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Asymmetric information and opportunistic behaviour in ex ante contract negotiations: precontractual liability regime

Castaldo Angelo, Conte Elisabetta e Gianluigi Galeotti

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Angelo Castaldo

Sapienza Università di Roma

Dipartimento di Studi Giuridici, Fisolofici e Economici

angelo.castaldo@uniroma1.it

Elisabetta Conte

Ministero dell'Economia e delle Finanze

Gianluigi Galeotti

Sapienza Università di Roma

gianluigi.galeotti@uniroma1.it

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Abstract

During negotiations, parties plan an exchange that will occur in the future and that implies a high level of uncertainty, regarding both contract conditions and final outcome. In this phase, parties are requested, according to country-specific legal framework, to act in good faith. As a matter of fact, the definition of the boundaries of the good faith principle could be used as a strategic variable to understand when a form of pre-contractual liability is both necessary and efficient. Once we have analyzed the different models of pre-contractual liability in force in the main legal frameworks, our work focuses on clarifying the social function of the civil norm that introduces pre-contractual liability, given the impact on agents' behaviour and on the level of efficiency of the negotiations. We will focus mainly on two issues. First, the failure to disclose information as a breach of the duty to act in good faith and the cases in which the introduction of a duty to disclose is efficient; secondly, the hold-up problem as a violation of the good faith principle and as opportunistic behaviour related to the level of reliance adopted by the party who hasn't made specific investment. Our aim is to identify and to explain the reasons of the efficiency enhancement given by the introduction of a pre-contractual liability regime.

JEL Classification: K12, K42, D82, D86
Keywords: Pre-contractual liability, Negotiations, Contract, Good faith, Duty to disclose, Reliance, Hold-up

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1. Introduction

Good faith is a principle deeply studied by law scholars. Its nature of general clause and of behavioural standard has stimulated many scholars to delve the level of the analysis regarding this principle, in order to point out its boundaries and to specify its content. The most used pattern of analysis is based on a double approach. The first step, more generally, stands upon the definition of the classes and legal schemes involving good faith (e.g. contracts, property, inheritance etc.). The second step entails a case by case analysis, realized in the field of a single legal scheme, with the aim of recognizing the meaning of good faith in relation to the parties' performance.

This work focuses on good faith in the pre-contractual stage, immediately prior to contract formation, in which parties act under uncertainty and asymmetric information.

Relatively to the concept of good faith during negotiations, for what concerns Italian law, Bianca (2000) explains that good faith "represents the principle of contractual solidarity and consists in loyalty and preservation". However, Ravazzoni (1974) depicts how loyalty and preservation are not the only elements of good faith performance, considering that a strict definition of a general principle would be arbitrary.

Economic literature has studied good faith and pre-contractual liability in order to point out the variables influencing parties (economic agents) behaviour. Summers (1968) claims that good faith in contractual stages is a concept without a specific meaning, whose role is to avoid bad faith performances. Schwartz & Scott (2007), analyzing parties' economic rationality during negotiations, point out the difficulties faced by the law in managing all those cases in which a party bears some costs in order to realize a project, due to the advanced status of negotiations. Bebchuck & Ben-Shahar (2001), Wils (1993) and Craswell (1996), base their analysis on how the different models of pre-contractual liability influence reliance and investment decisions during negotiations.

Our analysis of law, using an economic approach, focuses on the meaning of the good faith principle during negotiations and aims to point out the social function of the provision of a pre-contractual liability regime. We suggest that a more clear methodological framework of the good faith principle is necessary. Given that norms act as a constraint to rational economic maximising behaviour, it is necessary to understand if the positional and informational advantage enjoyed by a party, could be or couldn't be exploited both from an efficiency and juridical perspective. In other words, our aim is to understand the reasons and circumstances in which a good faith constraint should efficiently restrict agents' strategic

actions.

The proposed economic analysis of law is applied to two different situations proper of negotiations. The former points out how the presence of asymmetric information between parties can or cannot justify the provision of a pre-contractual liability regime, in order to enhance the efficiency of the exchange. The latter deals with ex ante specific investments made by parties in order to enhance the aggregated welfare surplus obtainable with the contract.

The work is structured as follows. In the first section, we provide an international overview of different models of pre-contractual liability. In the second, we furnish an economic analysis of law literature on the topic of pre-contractual liability. In the third section, we point out principal interpretations and justifications of the good faith principle. In the fifth, we focus on cases in which it is more or less efficient to admit the exploitation of an informative and positional advantage. Finally, we will draw main conclusions.

2. Civil Law vs. Common Law: two traditions in comparison

From a normative perspective, the concept of culpa in contrahendo stems from The Roman Law of obligations and develops into Civil Law countries also thanks to von Jhering's work "Culpa in contrahendo, oder Schadensersatz bei nichtigen oder nicht zur Perfektion gelangten Verträgen".

Starting from civil law countries, in Germany the BGB (Bürgerliches Gesetzbuch) did not contain any express or general provision for pre-contractual liability, just some given cases. The general discipline of culpa in contrahendo has been then built, by jurisprudence and scholars, recurring to the general clause of good faith (Treu und Glaube) to which § 242 subjects contractual obligations. After the 2002 reform of the Law of obligations, pre-contractual liability is now provided by § 311(2) of the BGB, which states "An obligation with duties under section 241(2) also comes into existence by the commencement of contract negotiations; (by) the initiation of a contract where one party, with regard to a potential contractual relationship, gives the other party the possibility of affecting their rights, legal interests and other interests, or entrusts these to them, or (by) similar business contacts". In the third paragraph it is deemed that "An obligation with duties under section 241 (2) may also come into existence in relation to persons who are not themselves intended to be parties to the contract. Such obligations come into existence in particular if the third party, by laying claim to being given a particularly high degree of trust, substantially influences the pre-

contract negotiations or the entering into of the contract.". Referring to § 241(2), this means that a given breach of this duty, even if we are in negotiation stages, could entail damages reparation, corresponding then to the Common Law principle of "breach of contract". Pre-contractual liability is included in the general discipline of performance error, overcoming any link with tort liability.

