WHY DO WE KNOW WHAT WE KNOW?

REEVALUATING THE ECONOMIC CASE AGAINST PRE-CONTRACTUAL DISCLOSURE DUTIES AND FOR BREAK-UP FEES

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The economic analysis of contract law offers influential arguments against pre-contractual disclosure duties and for break-up fees, based on the presumption that pre-contractual duties are (or should be) set to provide sufficient incentives to optimally invest in acquiring information at the negotiation stage. We suggest, however, that the existing analysis is flawed, since it overlooks an important incentive for investing in information gathering.

According to the conventional wisdom, a negotiating party will be motivated to invest resources in information gathering only on the basis of its expectation to extract the contractual surplus that the investment may generate. As a result, it is arguably essential to protect the investing party's ability to benefit from its investment (by allowing non-disclosure) or to strengthen its bargaining position by guaranteeing reimbursement for the investment (break-up fees). However, contracting parties (*e.g.*, the purchaser) invest resources in acquiring information not only—and probably not even primarily—to strengthen its bargaining position vis-à-vis its counterpart (*e.g.*, the seller). Rather, the investment in acquiring information is often aimed at achieving an advantage vis-à-vis its *competitors* (*e.g.,* other potential purchasers of the same asset), endeavoring to increase the investing party's likelihood of forming a contract. Thus, even if the seller is able to extract *all* the contractual surplus generated by the investment, potential purchasers may well find it beneficial to invest in acquiring information to gain a competitive edge toward sealing a deal. In layman's terms: a negotiator may invest in gathering information not only for the hope of sweetening the deal for herself, but also for the prospect of being able to submit a better offer to the other party.

As a result, the argument of the existing literature against imposing a duty to disclose information and in favor of reimbursement provisions cannot be substantiated without a careful inquiry into competition-based motivations to gather information. Specifically, the analysis yields that, among other things, the exemption from disclosure cannot be justified on efficiency grounds in case of information that players in the relevant market regularly collect (*e.g.*, examining the property that is offered for sale or interviewing potential job candidates). The competition-based motivation is insufficient, and legal protection is justified, only in the case of "exceptional" deliberately acquired information (*e.g.*, searching for oil reserves or conducting a thorough job-screening through an extensive training program).

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INTRODUCTION

When should a party negotiating a contract be liable for non-disclosure of a material fact to the other party? Economic analysis of contract law has offered an influential assessment of this issue. From an *ex-post* perspective, once a party has gained material information, it is socially desirable to freely distribute it. However, revealing information may in turn impair the information holder's bargaining power and thus decrease its share of the contractual pie. For this reason, from an *ex-ante* perspective, imposing a disclosure duty dilutes a party's incentive to invest in acquiring information. In order to determine the desirable legal regime, we must balance the *ex-post* efficiencies, achieved through discovery, with the *ex-ante* incentives created by protecting exclusive rights to the information. On the basis of this evaluation, Anthony Kronman has argued that the *ex-post* concern should prevail only in the case of "casually acquired information," whereas in the case of "deliberately acquired information" a duty to disclose need not be imposed, based on the *ex-ante* consideration.[1]

Exemption from disclosure duties is thus explained and justified by the law and economics literature as a necessary, though costly, method of providing incentives to invest in information gathering. However, according to the conventional wisdom, the privilege not-to-disclose will provide sufficient incentives to collect information only if the other party cannot infer from the investing party's behavior what facts the latter has discovered. When this condition does not hold, the existing economic theory re-predicts deficient incentives to invest, and accordingly reinforces the need for mechanisms that ensure reimbursement of the investing party for its expenditure if the negotiations fail, primarily termination or break-up fees.[2]

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[1] Antony Kronman, *Mistake, Disclosure of Information and the Law of Contract*, 7 J. LEGAL STUD. 1, 13 (1978). See also Steven Shavell, *Acquisition and Disclosure of Information Prior to Sale*, 25 RAND J. ECON. 20 (1994); James Gordley, *Mistake in Contract Formation*, 52 AM. J. COMP. L. 433, 451 (2004) (supporting the imposition of a duty of disclosure but agreeing that "there should be an exception if one of the parties has expended money or effort to acquire the information"); Christopher T. Wonnell, *The Structure of a General Theory of Nondisclosure*, 41 CASE W. RES. 329 (1992) (pointing at the risk that a legal duty to disclose would lead the information holder to refrain from trading rather than disclose). For a review of judicial decisions that followed Kronman's thesis see Nicola W. Palmieri, *Good Faith Disclosures Required During Precontractual Negotiations*, 24 SETON HALL L. REV. 70, 178-179 (1993).

[2] *See, e.g.,* Lucian Arye Bebchuk & Omri Ben-Shahar, *Precontractual Reliance*, 30 J. LEGAL STUD. 423 (2001); Avery Katz, *When Should an Offer Stick? The Economics of Promissory Estoppel in Preliminary Negotiations*, 105 YALE L. J. 1249 (1996); Juliet P. Kostritsky, *Bargaining with Uncertainty, Moral Hazard, and Sunk Costs: A Default Rule for Precontractual Negotiations*, 44 HASTINGS L.J. 621 (1993); Wouter P.J. Wils, *Who Should Bear the Costs of Failed Negotiations? A Functional Inquiry into Precontractual Liability*, 4 JOURNAL DES ECONOMISTES ET DES ETUDES HUMAINES 93 (1993); G. Richard

The aforementioned analyses share a common underlying assumption: a negotiating party will be motivated to invest resources in information gathering only on the basis of its expectation to extract the benefits that the investment will generate. As a result, it is essential to protect the investing party's ability to benefit from its investment (the no-disclosure rule) or to strengthen its bargaining position by guaranteeing reimbursement for the investment (break-up fees).

We challenge this underlying assumption of the existing economic theory. A contracting party (*e.g.*, the purchaser) invests resources in acquiring information not only—and probably not even primarily—to strengthen its bargaining position vis-à-vis its counterpart (*e.g.*, the seller). Rather, the investment in acquiring information is often aimed at achieving an advantage vis-à-vis its *competitors* (*e.g.,* other potential purchasers of the same asset) and thus to increase the investing party's likelihood of forming a contract. In layman's terms: a negotiator may invest in gathering information not only for the hope of sweetening the deal for herself, but also for the prospect of being able to submit a better offer to the other party. For instance, a supplier of a certain service who avoids investing in gathering information about the characteristics (and thus the costs) of supplying her services to a specific potential client could only offer her services for a price that reflects the average (or typical) costs of supplying the required service. But a supplier who acquires information about the actual costs of providing the service gains an advantage over its competitors, since this information will enable the company to offer a lower price to some of the clients—those that need a service that costs less than the average expenditure. Thus, even if the purchaser is able to extract *all* the benefit generated by the investment (*i.e.*, the difference between the average costs of supplying the service and the actual ones), suppliers may well find it beneficial to invest in acquiring information about the specific purchaser.

Therefore, the argument of the existing economic theory against imposing a duty to disclose information cannot be substantiated without a careful inquiry into competition-based motivations to gather information. This broader analysis challenges the prediction of under-investment in acquiring information in certain contexts and reveals that in some cases the actual concern pertains to *excessive* investment.

Specifically, the analysis yields three main policy recommendations: *First*, the scope of incentives to invest in collecting information is a function of the market structure; the legal

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Shell, *Opportunism and Trust in the Negotiation of Commercial Contracts: Toward a New Cause of Action*, 44 VAND L. REV. 221 (1991).

doctrines should therefore be adjusted to reflect the market. Competition-based motivation provides a potential buyer with incentives to invest in acquiring information to the extent that the investment generates sufficient competitive advantage. Thus, it is important to assess the scope of the exclusivity of the acquired information vis-à-vis the investing party's competitors. The required evaluation is what portion of the acquired information can be expected to leak to the investor's competitors and at what cost.

Second, a distinction should be made between "conventional" information and "exceptional" information. The former is information regularly collected by players in the relevant market, as defined by the forces of competition (*e.g.*, examining the property that is offered for sale or interviewing potential job candidates); whereas the latter is information that would not have been gathered simply in order to beat competitors (*e.g.*, searching for oil reserves or conducting a thorough job-screening through an extensive training program). We suggest that the exemption from disclosure or the imposition of reimbursement can be justified on efficiency grounds only as far as "exceptional" deliberately acquired information is concerned, but not in the case of "conventional" investigation.

Third, in certain cases, competition-based motivation may encourage inexperienced negotiating parties (*e.g.*, entry-level workers or new franchisees) to over-invest in collecting information, resulting not only with their net private loss but in social inefficiencies as well. The stipulation that the experienced party is responsible for reimbursement in such cases can thus be justified, not through the conventional argument of encouraging information-gathering, but through an opposite one, of providing incentives to the more experienced party to limit the other party's expenditure on collecting information, to the socially efficient level. This argument can also serve to justify extending employers' obligation to compensate potential employees for training periods, and to require franchisors to reimburse potential franchisees for their pre-contractual investments whenever the negotiations fail.

