

$$EVC = (V - S)/2 * U - C_C$$

As long as Competitor considers EVC positive, Competitor has incentive to interfere. Here, EVC is likely to be positive because C_C would not be substantial since we presume that Competitor gets a free ride on the information revealed by Buyer.[119]

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115. Concerning tortious interference generally, *see supra* note 27. However, Professor Farnsworth casts doubt on the availability of tortious interference in this context. Farnsworth, *supra* note 3, at 280 ("Even if an undertaking of exclusive negotiation is held to be enforceable, it does not necessarily follow that an action for tortious interference with that undertaking would lie.").

116. JamSports & Entm't, LLC v. Paradama Prods., Inc., 382 F. Supp. 2d 1056 (N.D. Ill. 2005). In this case, JamSports, a sporting events promoter, sued AMA Pro Racing for breaching an agreement, and Clear Channel, the rival of JamSports, for tortious interference with contract between JamSports and AMA. JamSports & Entm't, LLC v. Paradama Prods., Inc., 336 F. Supp. 2d 824, 827 (N.D. Ill. 2004). JamSports and AMA had not reached a final agreement. *Id.* at 846.

117. When negotiating the price, the cost Competitor incurred in the investigation (C_C) is a sunk cost and not considered. As Seller utilizes the information about the size of S as a bargaining chip, Seller and Competitor will divide the difference between V and S equally. Therefore, they will reach an agreement at the price of $(V + S)/2$. Thus, Competitor gains the profit of $(V - (V + S)/2 - C_C)$, or $((V - S)/2 - C_C)$.

118. Note that Competitor must incur the cost of the investigation (C_C) regardless of whether V is larger than S or not.

119. The most difficult and important part of the investigation is to find assets that can generate synergy. After Buyer discovers that some specific

However, if Competitor is required to compensate Buyer for the damages suffered because of Competitor's interference, ***EVC*** becomes smaller or even negative, and eventually Competitor loses the incentive to interfere. In particular, if punitive damages are added to the normal damages, ***EVC*** will fall significantly below zero. If we set ***D*** as the amount of the damages, including the punitive damages, Competitor's expected return can be expressed as (***EVC*** - ***D***). Is Competitor's behavior illegal in a way that warrants the imposition of punitive damages? The answer is yes.

First, Competitor infringes on Buyer's right to negotiate with Seller exclusively by providing its own evaluation of Target (*V*) to Seller. Once Seller learns the magnitude of *V*, it can utilize the information as a bargaining chip in its negotiation with Buyer. Therefore, by conveying the information, Competitor impairs Buyer's expectation under the Exclusive Method.

Second, the infringement is unfair because Competitor gets a free ride on the information Buyer produced. The value of Target had been uncertain until Buyer invested in the investigation and revealed Target's value. The fact that Seller agreed to negotiate with Buyer exclusively shows that everyone other than Buyer hesitated to pursue the investment opportunity because of the uncertainty; otherwise, Seller would not have decided to forgo other opportunities. Compare the situations of Buyer and Competitor. Buyer decided to invest despite the risk that Target would turn out to be worthless. On the other hand, Competitor did not take the risk and is now trying to poach the fruit of Buyer's investment after Target has turned out to be valuable. Competitor's egregious attempt to freeload while sacrificing the risk-taker invites the imposition of punitive damages. In fact, punitive damages were awarded in the *Jam Sports* case referenced above.[120] The danger of undercompensation also supports the award of punitive dam-

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assets of Target are valuable, Competitor can specify and evaluate the potential synergy more easily. *See supra* note 43.

120. *See supra* note 116. In this case, the jury assessed compensatory damages of $17,144,573 on the tortious interference, and punitive damages of $73,000,000 against Clear Channel (the competitor of the plaintiff). Note that the court ordered a new trial on the amount of damages because the jury returned a single damage combining the both damages on the basis of tortious interference with prospective advantage and contract. Since the jury did not show the amounts separately, the court could not estimate the

ages. As is the case with the calculation of expectation damages, proving the monetary value of Buyer's infringed right is extremely difficult. If Buyer is required to prove it with certainty, Buyer will be forced to suffer some loss. To seek to benefit oneself at the expense of the other party by putting the victim in danger of undercompensation is sufficient to trigger punitive damages.

The possibility of punitive damages significantly increases the uncertainty about the magnitude of D, or $(EVC - D)$. This risk will give Competitor an incentive not to be complicit in Seller's betrayal. To avoid this huge risk, Competitor should contact Buyer, not Seller, to ask permission to take part in the transaction when it is interested in Target.[121] Only after Seller is released from the duty not to negotiate with others will Competitor be allowed to convey its assessment of the value of Target to Seller. By providing strong incentive for Competitor to follow the steps that respect Buyer's rights, we can decrease R and make the preliminary agreement self-enforcing.