The situation in France is very similar to that in Germany before the 2002 reform. As a matter of fact, despite being a Civil Law country, in French contractual law there are few references to the principle of good faith, and none to culpa in contrahendo or duty to disclose. The only clear reference to good faith is kept down in article 1134 of the Code Civil, which states that "les conventions doivent être executes de bonne foi", and this rule clearly refers to the phase of the execution of contract, not to that of the formation. Notwithstanding the absence of an explicit provision, jurisprudence and scholars do not rule out the application of the good faith principle to ex ante contract negotiations, setting up a pattern of pre-contractual liability. The legal basis of this kind of liability is in art. 1382 of the Code Civil "Tout fait quelconque de l'homme, qui cause à autrui un dommage, oblige celui par la faute duquel il est arrivé, à le réparer", this means that, unlike in Germany, liability foundation is in tort (responsabilité civile délictuelle), and that some degree of fault is required, essentially as a breach of normal pater familias conduct.

Italy is one of the few countries that has a specific provision ruling pre-contractual liability. Art. 1337 of the Codice Civile named "Negotiations and pre-contractual liability", states that "During negotiations and in the formation of a contract the parties must behave according to good faith", while art. 1338 expressly rules that "The party that knew or should have known a reason for invalidity of the contract and did not disclose it to the other party, is responsible for the damage the latter has sustained in relying without fault on its validity". In addition to this, the Codice Civile provides also for a general clause regarding good faith (art. 1175), which clearly states that "Contracts must be executed in good faith". The presence of a provision on pre-contractual liability does not imply, per se, that negotiations are always binding. Generally, in order for pre-contractual liability to arise, negotiations are relevant when they concern essential elements of the contract, necessary to establish it. The amount of the compensation does not consist in the whole damage (otherwise parties would not be free to negotiate), but in the "negative interest", that represents the costs bared by the counterpart for unjustified recess and for financial losses. The good faith requested, according to scholars and jurisprudence, is objective good faith, meaning that behaviour must objectively be correct. Violations of good faith occurs, for example, in case of non serious

intent to negotiate (when a party enter negotiations only to disturb someone else's negotiation or in order to gain information); unjustified withdrawal (failure to conclude the contract after having produced in the counterpart a legitimate reliance on the conclusion); knowledge on the existence of invalidity causes; misrepresentation.

While in many civil law countries good faith is a concept present in all contractual phases and culpa in contrahendo is, more or less expressly, always provided, common law countries are cagier regarding the good faith principle and culpa in contrahendo. This is mainly due to a proper distrust for general clauses, which are often seen as a threat of arbitrariness, to a preference for a stiff dichotomy between contract/no-contract stages – which makes the provision for a kind of liability which depends on the contract more difficult, but does not necessarily entail the presence of a contact – and to the overall dominance of the freedom of contract principle.

England is the most reluctant country in regards to the application of the good faith principle and pre-contractual liability. In particular, general contractual law does not provide for a general duty of good faith, but only for some specific recalls in specific legislations. With regard to pre-contractual liability, the strong distinction between contract/no-contract phases has led Courts to accept with reluctance claims for damages occurred at a time in which no contract was in force. As a matter of fact, until the end of the 1800s, there was a substantial indifference for this topic, so much so that a typical legal doctrine was the caveat emptor (which literally means "let the buyer beware!"), providing that the purchaser could not take legal action against the seller for faults on the property that makes it unusable for normal usages (the only exception occurs when the seller voluntarily hides latent defects). A mitigation of this position came with the doctrine of representation: if a potential party of a contract makes a representation of facts which could affect the conduct of a normal reasonable man (the potential counterpart), knowing that it's false, and if the counterpart relies on this representation, they can claim damages and/or break off the contract even after having entered into it. A major opening to the concept of pre-contractual liability occurs with estoppel doctrine (protecting a party when the counterpart provides expectations on which they reasonably rely, and from which damages would be suffered if this expectation were not met), and particularly with the doctrine of promissory estoppel, which gives protection to a party who has reasonably relied on a promise made by the counterpart, preventing the latter from withdrawing the promise made. However, because English Courts tend not to broaden contractual law, including phases in which the contract is not signed, Courts are nowadays still reluctant to grant damages for pre-contractual liability, under both promissory estoppel

and tort liability. In the latter case, this is mainly due to a reluctance to grant a restoration for pure economic losses in tort, and it's for this reason that in order to award such kind of damages, Courts request misrepresentation tort, fraud or deceit.

With regard to the US contract legal system, initially there was neither a general duty to perform in good faith, nor a specific provision for pre-contractual liability. A good faith obligation was introduced under section 1-203 of the Uniform Commercial Code ("Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement") and under section 205 of the Restatement (Second) of Contracts ("Every contract imposes upon each party a duty of good faith and fair dealing in its performance and in its enforcement"), but it has not been extended to the negotiation phase, even if the duty to perform in good faith is used as a tool to provide a duty to disclose information. In the absence of a specific provision for pre-contractual liability, compensation for damages occurred ante contractum could be obtained through tort law or contractual law, in this second case thanks to promissory estoppel. However, the recourse to promissory estoppel is not so frequent: after the leading case Hoffman v. Red Owl Stores, in which the Court held that even if there was no basis to establish bargain liability (because there was no agreement on fundamental elements of the contract), in order for a cause of action for promissory estoppel to be sustained, there is no need that the promise entails all the essential details of a proposed transaction, and thus the Court granted Hoffman damages "necessary to prevent injustice", corresponding to costs and losses incurred by the claimant for having relied on Red Owl's conduct. Anyhow, this case remained isolated, insomuch as that "in the two decades since Red Owl was handed down, its influence has been more marked in the law reviews than in the law reports". This was mainly due to US Courts tendency not to grant damages for having relied on a counterpart promise, unless parties have shown their will to be bound. As emerged by a study by Schwartz and Scott (2007) on a sample of 140 preliminary negotiations and preliminary agreements cases litigated between 1999 and 2003, "(…) Courts will not grant recovery for early reliance unless the parties, by agreeing on something significant, have indicated their intention to be bound. Put more directly, the cases do not revolve around preliminary negotiations, but rather around preliminary agreements."