The Article proceeds as follows. Part I presents the basic foundations of the existing economic theory on pre-contractual investments in information gathering. Part II provides a survey of the main policy recommendation of the law and economics literature's, as well as a brief presentation of the prevailing legal doctrines about the scope of disclosure duties and the right to reimbursement for pre-contractual investment in information gathering. In this context, we will discuss three types of contracts: purchase of assets (Section II.A), mergers and acquisitions of firms whose shares are publicly traded (Section II.B), and franchise agreements (Section II.C). Part III details the flaws in the existing theory and presents a revised analytical framework that accounts for the competition-based motivation. Based on these revisions, Part IV presents our policy recommendations. Short summery notes conclude the paper.

I. THE CONVENTIONAL WISDOM

Gathering certain types of information in the pre-contractual stage is essential to enhance social welfare. For instance, producers will invest in improving the quality of their products only if consumers have sufficient incentives to acquire information about the product's quality before buying it, and can thus be expected to pay a higher price for better quality. If consumers do not research before buying a product, an "adverse selection" process, which results in a "lemons market," is expected and the benefits from efficient investment in quality will be lost.[3] The basic premise of the economic approach is that the scope of pre-contractual disclosure duties and of reimbursement obligations are (or should be) set to provide sufficient incentives to optimally invest in acquiring information at the pre-contractual stage.[4]

Imposing a duty to disclose relevant information enhances the information that the parties possess. However, when gathering information requires substantial investments, it is important also to ensure that each party has sufficient incentives to acquire information. The underlying assumption of the existing economic theory is that the motivation to invest in acquiring information is based on the expected effect of the investment on the party's share of the contractual pie. A party invests in acquiring information in the pre-contractual phase on the basis of its belief that there is a high enough probability that some positive information will be revealed, and that the information will enable it to gain an asset (or to supply some service) whose value (costs) is higher (lower) than the price paid. When a disclosure duty is imposed, the investing party bears the costs of acquiring information before the contract is formed, but cannot

[3] The seminal work on this issue is George Akerlof, *The Market for "Lemons:" Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970). See also, *e.g.*, Michael Rothschild & Joseph Stiglitz, *Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information*, 90 QUART. J. ECON. 629 (1976); Peter Siegelman, *Adverse Selection in Insurance Markets: An Exaggerated Threat* 113 YALE L.J. 1123 (2004).

[4] Providing incentives to gather information is certainly not the only way to prevent adverse selection. Quality regulations and warranties, for example, can be just as effective in preventing a market failure. The choice between different mechanisms for solving adverse selection problems is beyond the scope of this paper.

extract the benefits, since the price would reflect the actual value (costs) of the asset (service).[5] Thus, a straightforward application of the economic justification for granting property rights—providing sufficient incentives to invest resources in production—results in granting to a contracting party the exclusive right to use of the information it gathered.

On the basis of this line of reasoning, economists have developed important qualifications in delineating the appropriate scope of disclosure duties. *First*, the disincentive concern is relevant only when a party gains its information on purpose to extract a larger share of the contractual pie. This consideration is irrelevant—and a duty to disclose should thus be imposed—when the knowledge was acquired for different reasons. Examples are knowledge of facts about the asset that the owners gain as a by-product of using it, and information that was "casually acquired." Thus, one basic distinction should be made between information that was "deliberately" acquired for exploring the profitability of contracting and facts that were gained "casually."[6]

Second, the social and private value of information may diverge. The social value of information is determined according to the effects of the discovery on allocation decisions. Private value, in contrast, is concerned with the distributive effects of foreknowledge—the effect of the parties' information on the distribution of the contractual surplus.[7] For example, the social value of inventing a new fertilizer is limited to its contribution to overall production (*e.g.*, the ability to grow better watermelons at a cheaper cost), while the private value may encompass wealth transfers that occur due to such discovery (*e.g.*, the increase in the value of shares held by the inventor). Individuals invest in information for its private value, but legal rules are aimed to provide incentives to the gathering of socially valuable information. Therefore, it is unjustified to limit disclosure in order to facilitate efforts to achieve information that has only distributional value. Deliberate efforts should be rewarded if, and to the extent that, the information they seek to reveal is of social value.[8]

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[5] Assuming that the investing party does not enjoy absolute bargaining power at this stage. *See* Katz, *supra* note 2, at 1280 (arguing that "[i]n situations in which offerors hold the bulk of the bargaining power, …forcing the offeror to bear the costs of precontractual reliance…gives her the incentive to weigh those costs against the benefits she obtains from it. In situations in which offerees hold the bulk of the bargaining power, however, the common law rule of free revocability makes more sense, for in that case it is the offeree who needs the incentives").

[6] *See* the sources mentioned in *supra* note 1.

[7] The seminal work on this issue is Jack Hirshleifer, *The Private and Social Value of Information and the Reward to Inventive Activity*, 61 AM. ECON. REV. 561 (1971).

[8] *See, e.g.*, Robert L. Birmingham, *The Duty to Disclose and the Prisoner's Dilemma: Laidlaw v. Organ*, 29 WILLIAM & MARY L. REV. 249 (1988); Jules L. Coleman, Douglas D. Heckathorn & Steven M. Maser,

Finally, in the case of socially valuable information that is deliberately acquired it is essential to assess whether an exemption from the disclosure duty is sufficient to motivate a party to invest. Granting a party the right to withhold relevant information provides it a sufficient incentive to invest only if the other party cannot infer from the investing party's behavior what information the latter holds.[9] In many instances this condition does not hold. If a party knows of the other's investment in research (for instance, since the inquiry requires the other party's cooperation, gaining access to the asset or to the target firm's accounts), the content of the offer that the investing party extends or even its willingness to negotiate may often reveal important information to the other party. For instance, extending a job offer to a candidate who was selected from a group of candidates indicates that the employer possesses some information about the candidate's high-quality skills; and an acquisition offer may well indicate that the acquirer possesses some private (positive) information about the target's value.

The investing party's expectation that its counterpart will be able to infer knowledge from its behavior weakens the incentive to invest. The concern is especially severe when the inferred positive information is relationship specific to the investing party but general to the other party.[10] For instance, an assessment by a potential employer about the high qualities of a specific job candidate is relationship specific for the employer, but the candidate, who can infer this information from the fact that the employer has extended her a job offer, can use it in her negotiation with alternative employers. Inferred information is general to the job candidate when a substantial part of it is both verifiable and relates to the candidate's qualities, which are relevant to other employers as well. In such cases, the candidate may distribute the inferred information

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A Bargaining Theory Approach to Default Provisions and Disclosure Rules in Contract Law, 12 HARV. J. L. & PUB. POL'Y 639, 691-709 (1989); Janet K. Smith & Richard L. Smith, *Contract Law, Mutual Mistake, and Incentives to Produce and Disclose Information*, 19 J. LEGAL STUD. 467 (1990); Richard Craswell, *Instrumental Theories of Compensation: A Survey*, 40 SAN DIEGO L. REV. 1135, 1166 (2003); ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 245-250 (2nd ed., 1997).

[9] *See, e.g.*, Richard Craswell, *Offer, Acceptance, and Efficient Reliance*, 48 STAN. L. REV. 481, 494 (1996) ("…B's reliance incentives may remain undistorted if S cannot find out what effect B's reliance has had on the value of the transaction to B").

[10] *Relationship-specific knowledge* is (the part of the) information and know-how that a party can utilize only with respect to the particular contracting party, and hence has no value outside of the specific relationship. *General knowledge* is information and know-how that are relevant for alternative transactions as well, and thus have value outside of the specific relationship. The distinction between general knowledge and relationship specific knowledge was developed in the context of human capital by the seminal work of Gary Becker. See GARY BECKER, HUMAN CAPITAL 33-51 (3rd ed., 1993). The importance of this distinction is not limited to the labor market.

and cause competition among alternative employers, which would weaken the investing party's bargaining power. Telling acts are therefore akin to making (part of) the information public.

Therefore, according to the existing economic theory, when relevant information can be inferred from the investing party's behavior and can be used by its counterpart to strengthen its bargaining power an exemption from the duty to disclose information is insufficient. In such cases, economic analysis endorses mechanisms that provide additional protection to the investing party, by imposing restrictions on its counterpart. Among these, imposing contractual liability even without actual consent or otherwise limiting the non-investing party's activities once the investment has been made,[11] and imposing the other party to reimburse the investing party for its investment in information gathering if the negotiations fail (e.g., termination or break-up fees).[12] Applying such measures would make the pre-contractual investment relevant to the parties' ongoing decisions during bargaining and can thus solve the hold-up problem.