Unlike disgorgement, discussed in Section D, the award of punitive damages under the doctrine of tortious interference is a practical solution to the problem of the enforceability of a preliminary agreement as it is an established common law rule. Moreover, as we have already seen, there are some cases in which punitive damages were awarded for tortious interference with exclusive negotiation rights. Although it is difficult to expect a court to accept disgorgement as a remedy, we can rely on punitive damages on the basis of tortious interference in order to make a preliminary agreement self-enforcing.

F. *The Utility of Uncertainty: Encouraging Renegotiation*

The analyses in Sections D and E show that the uncertainties Seller and Competitor will face encourage them to respect Buyer's right to negotiate exclusively. Although it is difficult to enforce a preliminary agreement ex post by awarding monetary damages, we can make the agreement self-enforcing ex ante by adopting the rules that increase the risks Seller and Competitor will face. Such rules will not only protect Buyer's

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proper damages on only the basis of interfere with contract and punitive damages on it. 382 F. Supp. 2d at 1066-68.

121. *See, e.g.*, Jam Sports, 382 F. Supp. 2d at 1062 (competitor contacted seller without the permission of buyer).

right, but will also release courts from the difficult task of assessing the value of Buyer's right and thereby reduce litigation costs. Moreover, this uncertainty does not cause over-deterrence. As the parties are free to renegotiate over the conditions to release Seller from the duty to refrain from contacting others, the uncertainty does not deter socially desirable searches by Seller.

Certainty is usually preferred to uncertainty in the realm of contract law. This article emphasizes the utility of uncertainty in this specific situation.[122]

V.
LEGAL IMPLICATIONS AND SUGGESTIONS FOR PRACTICE

A. *Application of the Model to Practice*

The analysis through the model revealed that the relevant function of preliminary agreements for us is the allocation of the risk of third party interference. The analysis showed that there are three types of transactional dealing methods: the Auction Method, the Exclusive Method, and the Auction Method with Lockup. The choice of the dealing method is the result of parties' ex ante risk assessment; therefore, we should honor the parties' judgment. Since the three dealing methods are ideal and simplified ones, we would have difficulty in determining the type of a transaction in the real world. However, by utilizing the analysis through the model, we can comprehend the expectations parties have in transactions worth protecting and thus can determine both whether we should award a remedy to the breached-against party and the appropriate amount to be awarded.

In practice, Seller and Buyer often make an exclusivity agreement when they decide to begin due diligence.[123] This exclusivity agreement usually stipulates that Seller is prohibited from approaching other prospective buyers for a specified exclusivity period. It is important to specify the length of the

122. *See, e.g.*, John E. Calfee & Richard Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 VA. L. REV. 965 (1984) (discussing the effects of uncertainty).

123. This is also called a "no-shop clause" or "no-talk clause." *See* Norwitz & Kirman, *supra* note 21, at 105-06.

exclusivity period.[124] In addition to the exclusivity period, most exclusivity agreements specify termination fees.[125] This fee is payable when a seller defects from the agreement and contacts another prospective buyer. This common structure is best described as the Auction Method with Lockup. To understand this somewhat counterintuitive characterization, we have to determine which risks are allocated among parties and what is exchanged between them in such an exclusivity agreement.

The first risk is that the transaction between Seller and Buyer turns out to be intrinsically undesirable, i.e., produces no or negative synergy. This risk is allocated among the parties equally. When the parties reach an impasse, both of them walk away without any compensation (Case (ii) (Negative Case)).[126] As with the default rule of contract law, both parties incur their own costs at their own risk.

The second risk is that of third party interference. Even if the transaction between Seller and Buyer turns out to be in-

124. Professor Farnsworth points out that "[a] typical exclusive-negotiation clause obligates one party to refrain from negotiating with others for a stated period of time." Additionally, he puts emphasis on the importance of specifying a time limit for exclusivity. Farnsworth, *supra* note 3, at 279-80.

125. CARNEY, *supra* note 1, at 112 ("The acquisition market has been dominated by what were once called liquidated damage provisions but are typically called *termination fees* (formerly called *break-up fees*).").