3. **Good faith, duty to disclose and reliance: a brief survey**

The Good faith principle is a general clause present in both civil and common law countries, while a specific provision of pre-contractual liability (culpa in contrahendo) is not

so often provided. The open-endedness of the concept of good faith and its constant presence as a standard of conduct that parties must follow in bargaining, represent in many cases the basis for pre-contractual liability, which is developed as a violation of the principle to behave in accordance with good faith. But what does "good faith" mean? The concept is really boundless and there is no punctual definition of what it entails. A tool suggested by the literature (Summers, 1968) is to qualify good faith by its contrary, in a case by case approach. Summers argues that "in contract law, taken as a whole, good faith is an excluder. It is a phrase without general meaning (or meanings) of its own and serves to exclude a wide range of heterogeneous forms of bad faith". Actually Summers proposes an example, a list, of specific meaning of good faith, identified by their opposite observable in parties behaviour.

This construction clarifies that the good faith principle is a general rule, whose ratio is to fit in all those cases that are not predictable directly by the law, in order not to leave parties unprotected in the absence of a precise norm. The clause is so deliberately uncertain and undefined because this vagueness makes it more flexible, and, to some extent, more efficient. But on the other hand, this open-endedness makes its interpretation not only hard, but above all uncertain. Not being tied to a strict norm, the judge could interpret good faith in a very extensive way, reducing parties' incentive to enter into a bargaining (Sepe, 2006).

Taking the Italian legislator of the Civil Code of 1942 as a benchmark, in his intention and with regard to contract law, good faith is based on ethics and morality. In other words, it is a general rule of behaviour that imposes parties to act in accordance with honesty, fairness, probity and loyalty during contract formation and performance. The aim of the rule is, in last instance, to induce parties to cooperate. In the report by the Ministro Guardasigilli (Attorney General) on the project of the Code of 1942, it is clearly written that the good faith principle "recalls in the sphere of the creditor the consideration of the interest of the debtor and in the sphere of the debtor the correct respect for creditor interest " , therefore operating as a principle of reciprocity and cooperation.

This conception of good faith is perfectly in accordance with one of the establishing principles of the Italian Constitution, that of social and economic solidarity (Art. 2 Cost.). Therefore, in the mind of the legislator, the importance of good faith lays in the imposition, to all parties of a contractual relationship, of a duty to act in order to preserve the interest of the counterpart, irrespective of the existence of a specific contractual obligation or of a precise normative prescription.

This view of good faith can also be found in literature. Summers (1968) recognizes in good faith the basis of contractual morality, good faith is then a general rule of moral

behaviour that must be obeyed by parties and implemented by courts, in order to respect standards of reasonableness, fairness and decency.

The idea of good faith as a tool to induce parties to cooperate is shared by Farsnworth (1963), who argues that, even according to common sense and tradition, "Good faith performance has always required the cooperation of one party where it was necessary in order that the other might secure the expected benefits of the contract ...". But what does cooperation mean? Summers (1968) argues that "has always been an objective standard, based on the decency, fairness or reasonableness of the community and not on the individual's own beliefs as to what might be decent, fair or reasonable. Both common sense and tradition dictate an objective standard for good faith performance" .

Even if the function of the general clause of good faith is to protect all the cases not directly ruled by the law, in every day conducts and from an economic perspective, the meaning of good faith is very specific. In particular, concrete conducts reveal the economic rationality required by agents that have to act in good faith.

An economic interpretation of good faith is given by Burton (1980), who suggests that "good faith performance occurs when a party's discretion is exercised for any purpose within the reasonable contemplation of the parties at the time of formation", while "bad faith performance occurs when discretion is used to recapture opportunities forgone upon contracting".

Considering that good faith, far from being an uncertain concept, has to be modelled on the base of economic rationality followed by agents (contractual parties), it is important to mention the literature that has pointed out the impact that contractual and pre-contractual liability rules have on parties incentives to transfer and reveal information.

Ayres & Gertner (1989) and Bebchuck and Shavell (1991 & 1999) start their analysis from a well known rule of common contractual law, the Hadley rule , which states a limited liability rule for breach of contracts, limiting the amount of damages to ordinary foreseeable level of losses, in cases where the buyer has not informed the seller of his high performance valuation. Ayres & Gertner define it as a "penalty default (rule that) can restrict rent-seeking behaviour", since, Bebchuck and Shavell also point out, the more informed party has incentives to reveal information, enabling the seller to distinguish among high and low buyers valuation and encouraging to take an efficient level of precaution. Bebchuck and Shavell underline also that, limiting liability, implying that Hadley rule forces parties to communicate their performance valuation only in cases deemed efficient. These cases are those of "high valuation", which among all, represent the minority of cases. Even if this

literature refers to cases in which the contract is closed, it is useful in order to analyse actions in pre-contractual phase. In particular, it helps us to understand the social function played by rules governing liability and duty to disclose. If during contract implementation, it is important to know counterparty valuation in order to assume the right level of precautions, the disclosure of this valuation is meaningful during the pre-contractual phase too, because the knowledge of this kind of information enables parties to invest efficiently in reliance and encourages those who enjoyed a non serious negotiation, to exit bargaining.