To sum up, existing law and economics theory predicts under-investment in acquiring information during the pre-contractual stage, unless the legal provisions ensure either that (1) the investing party is both able and allowed to keep private the information that it discovers; or (2)

[11] *See, e.g.*, Craswell, *supra* note 9, at 484 ("The legal doctrines governing offer and acceptance can be interpreted to prevent one party from withdrawing in just those cases where an enforceable commitment would have been necessary to induce an efficient level of reliance by the other party. In those cases… even the party who now seeks to withdraw would have wanted to be committed… precisely in order to induce efficient reliance"); Omri Ben-Shahar, *Contracts Without Consent: Exploring a New Basis For Contractual Liability*, 152 U. PEN. L. REV. 1829 (2004) (suggests to give a party the option to bind her counterpart to his representation or to charge him with some liability in case he retracts); Omri Ben-Shahar, *"Agreeing to Disagree": Filling Gaps in Deliberately Incomplete Contracts*, 2004 WIS. L. REV. 389 (2004) (arguing that in order to induce optimal pre-contractual reliance "a party who seeks enforcement of a deliberately incomplete agreement [should] be granted an option to enforce the transaction under the agreed-upon terms supplemented with terms that are the most favorable (within reason) to the defendant"); Mark K. Johnson, *Enforceability of Precontractual Agreements in Illinois: The Need For A Middle Ground*, 68 CHI.-KENT. L. REV. 939 (1993) (recommending that the courts accept an intermediate, flexible regime of enforceable precontractual agreements); Melvin A. Eisenberg, *The Revocation of Offers*, 2004 WIS. L. REV. 271; Juliet P. Kostritsky, *Reshaping the Precontractual Liability Debate: Beyond Short Run Economics*, 58 U. PITT. L. REV. 325 (1997) (efficiency considerations justify a law-supplied default rule of a performance obligation that would act as an adjunct to private contractual arrangements). For critical assessments of these recommendations *see* Jason Scott Johnston, *Investment, Information, and Promissory Liability*, 152 U. PEN. L. REV. 1923, 1936-1939 (2004); Ronald J. Mann, *Contracts—Only* with *Consent*, 152 U. PEN. L. REV. 1873, 1887-1888 (2004); Eric A. Posner, *Economic Analysis of Contract Law after Three Decades: Success or Failure*, 112 YALE L.J. 829, 851-853 (2003).

[12] See sources mentioned in note 2 *supra*.

the investing party is protected from hold-up by its counterpart at the final stage of the negotiating process.[13]

II. IMPLEMENTING THE CONVENTIONAL WISDOM: DISCLOSURE DUTIES AND BREAK-UP FEES

In this Part we present the main recommendations of the law and economics literature in two contract law issues: the appropriate scope of disclosure duties during contractual negotiations, and a party's right to reimbursement for investment in information gathering. The first issue is relevant when the negotiations are successful, but it turns out that the buyer had acquired private (positive) information, that enabled her to purchase the asset at a bargain price. The second issue is relevant mainly when the negotiations fail, after the potential buyer invested in acquiring information. In both cases we are interested in the negotiation stage—the information a party held before the contract was formed and the investments made during this time.

In legal practice, the two issues under consideration are usually dealt with in a piecemeal fashion. Certain specific cases are examined under general principles of contract law (*e.g.*, a potential buyer's investment in investigating the property[14]); others under tailored rules for specific contracts (*e.g.*, a franchisee's investment in training[15]); and some under a distinct legal field such as corporate law (*e.g.*, the investment made before submitting a tender offer[16]) and labor law (*e.g.*, the investment in screening employees[17]). In a similar vein, the law and economics literature tends to discuss each of these contexts separately, without explicitly referring to arguments and policy recommendations made in the other fields. However, the specific evaluations in the different contexts can be explained by the general theory that was presented in the preceding Part. We will demonstrate this argument by briefly presenting the

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[13] In addition, under-investment will not occur if the information is general to the investor but relationship specific to the other party. See Shavell, *supra* note 1 (demonstrating that while buyers will under-invest in acquiring information if they are subject to a disclosure requirement, sellers may have sufficient incentives to acquire information even if they are required to disclose it). The conventional wisdom is thus applicable if the information is relationship specific to the investing party (whether or not it is relationship specific to the other party) or if the information is general to both parties (*e.g*. information about market conditions).

[14] *See* Section II.A *infra*.

[15] *See* Section II.C *infra*.

[16] *See* Section II.B *infra*.

[17] *See, e.g*., Walling v. Portland Terminal Co. 330 U.S. 148 (1947) (the Fair Labor Standards Act (FLSA) does not impose a duty to pay for railway yard training).

main conclusions of the law and economics literature concerning three types of contracts: purchase of assets, mergers and acquisitions of firms, and franchise agreements.

A. PURCHASING AN ASSET

At the outset, potential buyers are usually uninformed about the unique conditions and prospects of the property they are considering purchasing. To remove this uncertainty, they are required to study the property at hand and to assess its value. Such investigations are both costly and, to a considerable extent, relationship-specific.

The prevailing legal doctrine is that, short of fraud,[18] a buyer is not liable for non-disclosure of material facts that were legally available to both parties.[19] The Restatement of Contracts, Second explains that as a general principle a "party making a contract is not expected to tell all that he knows to the other party, even if he knows that the other party lacks knowledge on some aspects of the transaction. His nondisclosure, as such, has no legal effect except in [specific] situations."[20] From this general principle it is subsequently deduced that "[a] buyer of property, for example, is not ordinarily expected to disclose circumstances that make the property more valuable than the seller supposes".[21]

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[18] "Fraud" in the present context is a positive misleading statement. The legal distinction between an omission to convey information ("nondisclosure") and a misleading statement ("fraud" or "active concealment") goes directly to Chief Justice Marshall's short speech in *Laidlaw v. Organ*: "The question in this case is, whether the intelligence of extrinsic circumstances, which might influence the price of the commodity, and which was exclusively within the knowledge of the vendee, ought to have been communicated by him to the vendor? The court is of opinion that he was not bound to communicate it. …But at the same time, each party must take care not to say or do any thing tending to impose upon the other". Laidlaw v. Organ, 15 U.S. 178, 195 (2 Wheat) (1817). See also Hays v. Meyers, 139 Ky. 440 (1908). For a skeptical view of this distinction see Donald C. Langevoort, *Half-Truths: Protecting Mistaken Inferences by Investors and Others*, 52 STAN. L. REV. 87, 95-96 (1999).

[19] See, e.g., Restatement of Torts, Second, §551 comment k ("To a considerable extent, …superior information and better business acumen are legitimate advantages, which lead to no liability. The defendant may reasonably expect the plaintiff to make his own investigation, draw his own conclusions and protect himself; and if the plaintiff is indolent, inexperienced or ignorant, or his judgment is bad, or he does not have access to adequate information, the defendant is under no obligation to make good his deficiencies. This is true, in general, when it is the buyer of land or chattels who has the better information and fails to disclose it"); Restatement of Restitution, §12, illustration 9.

[20] Restatement of Contracts, Second, §161, comment a. §161 provides that "a person's non-disclosure of a fact known to him is equivalent to an assertion that the fact does not exist if" (which is considered as "misrepresentation," according to §159) where, among other things, "(b)… he knows that disclosure of the fact would correct a mistake of the other party as to a basic assumption on which that party is making the contract and if non-disclosure of the fact amounts to a failure to act in good faith and in accordance with reasonable standards of fair dealing."

[21] Restatement of Contracts, Second, §161, comment d.

This doctrine follows the decision in the famous case of *Laidlaw v. Organ*.[22] The plaintiff, Organ, obtained private information that the Ghent Treaty had been signed, which suggested that the price of U.S. tobacco would likely increase significantly. Before the information had become public, Organ concluded an agreement to purchase tobacco from the defendant, Laidlaw, without disclosing the news. After the information reached the market and the price of tobacco rose by 30% to 50%, Laidlaw tried to rescind the deal, claiming that it was attained by fraud. Chief Justice Marshall, in a famous *dictum*, stated that a party has no duty to communicate to the other party "the intelligence of extrinsic circumstances, which might influence the price of the commodity, …where the means of intelligence are equally accessible to both parties."[23] Another classic example is *Mcbride v. William*,[24] in which a seller of a tract of land refused to transfer the land, arguing that the buyer defrauded him by concealing the existence of a valuable coal mine on the property. The court ordered specific performance, stating that the buyer was not under a duty to disclose such information.[25]

The law and economics literature had extensively examined the case of disclosure of positive information by a potential buyer. Following Antony Kronman's canonical article *Mistake, Disclosure of Information and the Law of Contract*,[26] the conventional wisdom is that, generally, information that a potential buyer has deliberately acquired during the negotiation process should be immune from disclosure duties.[27]

It is not clear whether courts consistently follow the recommendation of the economic analysis. On the one hand, a recent comprehensive empirical study found that, as a general