126. Termination fee is not paid when the parties reach a conclusion that their further negotiation is useless because the agreement loses its legal effect in that case. *See* Farnsworth, *supra* note 3, at 283 ("A party to an agreement to negotiate who has undertaken to negotiate exclusively with the other is plainly not entitled to conclude a deal with a third party until the period for exclusive negotiation has expired or, absent such a period, until impasse has been reached."). A good example is *Kandel v. Center for Urological Treatment & Research*, 2002 WL 598567 (Tenn. Ct. App. Apr. 17, 2002). In this case, a doctor agreed to move his practice and his family from New York to Tennessee in order to join a urological practice. The parties signed an agreement that provided that the doctor would work for one year, and then the parties would negotiate in good faith to permit the doctor to purchase stock in the partnership. Unfortunately, after the one-year period, the parties did not reach an agreement. The court did not award any damages to the doctor. Professors Gilson, Sabel and Scott provide an accurate analysis of this transaction. Gilson et al., *supra* note 5, at 1430 ("The agreement to collaborate did not protect Dr. Kandel from the further risk that, once uncertainty was resolved, the formal partnership agreement might not be finalized. . . In short, the subsequent failure of the deal was a risk that both parties undertook at the time they entered into the preliminary agreement."). This is an example of Case (ii) (Negative Case) in the model.

trinsically beneficial (i.e., produces positive synergy), it is still uncertain whether Buyer will be able to conclude the deal. Under the default rule of contract law (i.e., the Auction Method), Buyer bears the risk. In the exclusivity agreement, the risk seems to transfer to Seller because of the "exclusivity" label. Surprisingly, however, the risk still remains on Buyer. To solve this mystery, we need to understand what is bargained for in the agreement. Buyer obviously agrees to invest in the due diligence and thus to incur the costs, but what does Seller agree to do? It agrees to refrain from contacting another prospective buyer for the stated period; Seller will be entitled to search for Competitor after the specified period expires. Therefore, Seller does not forgo the opportunity to find another buyer completely as in the case under the Exclusive Method. The model helps us clearly explain the risk allocation.

Under the Exclusive Method, Seller incurs the opportunity cost ($V/2 * R - C_H$) by throwing away the chance to find another buyer. What cost does Seller incur under the exclusivity agreement with a stated period? For example, consider an agreement that stipulates that Seller cannot search for Competitor for one and a half years. The first thing to be discussed is the relationship between the stated period and the time necessary to conduct the due diligence. Since the earliest Seller can finalize the deal is after the due diligence is completed, if the period is designed to cover exactly the due diligence period, Seller incurs no cost.[127] On the other hand, if the exclusivity period is longer than the due diligence period of, say, six months, then Seller incurs the time value of the opportunity cost. If we assume that the discount rate is r and that Buyer will walk away after the period expires, the expected value of the return of Seller's search after the one-year period (EVS_{1y}) is expressed as follows[128]:

127. In this case, we can understand that an auction starts when the due diligence is completed. Indeed, in the context of mergers and acquisitions, the end of a negotiation is often considered to be the beginning of an auction. WILLIAM J. CARNEY, MERGERS AND ACQUISITIONS: CASES AND MATERIALS 635 (3rd ed. 2011) ("The end of a negotiating process may be just the beginning of an auction.").

128. If Buyer will remain interested in acquiring Target after the period expires, assuming that everything will not change by time passage, Buyer will face an extremely severe situation. In that case, $EVS_{1y} = EVS_{P=1} / (1+r) = (S/2 +$

$$EVS_{1y} = (V/2 * R - C_H) / (1 + r)$$

Seller does not forgo the opportunity completely but retains EVS_{1y} even if it signs the exclusivity agreement with the stated period. Therefore, Seller can utilize EVS_{1y} as a bargaining chip in the negotiation with Buyer. In the negotiation between Seller and Buyer, they will reach an agreement at $((S + EVS_{1y}) / 2)$.[129] This shows that Buyer bears almost all of the risk related to Competitor's interference, therefore we can conclude that this transaction is essentially the Auction Method.

Thus, the true identity of an exclusivity agreement demonstrates why termination fees are so common. Because an exclusivity agreement is a kind of Auction Method, Buyer should not expect any remedies for breach by Seller because Buyer cannot expect any interests until it reaches a final agreement, as a principle of contract law. It can be supposed that practitioners are vaguely conscious of this hidden truth, and that must be the reason why termination fees are included in most exclusivity agreements. By adding termination fee clauses, drafters transform exclusivity agreements from the Auction Method to the Auction Method with Lockup, as termination fees are lockup fees in the model.

In light of the analysis above, consider how we should resolve disputes related to exclusivity agreements with stipulated exclusivity periods. First of all, if such an exclusivity agreement does not include a termination fee clause, the exclusivity clause should not be deemed legally binding. Even if breached-against Buyer brings a suit for damages, neither reliance damages nor expectation damages should be awarded because Buyer did not successfully negotiate with Seller over the compensation ex ante, even though it had the opportunity to do so. Of course, injunction should not be issued since Buyer has no interests to be protected.