Kronmann (1978) analyzes the efficiency of duties to disclose in contract law pointing out that, in cases of information with social value, imposing a duty to reveal could be inefficient. This is because recognizing a protection to the party who has invested in the acquisition of information represents an incentive for parties to invest in information, approaching then the socially optimal level of information production. The Legal system should grant a kind of property right for information resulting from a specific and costly research, while no protection or property right should be provided in cases where information has been acquired casually, without investment.

Levmore (1982), in the wake of Kronmann, keeps on studying the impact of duties to disclose on parties incentive to invest in information. He argues that buyer's incentives to invest in information should be protected by an optimal dishonesty rule. This rule should enable parties to lie during negotiations, not incurring in fraud, on the basis of the general principle of freedom of contract.

Shavell (1994) analyses duty to disclose taking into account on one hand, the nature of information owned by parties, and on the other, the characteristics of the owner (buyer or seller). According to his analysis, a duty to disclose should be imposed only when information is of social value. However, providing such a duty, in similar cases, could work as a deterrent for parties to invest in information that have any social value. Actually, efforts and costs referred to acquiring information that have social value correspond, from a social perspective, to a loss. In the case of socially productive information, Shavell distinguishes between buyer and seller. For the latter, the presence of an obligation to disclose may work as an incentive to make efficient investments, which whereas would be not optimal, but excessive. In the buyer case, the opportunity to impose a duty to disclose should be analyzed with a case by case approach. As a matter of fact, buyers' incentive to invest in information are different, because –unlike the seller- not holding a property right, implies that they do not have the possibility to reuse the information for their own convenience. The presence of an obligation to disclose discourages the buyer, but not the seller, in the production of

information with social value. In the case of revealing information, the buyer confers an advantage to the seller, who could reuse the information to increase the price of the goods, in that or in another transaction. The seller, however, when revealing information which increases the value of the goods, can exploit it to their advantage, given the advantage of holding the property right.

Borden (2008) proposes a Model of Two-Sided Informational Inputs, in which both seller and buyer acquire information on an asset that is defined as dynamic, to put it better, of an asset that, thanks to this information, can be used for another purpose thus obtaining a higher value . Borden proposes a rule defined Word to the Wise, which requires a minimal truthful disclosure, not diminishing parties incentive to invest in information and at the same time is consistent with the principles of fairness and good faith that rule pre-contractual and contractual phases.

Regarding reliance and hold up problems in pre-contractual phase, the literature is very rich. Wils (1993) and Bebchuk & Ben-Shahar (2000) claim that the provision of a too rigid pre-contractual liability regime, which for example lets the party who breaches negotiations bearing counterparty reliance costs, is inefficient. Such a regime would bring to assume excessive levels of reliance, also causing inefficiency distorting parties' decisions to break off or to continue negotiations. A strict pre-contractual liability rule implies also that courts should have a huge level of information.

In the wake of such considerations, Wils (1993) claims that pre-contractual liability should work as a deterrent to behave opportunistically for the party that enjoys a superior level of information, and proposes that pre-contractual liability should be independent from the fact that the party has broken off negotiations. The basis of this kind of liability should be found rather in the incorrect behaviour of the party who exploits their own informative advantage to the detriment of the counterparty. Bebchuck & Ben-Shahar (2000), show that also the absence of any kind of pre-contractual liability brings to inefficiency, or rather to levels of sub-optimal investments in reliance.

Schwartz and Scott (2007) assume that courts are not so inclined to grant protection in the pre-contractual phase, while they are in the case in which parties have reached a "preliminary agreement" on the essential terms of the future contract. Nevertheless, the uncertainty that governs the ex ante contract phase, can stimulate parties to assume opportunistic behaviours. In the pre-contractual stage, opportunistic behaviour is represented by delaying investments when the other party, performing in good faith, has already made theirs, and therefore in deviating from what asserted in the preliminary

agreement. Role of the courts is then to stimulate investments in the pre-contractual step, protecting the verifiable costs of reliance bore by the party who suffers the delay. Kostritsky (2008) critiques this approach, claiming that courts have to protect parties in all the steps of negotiation, putting aside from the presence of preliminary agreements, therefore using pre-contractual liability as a tool to fight and to prevent the onset of parties' opportunistic behaviours.

Procaccia (2008) conceives reliance parties' incentives as a function of the entity of damages in the case of a breakdown negotiations, demonstrating how, if parties are able to outguess which kind of damage will be delivered, expectation and reliance damages both produce optimal decisions to negotiate and invest. Ben-Shahar (2009) describes a no-retraction norm imposing liability on a party who withdraws from the terms on which previous parties came to an agreement on. As the author states, "once these terms are identified, a retraction would be any attempt by the party to reopen the negotiations over these terms in order to extract a more favorable division of the surplus, (...) thereby violating the plan to proceed with the negotiations" (p. 14). The retraction will cause an intermediate form of pre-contractual liability, being the retracting party liable for other party's reliance costs (incurred after the preliminary agreements). Giving protection to reliance costs, this rule will induce parties to an optimal level of reliance investments during negotiations, and will guard parties from the hold-up problem. The proposed rule does not prohibit renegotiations, it just narrows parties' bargaining power in the pre-contractual period, changing parties' incentives to retract, making them aware that a breakdown in negotiations will cause liability, as a matter of fact "a party cannot extract any of the added surplus created by the other party's reliance. He cannot hold up the other party and exploit the fact that reliance costs are sunk, because reliance costs are no longer effectively sunk. Any such hold up attempt gives the other party a chance to recoup its reliance costs by imposing retraction liability on the holding up partner" (p.15). Finally, Creed (2010) balances pre-contractual liability principles with tort principles in order to set the correct amount of damages, which should be determined with relation to reliance costs.