[22] 15 U.S. 178 (2 Wheat) (1817).
[23] *Id. at* 195. The Supreme Court nevertheless ordered a new trial (*Venire de novo*) because the "absolute instruction of the [district] judge was erroneous. …The question, whether any imposition was practiced by the vendee upon the vendor ought to have been submitted to the jury."
[24] 7 Ore. 491 (1879).
[25] Restatement of Contracts, Second, §161, illustration 10 is constructed based on this case: "A, seeking to induce B to make a contract to sell A land, learns from government surveys that the land contains valuable mineral deposits and knows that B does not know this, but does not disclose this to B. B makes the contract. A's non-disclosure does not amount to a failure to act in good faith and in accordance with reasonable standards of fair dealing and is therefore not equivalent to an assertion that the land does not contain valuable mineral deposits. The contract is not voidable by B."
[26] Kronman, *supra* note 1.
[27] Some qualifications to this rule have been suggested by the literature. Most notably, several commentators have argued, following the logic of Jack Hirshleifer (see *supra* note 7), that the no-duty-to-disclose-deliberately-acquired-information rule should be limited to cases that involve the gathering of socially valuable information (as opposed to information that has purely private value). See sources mentioned in note 8 *supra*.

matter, courts are significantly less likely to require disclosure from buyers of assets than from sellers.[28] Such disparity is justified according to the existing economic theory since buyer's information is more likely to be acquired through a deliberate investment whereas the seller's knowledge is achieved as a by-product of his possession of the asset.[29] However, on the other hand, the same research did not find support for the prediction that courts actually follow the deliberately-acquired / casually-acquired distinction.[30]

On the issue of using reimbursement for pre-contractual investment in information gathering as a compliment to nondisclosure rights, there is even a broader gap between the legal doctrines and the recommendations of the law and economics literature. As a general matter, courts refuse to require a negotiating party to compensate its counterpart ("pre-contractual liability").[31] Consequently, "[a] party that enters negotiations in the hope of the gain that will result from ultimate agreement bears the risk of whatever loss results if the other party breaks off the negotiations".[32] Indeed, the parties are certainly free to contract-out of the no-reimbursement-for-failed-negotiation regime, by signing a preliminary agreement that promises the buyer compensation for her pre-contractual cost. But to the best of our knowledge, in practice it is not

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[28] Kimberly D. Krawiec & Kathryn Zeiler, *Common-Law Disclosure Duties and the Sin of Omission: Testing the Meta-Theories*, 91 VA. L. REV. 1795, 1862 (2005).
[29] *See supra* note 6 and accompanying text.
[30] Krawiec & Zeiler, *supra* note 28, at 1856-1862.
[31] This rule is subject to three major exceptions: unjust enrichment resulting from the negotiations, misrepresentation made during the negotiations, and a breach of specific promise made during the negotiations. *See* E. Allen Farnsworth, *Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations*, 87 COLUM. L. REV. 217, 221-239 (1987).
[32] Farnsworth, *ibid*, at p. 221; STEVEN J. BURTON & ERIC G. ANDERSEN, CONTRACTUAL GOOD FAITH: FORMATION, PERFORMANCE, BREACH, ENFORCEMENT 330-331 (1995) ("[American courts] continue to view contract negotiations as, at bottom, an undertaking in which self-interest is the accepted norm. Each party assumes the risk that, despite a heavy investment in the negotiation process, no agreement will be reached"); Alan Schwartz & Robert E. Scott, *The Law and Economics of Preliminary Agreements*, WORKING PAPER 11 (2005) ("Courts will not grant recovery for 'early reliance' unless the parties, by agreeing on something significant, have indicated their intention to be bound," such that "Courts actually make some form of agreement a necessary condition to promisee recovery". The authors report that in a sample of 140 cases litigated between 1999 and 2003, absent misrepresentation or deceit, no liability was imposed for reliance investments made during the negotiation process.). The same general perception applies in England as well. see, e.g., *Regalian Properties plc v. London Docklands Development Corp* [1995] 1 All E.R. 1005 (Ch.) ("Each party…must be taken to know… that pending the conclusion of a binding contract any cost incurred by him in preparation for the intended contract will be incurred at his own risk in the sense that he will have no recompense for those costs if no contract results").

common to do so during negotiations over purchasing assets (or supplying services).[33]

In contrast, the law and economics literature provides vigorous support for entitling the investing party the right to reimbursement for its investment, either through contractual provision or legal intervention.[34] This recommendation responds to cases of pre-contractual reliance in general, without specifically addressing the issue of investment in gathering information. Nevertheless, this general recommendation clearly applies to the current context as well. It seems plausible to assume that at least some of the inquiries about the value of the asset require the cooperation of the owners, such that in the typical case, the seller can infer from the buyer's offer what type of information the buyer has acquired. It is also plausible to assume that whereas this information is relationship specific from the point-of-view of the buyer, it is a "general" one from the seller's perspective, who can distribute it to competing buyers, by informing them that a competing buyer has given a higher offer. It will enhance the seller's bargaining position and enable him to extract a substantial share of the contractual surplus generated by the buyer's investment. As a result, the no-duty-of-disclosure doctrine may well be insufficient to induce efficient investment in pre-contractual information gathering. Providing the buyer with the right to reimbursement for her pre-contractual investment if the negotiations fail seems thus justified under the premises of the existing theory.

B. ACQUIRING A PUBLICLY TRADED FIRM

The most vigorous academic debates concerning investment in pre-contractual information gathering have been waged in the field of mergers and acquisitions. Submitting a tender offer or negotiating a merger can be extremely costly. The acquirer is required to study the target, learn its potential value through tedious due diligence proceedings, and develop plans and strategies in order to convince the target's shareholders to approve the deal. Furthermore, these proceedings are so demanding on the management of the acquirer that opportunity costs are likely to be considerable as well.[35] Most, if not all of the research is relationship-specific—the information will not produce any gain for the acquirer unless the deal goes through. Given these

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[33] Posner, *supra* note 11, at 851-853 ("…the parties could enter a contract at the beginning of their relationship, one that specified what the promisee must invest and how the promisee will be evaluated. As far as I know, parties do not enter such contracts…").
[34] *See supra* note 11 and accompanying text.
[35] *See, e.g.,* John C. Coates IV & Guhan Subramanian, *A Buy-Side Model of M&A Lockups: Theory and Evidence*, 53 STAN. L. REV. 307, 332 (2000).

characteristics, it is not surprising that corporate law scholars have dealt extensively with both of the scenarios that we examine.

The disclosure requirements delineated by the Securities Exchange Act for an acquirer of a company are much broader than traditional disclosure duties of a buyer under the common law. If the acquisition is conducted through a tender offer, the bidder is required by the Williams Act to make a comprehensive disclosure, providing information about her plans for the target if the takeover is successful.[36] The purpose of this requirement is to allow the stockholders of the target company to make an informed decision about whether or not to retain their shares. In addition, if the acquirer is already an insider of the target company or if she received the information from an insider in breach of his duty toward the target company, the acquirer must disclose the information according to inside trading jurisprudence.[37] Furthermore, even without such demanding disclosure requirements, the mere submission of a public offer above market price may be sufficient to signal that the acquirer has some positive information about the target. Therefore, a simple no-disclosure rule is an inefficient mechanism to induce optimal investment in gathering information. The academic debate is what type of measures should be applied—if at all—to insure optimal investment.

According to one view, the potential acquirer should enjoy the right to exclusive use of the information she gathered. In the early 1980's, Frank Easterbrook and Daniel Fischel argued that the need to facilitate efficient search investment in information gathering in the market for corporate control justifies limiting the competition in this market by prohibiting the target's management from seeking competing offers after a tender offer was made.[38] This proposal encountered forceful opposition, led by Lucian Bebchuk and Ronald Gilson;[39] they accentuated

[36] The Securities Exchange Act of 1934, § 14(d), as amended by the Williams Act in 1968. For a detailed analysis of the disclosure requirements under the Williams Act *see, e.g.*, WILLIAM J. CARNEY, MERGERS & ACQUISITIONS 817-862 (2000).

[37] The Securities Exchange Act of 1934, § 10(b); Rule 10b-5 of the Securities and Exchange Commission. The Supreme Court approved the "misappropriation theory" of inside trading in U.S. v. O'Hagan, 521 U.S. 642 (1997). This doctrine, however, does not cover all the non-public information that an acquirer may have. *See, e.g.,* David T. Cohen, *Old Rule, New Theory: Revising the Personal Benefit Requirement for Tipper/Tippee Liability Under The Misappropriation Theory of Insider Trading,* 47 B.C. L. REV. 547 (2006) (discussing whether the personal benefit requirement applies to the misappropriation theory).

[38] See Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding To a Tender Offer,* 94 HARV. L. REV. 1161 (1981); Frank H. Easterbrook & Daniel R. Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982).