Second, if an exclusivity agreement includes a termination fee clause, courts should treat the clause as a liquidated

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$V/2*R - C_H) / (1+r)$. As the expression shows, in this situation, Buyer competes with not only future Competitor but also future Buyer itself.

129. Essentially, this outcome is the same with Case (iv) (Buyer Win Case). We can obtain the answer by substituting EVS_{1y} with V.

damages clause in a contract.[130] From the perspective of contract law,[131] the central question will be whether the amount of the fee passes the penalty test. If the fee is so high as to be deemed a penalty, a court may invalidate it. In this context, since the Buyer does not have any expectation interests worthy of protection, the amount of the fee should be examined according to the reliance interests of Buyer, i.e., the cost of due diligence and other opportunity costs. As long as the amount is reasonably related to the reliance interests, it should not be invalidated.

Next, we will examine exclusivity agreements without exclusivity periods or termination fees. Although some might argue that such an agreement is too indefinite to be enforceable,[132] the first issue to be resolved is whether the parties intended that the exclusivity period be limitless or not. If the parties agreed to make the period indefinite, this transaction should be characterized as operating under the Exclusive Method.[133] In this case, we should protect Buyer's expectations by utilizing injunction, disgorgement, and tortious interference as discussed above. Otherwise, the parties might have agreed to negotiate exclusively for a reasonable period.[134] In this case, the transaction is essentially a kind of Auction Method, as in the cases with specified exclusivity periods.

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130. Brazen v. Bell Atl. Corp., 695 A.2d 43, 47-48 (Del. 1997) (analyzing termination fees under the doctrine employed for liquidated damages).

131. From the perspective of corporate law, the issue is whether the amount of the fee is sufficiently high to coerce shareholders into voting to approve the merger. *See id.* at 49-50.

132. *See,* Candid Prods., Inc. v. International Skating Union, 530 F.Supp. 1330, 1336 (S.D.N.Y. 1982) (stating that silence as to the length of an exclusivity period is considered adversely in determining the clause's enforceability); *see also,* Farnsworth, *supra* note 3, at 280 (pointing "the importance of specifying a time limit for exclusivity").

133. Even if the period is stipulated, it may be so long as to essentially deprive Seller of its choice to search for Competitor; such a transaction might be characterized as operating under the Exclusive Method. For example, if Seller is in danger of bankruptcy, and a sufficiently lengthy exclusivity period is set to coerce the Seller to close the deal within the period, such a transaction should be deemed to operate under the Exclusive Method. In this case, the discounted present value of ***EVS*** becomes almost zero because the discount rate (r) is so large and because Seller practically agrees not to utilize the future ***EVS*** as a bargaining chip with Buyer.

134. David A. Savner & Norbert B. Knapke II, *Letters of Intent in the Acquisition or Sales of Privately Held Company,* 946 PLI/CORP 47, 55 (1996).

Finally, we should discuss exclusivity agreements without exclusivity periods but with termination fees. This kind of transaction should be deemed to operate under the Auction Method with Lockup. As in the cases with exclusivity periods, the validity of the termination fees is examined according to the penalty test. This time, Buyer has expectations to be protected because its right to negotiate exclusively does not dissolve with the passage of time. So, the amount of the fee can be examined according not only to Buyer's reliance interests but also to its expectation interests. Thus, even a termination fee, which is substantially higher than reliance interests, should pass the penalty test.[135]

Moreover, the duty of Seller not to search for Competitor terminates when Seller and Buyer reach a conclusion that the transaction between them does not produce any value, i.e., it is not worth pursuing. In this case, Buyer's investigation does not create valuable information on which Competitor tries to free-ride. Therefore, Seller is released from the contract with Buyer without indemnification. If Buyer insists on the validity of exclusivity in this case, such an argument should be rejected as an abuse of its right.

B. *Analysis of Cases*

It may seem that the theory provided here is useless for directing courts in solving real-world disputes. In this section, it will be shown that the theory can help courts make economically reasonable decisions, and assist scholars and practitioners in evaluating the validity of cases.