4. **Good faith as a key tool to shape pre-contractual liability**

During negotiations, good faith is the base principle for the application of pre-contractual liability. Today, it is the parameter used by Courts in order to judge parties behaviour. This is true both in countries which have a specific provision for pre-contractual

liability and in those which have not, that ground pre-contractual liability on the infringement of a duty to perform according to the good faith principle. In the negotiations phase, good faith can be seen as a tool to constrain parties' behaviour in order to preserve and promote allocative efficiency, inducing parties to cooperate. Each rational economic agent – as a bargaining party – aims to maximise their own welfare, adopting any possible strategy available. The role of good faith constraint is then to get rid of those strategies that could lead to an inefficient bargaining output. Not considering distributive issues, the good faith principle, limiting the strategies of economic agents, guides to a socially efficient equilibrium.

In legislator intention, acting in accordance to good faith means to bargain loyally - therefore avoiding any opportunistic behaviour – making the counterparty aware of the information owned. The effect of this provision is that of enhancing bargaining efficiency through an implicit reduction of transaction costs. Good faith constraint should then work as a variable in order to reduce information costs, legal costs and the overall costs of bargaining.

In order to provide a framework which is able to point out the social function of the pre-contractual liability regime, in our analysis we first assume that pre-contractual liability arises not only in consequence of a breach of negotiations, but also when the violation of the good faith principle has reflected its effects on the contract concluded. This assumption is grounded on a recent judgement of the Italian Corte di Cassazione, which has claimed that: "the rule provided by art. 1337 c.c. does not refer only to the hypothesis of unjustified negotiations break off, but has a general clause value, whose content cannot be clearly preconditioned. It implies the duty to loyally bargain, abstaining from catty or reticent behaviours and to communicate to the counterparty any relevant data, known or that could be known with the ordinary accuracy. Therefore, the violation of the duty to act in good faith during negotiations and contract formation is relevant not only in cases of unjustified bargaining break off – but also in cases of no contract conclusion, or in cases of conclusion of an invalid contract – but also in cases in which the concluded contract is valid and, anyhow, prejudicial for the victim of counterparty unfair behaviour." This thesis confirms the position of Sezioni Unite della Cassazione , which one year before, in a case related with financial brokers' duty to inform their customers, claimed that the violation of the duty to inform the customer can lead to pre-contractual liability if occurred during negotiations, even if the contract has been concluded .

A second important assumption in our work relates to the nature of the parties. Parties can be both sophisticated or naïve. This distinction is familiar not only to literature , but to American courts too, which frequently tend to distinguish between sophisticated and naïve

parties, mostly in order to decide which approach will better fit to contract interpretation and enforcement: actually, if parties are sophisticated, the approach will be more formalistic and very abided by freedom of contract .

"Sophistication dichotomy" is generally based on parties features, for example, firms or business entities, which habitually conclude repeated deals and contracts of the same nature and which know and manage some strategic variables like risk, costs or information, are deemed sophisticated. On the other hand, naïve parties are deemed to be those which do not regularly conclude deals or contracts of the same kind, that have poor knowledge of economic variables like market dynamics, costs and risk. These informational gaps determine a positional and informational asymmetry in respect to sophisticated parties. A typical example of naïve parties are consumers or small firms. For what pertains to our analysis, we take into account naïve parties, which are those who not only suffer a positional and informational asymmetry, but which bear high costs in order to protect their interest in the contract. The main argument on which we ground this choice is that sophisticated parties are already endowed with the necessary tools to protect themselves from counterparty opportunistic behaviour, thus, pre-contractual liability does not play a significant social role.

Actually, as far as sophisticated parties are concerned contracts are often homogeneous, bargaining can be seen as a repeated game, where the outcome can be contract conclusion or not. Availability of information - or anyhow the possibility to gain information at a lower cost than naïve parties - and expertise, enhance the possibility for sophisticated parties to figure out early on, different verifiable contingencies and scenarios. This not only enables parties to conclude a more complete contract, but also to have a greater awareness on the opportunity to conclude or not the contract and then to bring on or not negotiations. This implies that in the case of sophisticated parties, there could be a risk reduction of negotiations break off, which is the main cause for pre-contractual liability to arise. Another element to look upon is that in a repeated game dynamic, a preeminent role is played by reputation, more precisely by reputational sanctions, which could work as a deterrent for parties to behave opportunistically. Repeated contracts, entailing a long lasting relationship between parties, could bind parties' opportunism, creating a mechanism of self-enforcing contract. When parties are sophisticated, the provision of a good faith principle and then of pre-contractual liability could not be so efficient (Sepe, 2006), and this is mainly for three reasons. First of all, as claimed above, if parties conclude repeated contracts, in a frame of a long lasting relationship, good faith and pre-contractual liability mechanisms could be overreached by reputational sanctions. Self-enforcing mechanism and reputational

sanctions could be more efficient because they are endogenous mechanisms of opportunism deterrence and entail lower transaction costs, while pre-contractual liability could imply higher transaction costs due mainly to the costs to enter a judgment. Moreover, if parties are sophisticated and then experienced, they can shield themselves against any counterparty opportunistic behaviour, like for example the conclusion of a preliminary agreement. Through a preliminary agreement, parties can bind themselves to conclude a certain contract, whose essential elements – like price and economic conditions – are already set in the preliminary agreement they are concluding. Such considerations give substance to link the social function of pre-contractual liability to naïve parties. In particular, naïve parties do not usually get into complex or repeated negotiations, so they are not so seasoned; moreover, they generally suffer an information deficit that does not enable them to figure out possible contingencies.