[39] See Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982); Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers: A reply and Extension*,

the importance of a competitive market for corporate control, and the social damage that may result from limiting the ability of the management to seek for a higher-valuing acquirer. The latter approach seems to prevail.

Reimbursement is an alternative mechanism that has emerged to protect the potential acquirer's interests.[40] The general practice in negotiations of friendly takeovers is for the target company to provide the acquirer with a lockup agreement that compensates the acquirer in the case that the deal is not consummated. The most popular of these agreements is known as termination fees or break-up fees.[41] These agreements provide that the target will pay the acquirer a fixed amount of money in the event that the deal fails. Typical termination fees are set between 1% and 5% of the target's value, which is often a very considerable amount.[42] Some commentators argue that in spite of their gigantic size, termination fees represent reimbursement of actual reliance costs, mainly due to the acquirer's opportunity costs.[43] Others reject this claim, and view the magnitude of the termination fees as an indication that these fees are actually a

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35 STAN. L. REV. 23 (1982); Ronald J. Gilson, *A Structural Approach to Corporation: The Case Against Defensive Tactics in Tender Offers,* 33 STAN. L. REV. 819, 870-75 (1981); Ronald J. Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982).

[40] The choice between the two methods is more about *who* should be encouraged to initiate search, than about *how* to encourage investment in search: limiting competition to protect the information is designed to facilitate search by *hostile acquirers*, since in friendly deals the management is not likely to seek competing offers anyway; therefore tying its hands by legal limitations seems unnecessary; while reimbursement through lockups is designed to encourage search by *friendly acquirers*, since in hostile takeovers the target's management is, by definition, hostile to the acquirer efforts, and would not agree to any lockups. *See* Coates & Subramanian, *supra* note 35, at 314.

[41] Other kinds of lockup agreements include stock lockups (giving the acquirer a call option for some of target's shares), asset lockups (giving the acquirer a call option for some of target's assets), and expense reimbursements (giving the acquirer a right to sue for her verifiable expenditures). According to Coates & Subramanian, *supra* note 35, at 314-319, almost half of all friendly deals of above $50 million between 1988 and 1999 included a termination fee clause. See also Micah S. Officer, *Termination Fees In Mergers And Acquisitions*, 69 J. OF FINANCIAL ECON. 431, 442 (2003) (reporting 42.1% for the period of 1988-2000).

[42] See, e.g., Ely R. Levy, *Corporate Courtship Gone Sour: Applying a Bankruptcy Approach to Termination Fee Provisions in Merger and Acquisition Agreements*, 30 HOFSTRA L. REV. 1361, 1366-1368 (2003) (giving examples of termination fees agreed upon in the years 2001-2002. The termination fees range from $3 million to $1.6 billion).

[43] See, e.g., Coates & Subramanian, *supra* note 35, at 332, 358-360 (adding "switching costs" and "reputational effects" to "opportunity costs," and arguing that their accumulation may be significant). See also Easterbrook & Fischel, *supra* note 38, at 6-7 ("Bidders invest their own time in searching for targets, and the opportunity costs of managers' time so committed includes the value to the bidders of other projects foregone").

mechanism to deter hostile takeovers bids.[44] Be that as it may, the Delaware Court has applied a lenient "reasonableness" test to terminations fees, which in fact permits considerable latitude to a company's management. In the leading case of *Brazen v. Bell Atlantic*,[45] the court upheld a $550 million termination fee as "a valid liquidated damages provision," stating that it was a "reasonable forecast of damages."[46] The court asserted that in order to fail this "reasonableness" test "the amount at issue must be unconscionable or not rationally related to any measure of damages a party might conceivably sustain."[47] Most practitioners view *Brazen v. Bell Atlantic "*as a general judicial endorsement of lockups independent of the particular scrutiny invoked".[48]

The practice of providing termination fees and the permissive decision of the Delaware Court have been generally supported and encouraged in the law and economics literature. Ian Ayers, in an influential 1990 article,[49] set the tone by arguing that, extreme cases aside,[50] lockups do not create inefficiencies, since they do not affect the relative valuation of the target by additional potential bidders. The amount that a third party would be willing to pay for the target is decreased by the cost of the lockup (because buying the company would entail a liability that would detract from its value); but at the same time it lowers the incentives of the first bidder to compete over the target by the same amount (the first bidder's cost of buying the target is giving up the profits from the lockup). Accordingly, lockups would not affect the identity of the acquirer, but only the

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[44] See, e.g., David A. Skeel, Jr., *A Reliance Damages Approach to Corporate Lockups*, 90 NW. U. L. REV. 564, 596 (1996) ("bidders often do not have other, similar acquisition opportunities during the same time frame as their discussions with the target"). See also Bebchuk, *supra* note 39, at 1036-1037 ("…the search costs that first bidders incur do not seem to be at all large. …the search is frequently done for them by investment bankers").

[45] 695 A. 2d 43 (Del. 1997).

[46] *ibid*, at 50.

[47] *ibid*, at 48.

[48] Coates & Subramanian, *supra* note 35, at 331. For analysis of *Brazen v. Bell Atlantic* and its effect on the popularity of termination fees *see* Coates & Subramanian, *ibid.*, at 331-337. See also Heath Price Tarbert, *Merger Breakup Fees: A Critical Challenge to Anglo-American Corporate Law*, 34 LAW & POL'Y INT'L BUS. 627 (2003) (a comparative discussion of the judicial standards employed in the U.S. and the U.K. with respect to termination fees); Brian C. Brantley, *Deal Protection or Deal Preclusion? A Business Judgment Rule Approach to M&A Lockups,* 81 TEX. L. REV. 345 (2002); Ely R. Levy, *Corporate Courtship Gone Sour: Applying a Bankruptcy Approach to Termination Fee Provisions in Merger and Acquisition Agreements*, 30 HOFSTRA L. REV. 1361 (2003).

[49] Ian Ayres, *Analyzing Stock Lock-Ups: Do Target Treasury Sales Foreclose or Facilitate Takeover Auctions?*, 90 COLUM. L. REV. 682 (1990).

[50] Ayres terms extreme cases "foreclosing lockups," and defines them as cases in which the lockup reduces the recipient's reservation price below its initial offer. In other words, those are cases in which the termination fees cause the recipient to wish that the deal would not be consummated. See *id*. at 699-710.

distribution of profits from the deal.[51] If so, and given the desirable effects that lockups have on the incentive to invest in gathering relationship-specific information, courts should show great leniency toward lockups in general, and termination fees in particular. Ayers' insight was extremely successful, and though some scholars had refined and limited his argument,[52] the literature generally supports not only giving the management greater latitude to employ such mechanisms, but also encourages their use as a means to advance efficient investment in search.[53]

The view that acquirers should be reimbursed for their investments if the tender offer is rejected fits the general economic theory described above. As indicated, the submission of an offer may well serve as an indication of the information that the acquirer has gained. Thus, the acquirer faces a risk that an alternative acquirer will show up, and that the competition will reduce the first bidder's surplus (or even eliminate it, given that the investment in information gathering will be a "sunk cost" at this stage). The prevailing view is thus that in the case of mergers and acquisitions, awarding the right to reimbursement is essential to overcome the concern of under-investment in pre-contractual gathering of relationship specific information.

C. RECEIVING A FRANCHISE

Receiving a franchise has elements in common with both acquiring an asset and entering into an employment contract. The assets acquired by the franchisee are the lucrative trademark and tested know-how of the franchisor. The ensuing relationship is one of semi-employment because of the significant control maintained by the franchisor over the way the franchisee conducts her

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[51] The only caveat is that if the recipient is tied to her initial offer, this obligation can make her buy the company even if she prefers to lose the competition over the target, and receive the termination fees, *i.e.* it may be a foreclosing lockup. See *supra* note 50. For an extension of Ayres' argument through an application of the Coase Theorem see Stephen Fraidin & Jon D. Hanson, *Towards Unlocking Lockups*, 103 Yale L. J. 1739 (1994).

[52] *See, e.g.*, Marcel Kahan & Michael Klausner, *Lockups and the Market for Corporate Control*, 48 STAN. L. REV. 1539 (1996) (arguing that the hazard of second-bidder and anticipatory lockups can reduce the research incentives of potential hostile acquirors); Coates & Subramanian, *supra* note 35 (suggesting several possible distortions that may cause inefficiencies).