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135. It is widely accepted that termination fees should be around 3% of the value of the target. *See* CARNEY, *supra* note 1, at 113 ("Typical break-up fee is in the range of 1-6 percent of the value of the target, with a mean of 3.2 percent and a median of 3.3 percent."); *see also* Norwitz & Kirman, *supra* note 21, at 101 ("So-called termination or break-up fees—typically ranging up to 4% of the transaction value on a market capitalization basis (i.e., usually excluding debt, although there is room for some debate where the company's capital structure is highly leveraged)—commonly are used to induce another party to make a merger proposal by compensating that party if the merger is not consummated because a bid is made for the other party."). However, there is no reason to assume that the expectation of Buyer is only around 3-4% of the value of Target. If there is no exclusivity period, a much higher percentage of the value should be admitted as long as it has some reasonable relationship with Buyer's expectation.

According to the theory of this article, there are three possible sources of misunderstanding. First of all, people sometimes fail to distinguish between the Auction Method and the Auction Method with Lockup. A disappointed party who is not entitled to any damages is sometimes awarded reliance damages. If a transaction is conducted through the Auction Method, then a disappointed party should bear all the costs at its own risk. Second, when a transaction is conducted under the Auction Method with Lockup or the Exclusive Method and fails, a disappointed party is entitled to damages only when the cause of the failure is a third party's interference (Case (v) (Competitor Win Case)). In other words, when a transaction fails because the parties found it is not beneficial for them (Case (ii) (Negative Case)), the disappointed party should not seek any damages because it accepted such risk. The difficulty of distinguishing between Case (ii) (Negative Case) and Case (v) (Competitor Win Case) generates confusion. Finally, when a transaction fails and a disappointed party is entitled to damages, the issue is what kind of damages should be awarded. The answer provided by the existing theories is that reliance damages suffice in all cases. However, the analysis in this article showed that reliance damages are not enough when the parties have chosen the Exclusive Method. In this Section, three cases will be analyzed to show the theory's utility.

1. *The Auction Method, or the Auction Method with Lockup?*

In *Brown v. Cara,*[136] the defendant owned a parcel of land in Brooklyn, New York. This property was used as a parking lot and was subject to zoning limitations that made it unsuitable for commercial or residential development. The plaintiff, a developer, and the defendant contemplated developing the property for commercial and residential use. After some discussion, they made a Memorandum of Understanding (MOU) by which the parties agreed to work together to develop the property. According to the MOU, the plaintiff would provide resources necessary for the project while the defendant would provide only the property. The plaintiff moved pursuant to the MOU and succeeded in obtaining necessary approvals for the development. However, during the negotiation of the final agreement, the defendant was not pleased with the terms sent

136. 420 F.3d 148 (2d Cir. 2005).

by the plaintiff, and eventually the defendant refused to continue with negotiations. The court found that the defendant was liable for breach of the MOU, holding that it was a binding preliminary agreement.[137]

According to the Brief for Defendants-Appellees, the MOU failed to state whether it was binding or not.[138] Unlike the *Brown* court that took into account five factors in characterizing preliminary agreement,[139] this paper's proposal is that we should focus on the parties' intention to choose a dealing method. Since the default rule is the Auction Method, there will be no liability on the part of the defendant as long as we cannot find the parties' intention to choose the Auction Method with Lockup or the Exclusive Method. In this case, the court seems to find the fact that the plaintiff spent a considerable amount of money decisive.[140] However, under the framework proposed in this article, whether the plaintiff spent money or not does not matter at all. Rather, the relevant questions are whether the defendant agreed to negotiate with the plaintiff exclusively, and, if the defendant is allowed to negotiate with others, whether the plaintiff will be awarded some compensation. Since there is no such provision in the MOU, the plaintiff should be deemed to have spent the money at its own risk under the Auction Method. Thus, this case was wrongly decided according to the proposed framework.

2. *The Cause of Failure: Case (ii) (Negative Case) or Case (v) (Competitor Win Case)?*

In *Brown v. Cara*, if there had been a provision that made it clear that the parties chose the Exclusive Method, we would have to determine whether this was Case (ii) (Negative Case)

137. The court found that the MOU is a type II preliminary agreement. *Id.* at 156-59.

138. Brief for Defendant-Appellees at 28-29, *id.* (No. 04-5968-cv), 2005 WL 3948701, at *17-18.

139. 420 F.3d at 157 ("The considerations relevant to whether a preliminary agreement is a binding Type II agreement are: (1) whether the intent to be bound is revealed by the language of the agreement; (2) the context of the negotiations; (3) the existence of open terms; (4) partial performance; and (5) the necessity of putting the agreement in final form, as indicated by the customary form of such transactions.").