5. Ex ante effectiveness

As stated above, good faith is a general clause used by legislators to react, with a flexible concept, to parties economic behaviour and thus to provide a tool of protection for parties interest in the steps that precede contract. The choice of a supple principle as a base for pre-contractual liability is very meaningful, because it could enable liability to be a malleable tool - not too rigid, nor too flat – which is very important in bargaining phases considering that providing or not a different form of pre-contractual liability, has a direct impact on parties incentives to enter the contract and to invest, both in information and reliance.

Actually, the role of good faith in pre-contractual liability is to provide a tool to qualify parties' behaviour in relation to bargaining essential elements like information disclosure and reliance investment.

Given the two assumptions stated above (see par. 3), the following analysis aims on the one hand, to understand the economic reasons able to explain and justify the presence of such a form of liability, and on the other, from a legal and economic perspective, to provide a more precise definition of the good faith principle in ex-ante negotiations. The analysis is based on a two step approach. The first step entails the study of inefficiencies linked to a bargaining that is affected by asymmetric information, pointing out negotiations in which a form of pre-contractual liability, seen as a breach of the good faith principle, leads to more efficient outcomes, from both a social and economic perspective. The second step, given the

solution provided to the information market failure, entails the analysis of bargaining in which parties suffer or benefit from a "positional asymmetry" that deeply affects parties' decisions on investment and reliance.

5.1 The first step of the analysis: good faith and the duty to disclose

In economic literature it is well known that asymmetric information represents one of the most relevant market failures, which prevent market and economic agents to reach allocative efficiency. Generally speaking, asymmetric information occurs when a party of an economic relationship enjoys a higher level of information than their counterpart. This informational deficit that concerns parties skills or actions, deeply affects the bargaining output from both an individual and social perspective, since parties are inclined to behave opportunistically .

Nevertheless, even though economic literature is so keen in underlining the negative impact on efficiency deriving from an informational unbalance, it has to be taken into account that in some cases, in order to avoid under-investment phenomena in the information market, there could be an economic justification for information misalignment.

The presence of informational imbalances is very common in contract theory, this implies that especially in bargaining phases (ex-ante contract) under an economic and legal perspective is very important to understand how and when asymmetric information can to some extent be justified.

In the bargaining phase, information could have both allocative and distributive consequences, which could affect directly the surplus expected from the contract, and, indirectly, social welfare. If it is true that the more parties are informed, the more they are able to reach allocative efficiency, and then to enhance indirectly social welfare, generally speaking a duty to disclose could be seen as a tool to raise social welfare. In any case, since this construction should be applied to single contracts, it is then necessary that parties have not only the right incentives to cooperate, sharing information in the negotiations phase, but also the right incentives to invest in the production of information. In the pre-contractual field, these could be provided through rules regulating the duty to disclose, deciding which kind of information should be subject to disclosure and which not. However, ruling the duty to disclose is very delicate, because it entails a trade off: if on one hand it allows, to some extent, to overcome information asymmetries existing between parties, on the other, it impacts directly on parties incentives to produce information. The incentive for parties to

invest in information is actually linked to the fact that investing in information may increase the value of parties' surplus, then a duty to disclose could lower the expected value of parties' surplus (Shavell, 1994). This means that if the rule is not efficient, for example because it is too rigid, parties' incentive to produce information will be reduced, decreasing then social welfare too.

Generally, legislators are not so inclined to provide general duties to disclosure, for example in Italian pre-contractual rules there is not an unspecified duty to disclose information, but just a duty, provided by art. 1338 of the Civil Code, imposing on the party who knows or should know a cause of invalidity of the contract, to inform the other party. More frequently, legislators intervene stating principles like transparency, which is a kind of general duty to disclose provided when there is an evident imbalance in parties relationship, like for example in the relationship between public administration and citizens. Specific duties to disclose, in the form of duties to inform are provided also in cases where there is a clear imbalance between parties contractual power, like for example in financial markets and brokerage in the relationship with consumers. In other cases, the legislator intervenes with specific duties of "non disclosure", protecting information possessed by a party with enforceable property rights on it providing forms of "private monopoly", as in the cases of patents or intellectual property rights in general.

A useful tool to distinguish cases in which the duty is needed and if violated the party is liable, from those in which it is not, is the use of good faith. With regard to information, the duty to act in good faith could overlap with the duty to disclose information: if a party knows something relevant ignored by the counterpart, good faith behaviour would imply, considering that this principle should entail cooperation and consideration of counterparty interest, to disclose it. But as stated above, if the provision of a good faith constraint should internalise parties' economic rationality, then it is important to understand when that constraint to parties' rational behaviour is efficient.

We propose, first of all, that it is necessary to distinguish between different kinds of information, using two parameters, cost and productivity . When referring to cost, we mean the cost of the production of information, which could include the creation of special expertises and the cost of research and acquisition of information (ex. a master in geology, chemistry). "Productive information" enables a better and more efficient use of a scarce resource (e.g. a not known particular use of the goods or the service), revealing then parties valuation of the performance object of the future contract.

For what concerns the costly information, the disclosure of this kind of information

could entail some inefficient consequences.

When the cost of information is negligible, because the information is easily accessible, information is very close to common knowledge, and, from an economic perspective, it almost assumes the characteristics of a public good, more precisely of a club good, because it is excludable but non-rival. When a party has not invested neither in the production, nor in the research of information, but has obtained the information at no cost, even if from an economic maximising perspective it could be efficient to exploit it, the provision of a duty to disclose has no effects on party incentives to invest in information, because the party has not put in place any economic relevant activity deserving a specific protection. This means that in this case the provision of a constraint to party economic behaviour could be justified. Actually, constraining parties conduct in this case has no negative impact on economic variables that drive parties' behaviour, while introducing a "duty to cooperate" can improve both parties' surplus and then social welfare. Therefore, in this case good faith rule impose the party who has the information to reveal it to the counterpart. A good example of such a situation is depicted by Cicerone who refers to the tragedy of Rhodian citizens who experienced a long period of famine. Roman merchants full of wheat sailed towards the isle of Rhodes and one of them, thanks to favourable winds, arrived on the island before the other merchants. Did the merchant who arrived first on the island have to reveal to Rhodians, in the phase of price bargaining for wheat, the information that other merchants (with ships full of wheat) were arriving on the island? According to our view, since information was costless and non-productive, it should be disclosed on the basis of the application of the good faith principle, which is tuned with economic efficiency.