[53] Interesting enough, empirical studies tend to show two results: *First*, lockups significantly increase the premiums that target shareholders receive (see Officer, *supra* note 41, at 449-452); *second*, lockups significantly increase the prospects that the deal will be completed (*see* Coates & Subramanian, *supra* note 35, at 347-353; Officer, *id*., at 456-458). The first result fits with Ayres' predictions, since if indeed lockups are mechanisms for encouraging efficient investment in search, we should expect higher profits, and higher premiums, but the second result is hard to reconcile with this model.

business.[54] These two complementary aspects of franchising necessitate considerable investment by the franchisee in acquiring required information, learning the know-how that the franchise provides and complying with the franchisor's requirements. Furthermore, since the ability to learn and apply the information is crucial not only for the franchisee's success but also for the way her operation will affect the franchisor's reputation (*i.e.* the value of his trademark), it is both reasonable and customary for at least part of the training to be conducted during the negotiation period, as part of a screening procedure.[55]

Since most of the information that the franchisee acquires is already known to the franchisor (usually he is the one who provides it), cases of discovery of positive information by the franchisee are unlikely.[56] However, it is common that a case of unsuccessful negotiations over a franchise will cause disagreement over the responsibility for the costs that the failed-franchisee has incurred. According to the celebrated case of *Hoffman v. Red Owl*,[57] in certain circumstances the franchisor should reimburse his counterpart for her pre-contractual investments. In this case, the plaintiffs, the Hoffmans, owned and operated a bakery. They contacted the defendant, Red Owl, a firm that owned and operated a chain of grocery stores, and extended franchises to individuals. During the negotiations, the Hoffmans, at the guidance of the divisional manager for Red Owl, invested a considerable amount of time and money in training to become Red Owl store operators. Among other things they bought a small grocery store, operated it for few months, and then sold it. These investments created two sorts of knowledge. First, it gave the Hoffmans valuable experience in running a grocery store, and thus raised the expected returns

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[54] See Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 STAN. L. REV. 927, 931-932 (1990).

[55] A good example of such dynamics is the franchisees' selection procedures of McDonald's Corp. These procedures include several interviews, a three-day "in restaurant" evaluation, and a training course of between 9 to 24 months (approximately 20 hours a week). *See* http://www.mcdonalds.com/corp/franchise/faqs2.html (last visited 6.26.2006). Candidates participate in this training at their own cost. See e.g. McDonald's Corp. v. Miller 1994 U.S. Dist. Lexis 13243 (Dist. of N.J.) (rejecting the claim of a trainee for wages for his training period that lasted almost a year, based on the finding that the defendant repeatedly warned the trainee that there was a substantial risk that he would not be hired as a franchisee).

[56] In principle a potential franchisee may comes up during her training with a new and exciting way of developing the franchise, but it is doubtful whether the legal rules that regulate such exceptional incidents have any effect on the incentives to invest in training. Conversely, it is much more likely that investments in acquiring knowledge, which is not provided by the franchisor (*e.g.* locating the best operation area), would result in higher profits, but it is hard to conceive of real-life situations in which the franchisor would have any claim against the franchisee because she was too diligent in the precontractual stage.

[57] 133 N.W.2d 267 (Wis. 1965).

that Red Owl would receive if they awarded them the franchise (gains both parties are expected to share).[58] In addition, this experimental period provided Red Owl with a valuable opportunity to examine the Hoffmans' competence as grocery store managers (*i.e.* allowed Red Owl to perform job-screening).[59] Despite the Hoffmans' investments (or maybe because of them[60]) the deal did not materialize. Red Owl officials informed the Hoffmans that the required capital to open a Red Owl franchise was almost double than the initial estimations. In response, the Hoffman's broke off negotiations with Red Owl and sued. The court ruled in favor of the Hoffmans, based on the doctrine of promissory estoppel, and awarded them damages equal to their reliance losses.

The influence of the decision in *Hoffman v. Red Owl* on the law of contract formation is highly debated. Some claim that it is an isolated case, whose ruling is rarely repeated, while others view it as an influential precedent that led the way for an enduring use of the promissory estoppel doctrine.[61] Be that as it may, it seems that, at least in the field of franchising, it has a

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[58] *See, e.g*., G. Richard Shell, *Opportunism and Trust in the Negotiation of Commercial Contracts: Toward a New Cause of Action*, 44 VAND. L. REV. 221, 263 (1991) ("In Hoffman the plaintiff undertook costly steps to leave his old profession and train himself as a grocer. These investments would have benefited both the franchisee and the franchisor had the deal gone through"); Craswell, *supra* note 9, at 495 (arguing that Hoffman relied on receiving the hoped-for franchise in several ways, including selling his bakery and buying a separate grocery store "in order that he gain experience in the grocery business").

[59] Interesting enough, the report of Hoffman v. Red Owl state that "[a]fter three months of operating this Wautoma store, the Red Owl representatives came in and took inventory and checked the operations and found the store was operating at a profit." (133 N.W.2d 267, 269 (Wis. 1965)). *See also* Juliet P. Kostritsky, *When should Contract Law Supply a Liability Rule or Term?: Framing a Principle of Unification for Contracts*, 32 ARIZ. ST. L.J. 1283, 1322 (2000) ("The franchisee's acquisition and operation of a small grocery store provided invaluable information in advance about his potential for success in a business enterprise, information that the franchisor would probably be unable to obtain in any other manner"); Jason Scott Johnston, *Communication and Courtship: Cheap Talk Economics and the Law Of Contract Formation*, 85 VA. L. REV. 385, 498 ("pre-trade reliance is (as…was in Hoffman) undertaken not primarily to enhance the value of an expected trade but to determine whether trade will be mutually beneficial"); Robert E. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, 103 COLUM. L. REV. 1641, 1683 (using Hoffman as an example for a case in which "the parties may be learning about each other's competence").

[60] See, e.g Johnston, *ibid*, at 498 (suggesting that "what Red Owl learned was that Hoffman wasn't a good enough manager to operate a large grocery store, and, late in the negotiations, that he had only limited capital and would need his father-in-law as a partner in order to raise sufficient funds").

[61] Compare between Schwartz & Scott, *supra* note 32 ("[*Hoffman]* is an outlier; the case has not been followed in its own or other jurisdictions"); Randy E. Barnett & Mary E. Becker, *Beyond Reliance: Promissory Estoppel, Contract Formalities, and Misrepresentations*, 15 HOFSTRA L. REV. 443, 491 (1987) ("*Hoffman* is the first of a small but continuing line of cases in which courts have used promissory estoppel to afford a remedy for negligent promissory misrepresentation"); Johnston, *ibid*, at 496 ("Some commentators have stated that Hoffman has not often been followed…This is, I think, no longer correct.") and Gregory M. Duhl, *Red Owl's Legacy*, 87 MARQ. L. REV. 297 (2003) (stating that "Red Owl has

strong hold. The general convention within franchise law is that potential franchisees are entitled to reimbursement of their reasonable reliance costs, if extensive negotiation efforts fail due to the franchisor unwillingness to consummate the deal.[62] Similar rulings can be found in related contexts, such as negotiations between a manufacturer and potential dealer[63] or supplier.[64]

The law and economics literature has usually embraced this rule as one that promotes efficient investment in pre-contractual reliance.[65] According to the prevailing reading of the case, Red Owl tried to opportunistically increase the capital it required from the Hoffmans, based on its assessment that they would be forced to accept these new terms after their investment was already "sunk." Arguably, anticipating such a prospect, future franchisees would under-invest; therefore legal intervention is required to rectify this inefficiency.[66] *Hoffman v. Red Owl* is thus viewed as a model demonstration of a case in which the party that invests in acquiring information has no ability to reap the full benefit of its investment, because any knowledge that it acquires is inevitably shared with the other party. The theory predicts that such conditions are sure to produce under-investment in information gathering, unless some sort of a reimbursement requirement is introduced. The courts recognition of such a duty, via the law of promissory estoppel, is thus viewed as a welcomed extension of the doctrine, facilitating efficient investment in information gathering during the pre-contractual stage.

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exerted a pervasive influence on contract law", but adding that "[t]he real tragedy of Red Owl is that even courts in Wisconsin have limited the potential reach of Red Owl and the promissory estoppel doctrine").

[62] *See, e.g*., Goodman v. Dicker, 83 U.S. App. D.C. 353 (1948); Chrysler Corp. v. Quimby, 144 A.2d 143 (1958); Midwest Energy Inc. v. Orion Food Systems Inc., 14 S.W.3d 154 (Mo. App. E.D. 2000); Duhl, *ibid,* at pp. 305-307 ("Red Owl has been central to franchise law for nearly forty years"); Farnsworth, *supra* note 32, at 236-237; Paul T. Wangerin, *Damages for Reliance Across the Spectrum of Law: Of Blind Men and Legal Elephants,* 72 IOWA L. REV. 47, 55-58 (1986) (explaining both *Goodman* and *Hoffman* as "a routine application of a somewhat obscure principle in the common law of agency").

[63] *See, e.g*., Walters v. Marathon Oil Co., 642 F.2d 1098 (7th Cir. 1981) (negotiation between an oil company and a gas station).

[64] Werner v. Xerox Corp. 732 F. 2d 580 (7th cir. 1984).