140. *See id.* at 158 ("we find that the fourth prong, partial performance, cuts strongly in favor of finding the MOU to be a Type II agreement.").

or Case (v) (Competitor Win Case). Since the defendant refused to continue negotiation with the plaintiff because the defendant was offended, some might argue that this was Case (ii) (Negative Case), and there is no liability on the part of the defendant. However, in light of the fact that the market price of the property increased because of the rezoning, this case should be characterized as Case (v) (Competitor Win Case). The defendant can sell the property to a third party at a higher price thanks to the effort of the plaintiff. In other words, when a buyer's effort increases the economic value of the property of a seller, such a case should be dealt with as Case (v) (Competitor Win Case) if their negotiation fails.

The second case we draw our attention to is *In re Matterhorn Group, Inc.*[141] Here, the plaintiffs, Matterhorn, were former licensees of the defendant-licensor, Swatch. Swatch intended to expand its operation to sell its watches in the United States and made a letter of intent with Matterhorn. The letter of intent provided that the Matterhorn would have the exclusive franchise for a list of locations. The agreement stipulated that Matterhorn would invest in finding good locations and file applications to Swatch for franchises at those locations.

Vail was one of the locations stipulated in the list. Swatch rejected Matterhorn's application of Vail because Vail was too geographically far from Matterhorn's base of operation in the Northeast. The court held that Swatch breached an enforceable preliminary agreement on the ground that such reason was not provided in the letter of intent and awarded the out-of-pocket costs incurred in investigating Vail.

Professors Schwartz and Scott support this decision on the basis that they can identify strategic behavior on the part of Swatch.[142] However, it seems that the court held Swatch liable not only because Swatch delayed the processing of the applica-

141. Nos. 97 B 41274(SMB), 97 B 41276(SMB), 97 B 41277(SMB), 97 B 41278(SMB), 2002 WL 31528396 (Bankr. S.D.N.Y. Nov. 15, 2002).

142. Schwartz & Scott, *supra* note 6, at 697 ("Swatch engaged in the strategic behavior that our model predicts: it delayed processing several applications and failed to secure the necessary approvals. The court found Swatch to be in breach of a preliminary agreement to bargain in good faith and awarded Matterhorn reliance damages based on the out-of-pocket costs of investigating the locations in question.").

tion, but primarily because Swatch rejected it for an improper reason, one not stipulated in the letter of intent.[143]

According to the theory developed in this article, the court should not have held Swatch liable since the failure was Case (ii) (Negative Case) rather than Case (v) (Competitor Win Case). After making the letter of intent, Swatch adopted a "cluster approach" under which all of the stores opened by a licensee had to be located within a relatively close geographical proximity to the licensee. Although it is not certain why Swatch adopted the new policy, it is likely that Swatch considered it operationally efficient. If this was the case, the reason for rejecting the application was because Swatch thought Matterhorn's operation in Vail was not economically beneficial for both parties. It seems that Swatch reached a conclusion that this specific transaction was Case (ii) (Negative Case). So, according to the theory developed in this article, the court should not have awarded damages to Matterhorn. Thus, when a transaction between the parties does not produce substantial economic value, such a case should be dealt as Case (ii) (Negative Case) if their negotiation fails, and a court should not award damages to a disappointed party.

The point here is that such disappointed party does not suffer anything from the failure of the transaction. In this situation, the disappointed party does not have any expectation to be protected, and the breaching party is required to pay damages only because it terminated the useless negotiation. This seems to be a punishment. As Professors Schwartz and Scott argue, such punishment might have positive effect of controlling opportunistic behavior.[144] However, it also has the negative effect of incentivizing the disappointed party to behave strategically to seek damages. This diminishes ex post efficiency.

143. *In re Matterhorn Group*, 2002 WL 31528396, at *17 ("Swatch breached the Letter of Intent by rejecting the Vail application for improper reasons.").

144. Schwartz & Scott, *supra* note 6, at 667 ("A reliance recovery will encourage parties to make preliminary agreements and will deter some strategic behavior.").

3. *What Remedy Should Be Awarded?*

The final case to be examined is *Stanford Hotels Corp. v. Potomac Creek Associates, L.P.*[145] This case is unique in that the court found specific performance could be granted for a breach of a preliminary agreement.[146] The defendant owned hotels and was in the process of selling them, and the plaintiff was an interested potential purchaser. They made a preliminary agreement that obligated the parties to negotiate a final agreement in good faith. Two points should be noted. First, the defendant conceded that the preliminary agreement constituted a binding contract.[147] Second, the defendant also conceded that it had an obligation to deal exclusively with the plaintiff.[148] However, the defendant sold the property to a third party. The court held that the remedy for the breach of this preliminary agreement was not limited to reliance damages but included expectation damages. Furthermore, the court indicated that if expectation damages are not fully compensatory, specific performance could be granted.