In other cases parties are in a position of superior information compared to the counterpart, but this condition is the result of investment in information, thus it can be considered as costly. In this case, information could be deemed very close to a private good. Having invested in its production or acquisition, the information is rival and above all excludable. A good example of such an investment could be represented by the case in which a party invests in an expert in geology, and during the bargaining for land, has an advantage over the counterpart, due to the greater information of the precious characteristics of the soil, that is unknown to the land owner and which they discovered thanks to the investment made. Given the investment made and in order to give the right incentive for this type of investment (which improves human knowledge and above all social welfare), the right to exploit that informational advantage must be granted. The provision for a duty to disclose information could actually demotivate parties in investing in the acquisition of information,

because parties will know, that their advantage – in terms of the portion of surplus obtainable with the investment in information – will be shared with their counterparty.

Anyway, not in all cases in which information is costly a party should be obliged to share it with the other party. This is the case in which the information is the result of an investment that the party would have done in any case.

In this case, the matching of the economic rationality with the duty to disclose depends on the kind of information owned by a party. Actually, this information, even though costly, could be not-productive or productive. In the first case, both from an economic and normative perspective, it is efficient to constrain parties' behaviour by providing a duty to disclose. This is justified because a party bears an investment which would be incurred in any case (Kronman, 1978) and secondly because the disclosure of such information is not able to disincentive parties investment. Contrary, in the case in which the information owned by a party is productive, the absence of a duty to disclose could be more efficient. If productive information enables a better use of the resource, the availability of this information will allow an efficient allocation of the resource through transaction, because it will be allocated to the party who values it the most.

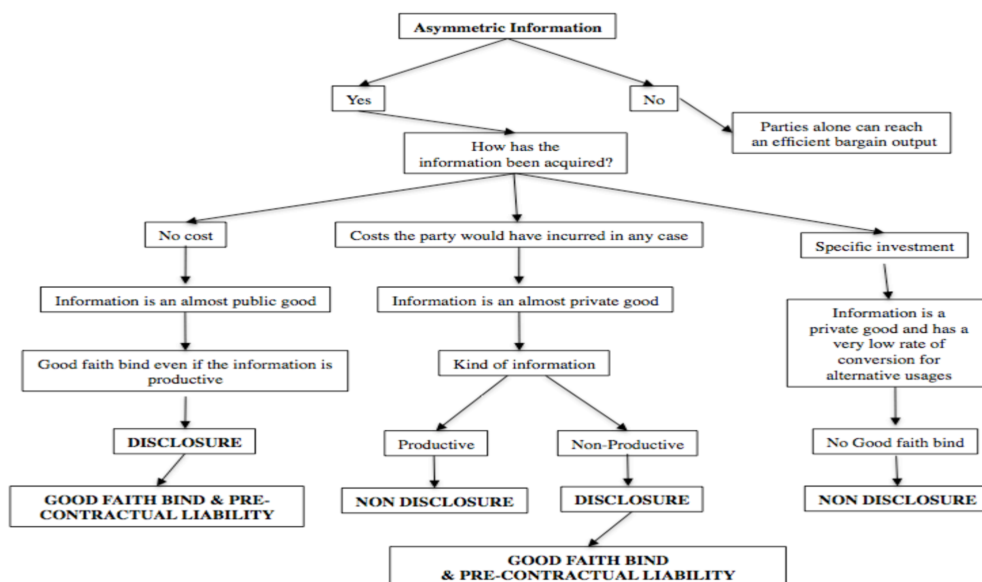
Regardless of cost and productivity, another element that is of paramount importance when assessing good faith relies on the specificity of the informational investment.

Specific investments are those in which there is very low chance to reuse the asset (in this case, information) for alternative usages without incurring in high switching costs or in a strong decrease of asset value (Nicita and Scoppa, 2005).

In this perspective if negotiations do not come to an end, the cost of the information will become a sunk cost. Since in this case too information could be considered as a private good, it is not only economically, but also socially justifiable, that the party who has made the investment has the right to exclude others from the fruition of this information. This case can be considered as well as a case of costly information. If the party that makes specific investments in information, knows from the very beginning that they will be obliged to reveal that information to the other party, eliminating then the advantage that has been created with the investment, they will be seriously demotivated in investing in information. This implies that not only the level of information, but also the rate of investment in information would be socially suboptimal, as well as the final surplus of the exchange. Therefore, in this case the fruition of the information only by the agent who has invested, is not only socially justified, but efficient. Following this reasoning, in these cases good faith does not call for a duty to disclose information. Actually, providing a duty to disclose would be inefficient,

because it could have a negative impact on parties' incentives to invest in information. Moreover, in the case of specific investment, since the party who invests is subject to counterparty's opportunistic behaviour, the previous distinction between productive and non-productive information is superfluous, because in any case it would be not efficient to impose a duty to disclose. Even if the information obtained with a specific investment is non-productive, unlike the previous case - where the investment would have been made in any case - in this case the specificity of the investment seriously exposes the party who had made it to counterpart opportunistic behaviour. The uselessness of a duty to disclose is consistent even because if the counterpart knows that the other will be obliged to disclose their information, they will have incentives to behave opportunistically, free riding on the investment in information made by the other party in information. Furthermore, not imposing a duty to disclose implies that the party who does not invest could have more incentives to invest in information, knowing that the other will not reveal any information, enhancing thus the total level of information and, consequently, contract surplus.