[65] *See* Johnston, *supra* note 11, at 1934 ("economic analysts of contract law came to view *Hoffman* as exemplifying the other side of the reliance problem: the specter of inefficient underreliance"); Katz, *supra* note 12, at 1299-1300 ("optimal precontractual reliance, then, will ordinarily require holding the franchisor liable for precontractual representations and offers"). For a different view see Schwartz & Scott, *supra* note 32 (arguing that a preliminary agreement should be essential for imposing liability).

[66] *See, e.g.,* Bebchuk & Ben-Shahar, *supra* note 12, at 404; Katz, *supra* note 12, at 1255.

III. REEVALUATING THE INCENTIVES TO INVEST IN INFORMATION GATHERING

A. THE COMPETITION-BASED MOTIVATION

The underlying premise of the existing economic theory is that a party's exclusive motivation to invest resources in acquiring information is its expectation to extract the benefit (added-value) that the investment will generate. However, parties may well invest in acquiring information on the basis of another motivation—their expectation to gain an advantage vis-à-vis their competitors (competition-based motivation).

An uninformed bidder only offers a price that represents the expected value of the relevant type of assets. If other bidders submit their bids on the basis of private information they acquired, the uninformed bidder cannot expect to win the competition for assets whose value is higher than average. As a result, the uninformed bidder will lower her assessment of the expected value of assets and will offer an even lower price, until eventually she will end up competing only for assts of the lowest value. Investing in acquiring information may thus provide more business opportunities for the bidder and can eventually make her better off.

Consider, for instance, the paradigmatic case of a would-be purchaser who invests in gathering information about the value of an asset. Assume that the current market price of the asset (say a cow), given the available information (the cow is probably barren), is $100; while, the potential buyer has found that the "correct" market value of the asset, given some private information she possesses, (the cow is fertile) should be $130. The argument of the existing economic theory against requiring the buyer to disclose positive information about the asset to the seller is based on the assumption that the disclosure will increase the price that the buyer will have to pay (for instance, to $120),[67] and would thus considerably dilute the buyer's *ex-ante* incentive to invest resources in acquiring such information (in our example, from $30 to $10).[68] While the first part of this prediction, the price increase, seems plausible, we suggest that the second part, a substantial dilution of the incentives to invest, is uncertain.

[67] The price may not fully reflect the new information (*i.e.*, may not rise to $130) if the seller can observe the information only partially or if he faces difficulties in reliably conveying the data to alternative buyers.
[68] According to the conventional wisdom, we should proceed by asking whether the information, which is clearly of social value, was acquired deliberately (or, if we prefer rule utilitarianism, whether this kind of information is usually achieved by deliberate effort). *See* COOTER & ULEN, *supra* note 8, at 248.

Presumably, a buyer who purchases an asset for its market price, without specific information as to whether the asset's actual value is higher or lower, extracts some "normal profit" from the transaction, which is some fraction of the surplus that the deal generates (say a $20 fee per each cow).[69] In the typical case, several would-be buyers compete over this "normal profit." A person who discovers that the asset's actual value exceeds its current market price is able to submit a higher price offer ($120 in our example) and thus to significantly increase her chances of purchasing the asset and extracting both the "normal profit" ($20) and part of the added-value that the information revealed ($10). The competition between potential buyers and the existence of some "normal profit" from the transaction provide an important motivation to invest in acquiring information. Thus, the prospect that the buyer will be required to pay for the asset a higher price as a result of disclosing the positive information about the asset to the seller does not necessarily discourage the buyer from investing in acquiring information.

The benefit that a bidder gains from collecting information can thus be divided into two categories: (1) an advantage gained vis-à-vis *the seller*, resulting from holding private information (extracting the contractual surplus that the investment generates); (2) the advantage gained vis-à-vis *competing purchasers* due to the opportunity to submit a better price offer (extracting the "normal profit" of the transaction). Disclosing the information to the seller undermines the first benefit, but not necessarily the second. Quite the contrary, if the seller cannot convey the information to the bidder's competitors, disclosing the information to the seller may give the bidder a competitive advantage, which may counteract the effect of losing the first benefit. Thus, whereas according to the existing theory it would be a disincentive to investment in research if the informed bidder has to pay a higher price whenever her investment yields positive information about the asset, taking into account the competition-based motivation reveals that this prospect provides an incentive to invest since it increases the bidder's likelihood of purchasing the asset.

The importance of competition-based motivation is well known in a related field—intellectual property rights. Innovators invest in R&D since their major motivation is the

[69] We use the term "normal profit" to indicate the buyer's surplus above the cost of performance, assuming the buyer would *not* acquire the information. Notice, that the fact that there is a "normal profit" in a given transaction does not mean that players that operate in that market are making net profits. In order to gain the "normal profit" players may decide to invest in acquiring information, and if they do so their net profits would be much lower than the sum of "normal profits" that they extract.

competitive advantage that the innovation is expected to provide them.[70] For instance, Ford is motivated to invest billions of dollars in R&D notwithstanding that it will not be able to extract from its customers all (or even a substantial portion of) the value that consumers will derive from Ford's investment in developing better automobiles. Ford invests in R&D on the basis of its assessment that it will increase the likelihood that potential customers will purchase its automobiles rather than those of competing firms, and will thus enable Ford to extract "normal profit" from such transactions. We suggest that this rationale also applies in the context of pre-contractual investment in information gathering.

The incentives that competition-based motivation provides do not necessarily induce optimal investment in acquiring information. An investment is socially desirable if it is expected to generate a contractual surplus that exceeds its costs. However, from the investing party's perspective, the competition-based benefit that the investment yields is its effect on the investor's likelihood of extracting the "normal profit." As a result, the amount of pre-contractual investment in gathering information may be lower, equal to, or even higher than the socially optimal one. The following Sections delineate the two main factors that determine the extent of the competition-based motivation to invest: (1) the effect of acquiring information on the likelihood of winning the contract; and (2) the amount of "normal profit" that the purchaser extracts from contracting compared to that of the optimal pre-contractual investment.

B. INVESTMENT'S EFFECT ON THE LIKELIHOOD OF WINNING A CONTRACT

The competitive benefit that a bidder gains from acquiring information is the ability to outbid the market whenever she discovers positive information about the asset's actual value. Thus the competition-based motivation to invest in collecting information is determined by the ability to use the information to submit a better offer to the seller without disclosing the information to other potential bidders. Clearly, if other bidders can infer the acquired information from the price offer and likewise adjust their price offers, the competition-based motivation is diluted.

As a general matter, competition-based motivation to invest in acquiring information is negatively correlated with the degree to which the information is expected to leak to competitors before a contract is formed. Bids can be observed by competitors when they are submitted

[70] *See, e.g.*, Hirshleifer, *supra* note 7; Ted Hagelin, *Competitive Advantage Valuation of Intellectual Property Assets: A New Tool for IP Managers*, 44 J.L. & TECH. 79 (2003) (provides a detailed description of a new method to value intellectual property assets—Competitive Advantage Valuation).

publicly, as in the case of a tender offer; in such circumstances bidders can infer acquired information by observing competing price offers. In other cases, the seller can inform potential purchasers about the price offers that were submitted by other bidders. If a bidder who invests in research is required to disclose information she gathers to the seller, the seller may even convey the positive information to the bidder's competitors to raise the bidding.

Nevertheless, it seems that typically, the flow of information to competitors is only partial. In many cases inferring information about the asset's value from a price offer is imperfect. A price offer is often based on the offeror's subjective evaluations of relevant factors, her expected uses of the asset, her time preferences and risk aversion, and other subjective factors. Thus, the possibility of inferring "hard" facts from a price offer is rather limited. In addition, information coming from the seller himself (*e.g.*, reports about high price offers from third parties) may not be fully reliable, given the seller's private interest in distributing "cheap talk," optimistic assessments about the value of the asset. Indeed, a standard assumption in the economic literature about the employment sector is that a worker's productivity can only be observed by the worker and the current employer, but not by third parties.[71] Actually, it is reasonable to predict that the types of information that potential buyers collect have relatively high costs of verifiability, and thus could not be easily relayed by the seller. In contrast, information that could be reliably communicated by the seller would be efficiently (or even excessively) collected by the seller and distributed to the competing buyers.[72] Furthermore, given the limited effectiveness of spreading non-verifiable information, the seller may have an interest, from an *ex-ante* perspective, to credibly commit not to distribute information between competing buyers (for instance, by conducting a seal-bid auction), to induce them to efficiently invest in acquiring information.

Moreover, even if the seller can reliably reveal the information to competing potential buyers, the bidder may still gain an advantage by investing in research, if by submitting the first

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[71] *See, e.g.*, Chun Chang & Yijiang, *A Framework for understanding Differences in Labor Turnover and Human Capital Investment*, 28 J. ECON. BEHAVIOR & ORG. 91, 94 (1995).