This case conforms exactly to the theory provided in this article, even though existing theories cannot provide justification for the holding. When there is a breach of a preliminary agreement, we should try to put the breached-against party in the position in which it would have been had there not been a breach. This article supports this decision and expects that courts will follow it in future cases.

C. *Suggestions for Practice*

In Section A, we discussed how we should construe exclusivity agreements utilized in practice and what the legal consequences of such agreements should be. This section provides suggestions for practitioners on how to utilize preliminary

145. 18 A.3d 725 (D.C. 2011).

146. *Id.* at 727-28 (holding that "specific performance was available to enforce the preliminary contract in accordance with its terms").

147. *Id.* at 729 (a witness testifying on behalf of the defendant's corporate parent conceded that "the letter, as modified and signed by both parties, constituted a binding contract ('Preliminary Agreement') that obligated the parties to negotiate in good faith a Definitive Agreement for the purchase and sale of the Hotel on the price and other terms in Stanford's offer.").

148. *Id.* at 733 (a defense witness testified "'there was an obligation not to negotiate the sale of the Hotel with any other parties' while the Preliminary Agreement was in force.").

agreements to facilitate their businesses by properly allocating the risks.

We will discuss the appropriate agreement for a prospective buyer to make when facing an investment opportunity similar to the one discussed above. You (the buyer) should consider whether it is advantageous to invest under the Auction Method. If it seems too risky to invest under that scheme, you should negotiate with the seller over the conditions of your investment in the investigation. If the seller agrees to choose the Exclusive Method as the dealing method, make a document that stipulates that your agreement is a contract specifying your choice of dealing method. Clarify that you promised to invest in the investigation in exchange for the seller's promise to forgo any other opportunity.

On the other hand, if the seller insists on retaining the opportunity to find another buyer, you should negotiate to obtain a lockup, i.e., a termination fee. The first thing to be negotiated is whether the period of exclusivity is limited or not. If the exclusivity period is set to cover only the due diligence period, you should recognize that the agreement is minimally binding at best. You can demand some termination fee in order to be compensated for the cost of the due diligence, but such a fee will be paid in only an extreme case because the seller will be free to contact another buyer after the due diligence is completed. Otherwise, you will have a period of time to negotiate exclusively after the due diligence. This time, you should demand a termination fee. Without such provisions, you cannot seek any damages if the seller breaches because you have no interests to be protected under the Auction Method. The amount of the termination fee should be based on the expected cost of the due diligence. If the fee is too large, courts may invalidate it as a penalty clause.

If you succeed in rejecting the limitation on the exclusivity period, you should make it clear that you are not defining the period because you agreed not to limit it; otherwise, a court might hold the agreement unenforceable on the grounds of indefiniteness.[149] In this case, you can demand a substantially higher termination fee because you have certain expectations that will not disappear by the passage of time. Since this termination fee is the price for the seller's redemp-

149. *See supra* note 124.

tion of the right to contact another buyer, it is not necessary for the fee to be related to your reliance interests. When negotiating the size of the fee, you might hesitate to demand a sufficient amount of money because such a demand involves revealing your expectation of a large profit from the transaction. In that case, it might be helpful for you to utilize a fee indexed to the amount of money a competitor will offer. By adopting this indexation, the amount of the fee will lose its relationship to your own estimation of the profit, and you will avoid having to reveal your own estimation. Never expect courts to enforce a document that states that both parties will negotiate in good faith. Good faith is an unclear standard.[150]

Next, we will discuss how a seller and a competitor should behave. During the negotiation under the Exclusive Method, you (the seller) should not deviate from the agreement without the buyer's consent. You should negotiate with the buyer over the release from the obligation not to search for other buyers. If you are a prospective competitor, you should not contact the seller in violation of the buyer's exclusive right. Infringement of the buyer's right risks imposition of punitive damages as in the *Jamsports* (2005) case. Conversely, if you are in the position of the buyer, you should inform your competitors that you have the exclusive right to negotiate so that they are deemed aware of your exclusive right. By doing this, you can easily prove that your competitor consciously infringed on your right in the event of a dispute. If practitioners follow these suggestions, the parties will gain what they bargained for, and there will be fewer conflicts.

150. It seems that the obligation to negotiate in good faith is sometimes considered to imply a duty not to negotiate with others. *See* Itek Corp. v. Chi. Aerial Indus., 248 A.2d 625, 629 (Del. 1968) ("[I]n order to permit its stockholder to accept a higher offer, CAI willfully failed to negotiate in good faith . . . ."); *see also* Venture Assocs. v. Zenith Data Sys., 96 F.3d at 277 (suggesting that an obligation not to entertain other offers might be thought of as a component of the concept of good faith). One suggestion, however, is that the parties should not expect a court to interpret "duty to negotiate in good faith" as "duty to negotiate exclusively." The parties should make it clear that they intend to negotiate exclusively in the form of a contract. As Professor Farnsworth suggests, "Given the uncertain state of the law on such matters, no drafter should leave them to a court." Farnsworth, *supra* note 3, at 273.