Fig. 1 – *Bargaining & Asymmetric information*



Looking at figure 1, we can depict, synthetically, the different situations in regards to bargaining. If there is no asymmetric information among parties and given no positional asymmetry, then bargaining leads to an efficient output. In the case of the existence of asymmetric information, we can figure out three different scenarios. The first entails that

information is obtained at no cost, thus, information is almost a public good. Allocative efficiency gives substance to good faith principle throughout the duty to disclose. The second case is that in which a party owns information which is the result of an investment that would have been made in any case. In this case we have to distinguish between productive and non productive information. In the former case, economic rationality suggests the absence of a good faith constraint, in other terms; agents have no duty to disclose. In the latter hypothesis, if information is costly but non-productive, good faith constraint applies and parties are subject to a duty to disclose. The last case that can be figured out in ex ante negotiation is the case in which information is the output of a specific investment. In this case, regardless of cost and productivity, the link of the investment to the ex ante contractual relationship, creates a stronger argument that makes the constraint of good faith fall.

5.2 The second step of the analysis: positional asymmetry and reliance

We have seen how the provision of pre-contractual liability, can improve allocative efficiency in a flexible but well defined manner.

Nevertheless, information is not the only issue that affects the expected value of the ex ante negotiations. Let's assume that information is equally distributed among parties. Does the provision of pre-contractual liability still play an important role in granting incentives for allocative efficiency? Can we imagine conducts that should be sanctioned because they are in contrast of good faith? In several cases it can represent a remarkable factor the decision to undertake investments that have to be made ex ante the conclusion of the contract, in order to enhance overall bargaining surplus, on the reliance that contract will be signed in a close period time.

For example, in negotiating an a employment contract, the potential employee could abandon their current work position in order to improve their skills for the new job, or the firm, before signing the contract, they could start making investments on facilities, human capital, etc., relying on the certainty that the contract will be signed.

It is evident in these cases, that from both sides, bearing those types of investments allows an increase in the expected value of the contract. Nevertheless, would the party effectively incur in those investments in the absence of a liability regime? Probably not.

In general terms, in the case of ex ante specific investments, good faith constraint could be considered justified, both from an economic and social perspective. Starting with the economic perspective, this kind of constraint to party rational economic behaviour could be

efficient because, given the fact that specific investments are made with the aim of increasing the final contract surplus, good faith constraint could act as a tool of protection. If a party makes a specific investment, and then the counterpart behaves opportunistically, the presence of a duty to act in good faith, duty that could be breached by the opportunistic behaviour, could actually allow the party who has made the investment to have the losses restored, by the functioning of pre-contractual liability. Providing a pre-contractual liability, through the provision of a duty to act in good faith, could then give incentive to the party who should made the specific investment to make it and to invest optimally, because they know that their investment will be protected by the law. On the other hand, knowing that opportunistic behaviour could be considered as a breach of good faith duty, the incentives for the counterparty to behave opportunistically and to lock in the other party will be reduced.

The duty to act in good faith could then enhance the attitude of parties to cooperate.

This is efficient even from a social perspective, because if the total surplus of the exchange is not only propelled, but also protected, it positively affects aggregate social welfare, even because the level of investment entailed in the contract, even of specific investment type, will be efficient and optimal. Moreover, if parties know that there is this kind of protection that will give incentive to parties to behave not opportunistically, transaction cost of the exchange will be reduced.

However, this construction meets two limits. The first one is, not unusually, linked with the concept of good faith. Being a general clause, it is not be easy to understand when the opportunistic behaviour should be qualified as a breach of good faith constraint. This is due not only to the width of the concept of good faith, but also to judges' scarce economic knowledge. Actually, the concept of opportunistic behaviour and of hold-ups are typical economic concepts, hard not only to understand, but also to identify in real cases. This could then lead to an incorrect use of pre-contractual liability by judges, creating a direct impact on parties, which would probably propel to sub-optimally level of investments and to an incentive to behave opportunistically.

The second limit deals with an "abuse" of the clause by the party who made the investment. Knowing that the breach of the duty could lead to the condemnation of the counterparty, the party who made the investment could themselves be propelled to act opportunistically, making the investment to lock in the counterpart. This could be true if the game is one shot, but what if the relationship between parties implies a series of contracts?

6. Main conclusions

The proposed work aimed to point out the social role of the provision of a pre-contractual liability regime through an analysis of the principle lying at the basis of this kind of responsibility, the principle of good faith. Since this principle is a general clause, it is necessary to understand the variables that should be taken into account when conjugating it with the concrete case. From an economic perspective, given that norms act as a constraint to rational economic maximising behaviour, it is then necessary to understand when it is efficient and when it is not - both from a social and economic perspective - to provide a constraint, specified as a good faith constraint type, to parties rational economic conduct. In the case of negotiations, this can be done focusing on asymmetric information and reliance. It is necessary to understand if the informational and positional advantage enjoyed by a party, could or not could be exploited both from an efficiency and juridical perspective.

When it comes to information, in order to figure out if it is efficient or not to impose a good faith constraint, in the form of a duty to disclose, we have analysed information distinguishing between costly-non costly, productive-non productive and specific information. The argument implies that, if information is not costly and then close to a public good, both economic and social arguments claim for a duty to disclose. In the second case studied, the one of information that can either be costly and productive, or only costly (close to a private good), we argued that, in the former case, economic rationality suggests the absence of a good faith constraint and then the absence of a duty to disclose, while in the latter, if information is costly but non-productive, a good faith constraint should be provided and then parties should be obliged to disclose their information. In the last case, the information is considered as the output of a specific investment which has a very low possibility to be used for alternative usages. In this case what is relevant is the strict link of the investment made to the ex ante contractual relationship, that justifies the right of the party who has made the investment to exploit the information, without being obliged to disclose it.

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