VI.
CONCLUSION

We have examined how a preliminary agreement functions in allocating the risks of interference by third parties. In order to encourage Buyer to invest in the investigation to remove the uncertainty that disturbs the realization of a complicated transaction, the parties' choice of dealing method should be respected and enforced.[151] This article illustrates that we can accomplish this goal by treating a preliminary agreement stipulating the dealing method as a contract. There are two advantages in construing a preliminary agreement selecting the dealing method as a contract. First of all, this rule makes it clear when a breach of a preliminary agreement provides the basis of legal responsibility.[152] The breached-against party can seek damages only when the parties have agreed to

151. As this article has stressed repeatedly, a preliminary agreement is necessary in a complicated transaction, not in a standardized transaction. Although the court in *Teachers* stated that "[g]iving legal recognition to preliminary binding commitments serves a valuable function in the marketplace, particularly for relatively standardized transactions like loans," Teachers Ins. & Annuity Ass'n of Am. v. Tribune Co., 670 F.Supp.491, 499 (S.D.N.Y. 1987), this description is the very reverse of the truth. Indeed, there was no well-functioning market in the case of *Teachers* because only the plaintiff showed interest in the transaction. The factual part of the opinion states that the defendant's "advisers believed that only a small number of institutions would have the means and flexibility to contemplate a loan of these specifications." *Id.* at 493.

152. Utilizing the model of this article, consider the two cases that characterize preliminary agreements as contracts. In *Venture Assoc.*, Seller and Buyer did not reach a final agreement, but Judge Posner did not find the defendant liable for the failed negotiation. Judge Posner pointed out in the opinion that no other seriously interested prospective purchaser other than the plaintiff had appeared during the period of the negotiation. *See* 96 F.3d at 280. The fact that the parties failed to reach a final agreement shows that they found that the transaction between them was not mutually beneficial; otherwise, they must have reached an agreement anyway. So, this case can be characterized as Case (ii) (Negative Case), not Case (v) (Competitor Win Case), in this article's model. The conclusion of Judge Posner that the defendant is not liable is consistent with the analysis here. The second case to be examined is Jamsports & Entm't, LLC v. Paradama Prod., Inc., 382 F. Supp. 2d 1056 (N.D. Ill. 2005). In this case, Seller and Competitor reached a final agreement, ignoring the contract of exclusive negotiation between Seller and Buyer. This case can be characterized as Case (v) (Competitor Win Case) in the model. The conclusion of the court that Seller is liable consists with the theory developed in this article.

conduct their transaction under the Exclusive Method in the form of a contract. If there is no contract, there is no responsibility.[153] With a clearer rule, there will be fewer conflicts among parties and thus less litigation. Diminishing litigation costs will benefit both parties and society as a whole.

Second, by construing a preliminary agreement as a contract, we can find Buyer's consolidated right to exclusive negotiation with Seller. With a solid right, we can characterize Competitor's participation in Seller's attempt as tortious interference, and the punitive damages on the doctrine of tortious interference constitute an integral part in the enforcement of a preliminary agreement by increasing the risks associated with breach. If we regard a preliminary agreement as an agreement that falls short of a contract, the utilization of tortious interference would be impossible. Under such a categorization, Buyer has no action against a third party and cannot seek damages on the basis of tortious interference with its consensual right.

If a Type II agreement is to stipulate a framework within which parties will seek their ultimate objective, this article has attempted to extract the choice of dealing methods among frameworks as a consolidated contract. Although other frameworks are not addressed here, such a method appears to resolve the confusion and ambiguity inherent in Type II preliminary agreements. We should avoid relying on the generality that reliance damages are always the appropriate remedy for the breach of Type II preliminary agreements, but we should examine each preliminary agreement utilized in a specific transaction for what is being exchanged in the agreement. By paying attention to each transaction, we will be able to determine what remedy is appropriate for the breached-against party in each case. This seems to be the only way to settle the problems surrounding Type II agreements.

153. Note that this paper does not insist that even misrepresentation in the negotiation process does not provide the basis of legal responsibility. If there is misrepresentation or deceit, other legal doctrines deal with such a situation. *See, e.g.*, Schwartz & Scott, *supra* note 6, at 672.