[72] *See, e.g.,* Shavell, *supra* note 1, at 21, 34 (sellers have sufficient incentives to collect information that they can credibly reveal but insufficient incentives to collect information that cannot be credibly conveyed by them). A fundamental result from auction theory is that the public release of information regarding the valuation of an object can intensify competition among bidders by making values more predictable and can also lower the relative value of a bidder's own private information thus reducing his rents. *See, e.g.*, Paul R. Milgrom & Robert J. Weber, *A Theory of Auctions and Competitive Bidding*, 50 ECONOMETRICA, 1089 (1982); Colin M. Campbell & Dan Levin, *Can the seller benefit from an insider in common value auctions?*, 91 J. ECON. THEORY 106 (2000); Jacob K. Goeree & Theo Offerman, *Competitive Bidding in Auctions with Private and Common Values*, 113 ECON. J. 598 (2003).

price offer it gains a competitive edge. Presumably, the seller would have to invest resources in seeking new offers, as well as reliably convey the newly discovered positive information. As a result, a potential buyer who invested in acquiring information can substantially increase her likelihood of winning the contract by submitting a high enough price offer, that would make it unprofitable to the seller to conduct "bid shopping."[73]

To sum up, the strength of the competition-based motivation depends on the ability to conceal information from *rivals* (other buyers) and not on the right to hide it from one's potential *partner* (the seller). When a relatively high portion of the information effects competitors' valuations as well and can be expected to leak to them, the information is non-exclusionary ("common pool" problem). In that case, under-investment can be expected since each of the potential buyers can benefit from the information regardless of their contribution to its discovery. In contrast, when the information is "subjective" (*i.e.* it effects only the investor's valuation) or when the flow of information to competitors is partial or costly, the party who invests in research may foresee enough benefit from competition-based advantage to invest in acquiring information, even if the bidder is compelled (whether in fact or by law) to share this information with the seller.

C. The Amount of "Normal Profit" in the Market

The second factor that determines the extent of competition-based motivation is the amount of "normal profit" that the investing party expects to achieve from winning the contract. As indicated, "normal profit" received by the investing party is distinct from the surplus generated by its pre-contractual investment. The reward under consideration is the buyer's earnings from consummating deals in the specific market, independent of the information that the investment in research may produce. In other words, "normal profit" is the revenue that a seller would gain in that market, absent any informational advantage over the seller or other potential buyers.

"Normal profit" resulting from a contract can be generated by any mechanism that ensures that actors in the given market cover not only their variable costs of performing the contract but

[73] *See* Ofer Grosskopf & Barak Medina, *Rationalizing* Drennan*: On Irrevocable Offers, Bid Shopping and Binding Range*, WORKING PAPER (2006) (demonstrating that search and transaction costs for bid shopping form a self-enforced "binding range," *i.e.*, a set of market prices in which the offeree is practically (even if not legally) bound to use the offer on which he relied upon, which enables the offeror to extract some profits).

also their fixed and "sunk" costs (including the opportunity cost of not switching to another market).[74] This outcome can be achieved through various mechanisms, such as regulatory intervention (*e.g.*, minimum wage laws), imperfect competition (*e.g.*, tacit collusion between a limited number of repeating players),[75] limited market entry (*e.g.*, the number of bidders that participate in an auction)[76] or bounded rationality (the tendency to irrationally account for sunk costs).[77] Indeed, several surveys of pricing practices reveal that most firms treat fixed and "sunk" costs as relevant for pricing decisions.[78] If these studies are accurate, we must conclude that, at least in the surveyed sectors, the market price exceeds variable costs, such that agreements include some positive reward ("normal profit").

As indicated, competition-based motivation encourages investments that are aimed at increasing the likelihood of capturing the "normal profit" in the relevant market. The private interest to invest then is not based on the expected surplus created by the information gained (its

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[74] For an extensive analysis *see* Ofer Grosskopf & Barak Medina. *Regulating Contract Formation: Precontractual Reliance, Sunk Costs, and Market Structure* 39 *Conn. L. Rev.* __ (2007) (analyzing different mechanisms that may generate sufficient compensation for investments in pre-contractual reliance and fixed costs).

[75] When dealers repeatedly interact, tacit collusion that results in a price that compensates them for their precontractual reliance can be sustained. This occurs if the gains that each dealer derives from continued cooperation—i.e., from offering a price that would enable her to cover all her costs including pre-contractual ones—outweigh the gains from undercutting to grab more deals—i.e., offering a higher price, that would not enable her to cover her "sunk costs." For a general presentation of the concept of tacit collusion, *see* JEAN TIROLE, THE THEORY OF INDUSTRIAL ORGANIZATION (1988), ch. 6.

[76] *See, e.g.,* Kenneth R. French & Robert E. McCormick, *Sealed Bids, Sunk Costs and the Process of Competition*, 57 J. BUS. 417 (1984) (with a finite number of bidders, each bidder will offer more than she thinks her variable costs will be, leaving some expected profit for the winner that will cover her pre-contractual costs).

[77] *See, e.g.*, Hal R. Arkes & Catherine Blumer, *The Psychology of Sunk Cost*, 35 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 124 (1985); Oswald Huber & Gabriele Seiser, *Accounting and Convincing: The Effect of Two Types of Justification on the Decision Process*, 14 J. BEHAV. DECISION MAKING 69, 70 (2001) (reporting on continuous commitment to the "sunk cost effect" even when decision makers have to justify their choice); Itamar Simonson & Peter Nye, *The Effect of Accountability on Susceptibility to Decision Errors*, 51 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 416, 440 (1992).

[78] Vijay Govindarajan, & Robert Anthony, *How Firms Use Cost Data in Pricing Decisions*, 1983 MANAGEMENT ACCOUNTING (July) 30 (82% of the 505 Fortune 1000 companies surveyed used full cost pricing); Eun Sup Shim & Ephraim Sudit, *How Manufacturers Price Products*, 2/1994 MANAGEMENT ACCOUNTING 37 (70% of the 141 companies surveyed used full cost-based pricing); MICHAEL W. MAHER, CLYDE R. STICKNEY, & ROMAN L. WEIL, MANAGERIAL ACCOUNTING 258 (8th ed., 2004) ("Overwhelmingly, companies around the globe use full costs rather than variable costs" in their pricing decision); CHARLES T. HORNGREN, SRIKANT M. DATAR, & GEORGE M. FOSTER, COST ACCOUNTING 427-40 (9th ed., 2000) (reporting on surveys in which a majority of managers in the United States, the United Kingdom, and Australia take fixed and sunk costs into account in pricing).

"added-value") but rather on its effect on the likelihood that the investing party will extract a "normal profit." Thus, the incentive of generating "normal profit" motivates parties to invest only in information gatherings that will cost less than this profit. More expensive investments—which may very well be cost-effective ones in terms of the contractual surplus they generate—can only be encouraged by granting the investing party the full benefits that the research generates or through reimbursement provisions.

Similarly, competition-based motivation supports only investments whose a-priori likelihood of revealing positive information about the asset's value is substantial. As indicated, the motivation to invest is based on the prospect that the investing party will reveal some positive information, and thus enable her to submit a higher price offer that will increase her likelihood of purchasing the asset and extracting "normal profit." Therefore, the competition-based motivation may be insufficient in cases of investments that are only rarely expected to yield positive information. Such investments may be socially desirable (for instance, since they may reveal that the value of the asset is very high). In these cases, legal protection will be required to provide sufficient incentives to invest.

For illustration, consider the case of an investment in acquiring information about the value of a piece of land. Certain types of investments are clearly cost-effective to the buyer—these are investments that cost much less than the value of the acquired information, and that have a reasonable likelihood of revealing some positive information about the land's value. Examples are inquires about development plans of the area or about possible uses of the land. Competition-based motivation may well be sufficient to induce optimal investments in such inquiries. Since competition-based motivation is enough to generate these investments in research, we argue against the common support of non-disclosure rights. Imposing a disclosure duty on the buyer will not stall its research as long as the information is disclosed to the seller and not directly to the competing bidders. In contrast, in cases when the research is expensive and there is only a marginal likelihood of discovering some positive information about the land's value (for example, the search for oil or other minerals in the land), the concern of under-investment is substantial. Bidders cannot be expected to make such an investment simply for the benefit of extracting "normal profit" from the land transaction.

More generally, in a competitive market one can expect the formation of a stable equilibrium, in which "normal profits" support investment in a certain level of "conventional" information gathering for the given market. If "normal profits" are lower than each player's average investment per contract, than either the "conventional" level of investment in information gathering in that market will decrease, or some dealers who operate in the market will lose money, and they will be induced to leave the market.[79] Consequently, the "conventional" level of information gathering will decrease or the "normal profit" will increase (for instance, since the remaining dealers will then possess greater market power) until the market price fully covers the operation costs of the dealers who remain in the market. In equilibrium, players are motivated to invest in such inquires as the "conventional" level dictates in order to secure a reasonable likelihood of purchasing goods that are offered for sale. However, they will avoid excessive investments ("exceptional" ones) since although such investments may increase their rate of success, "normal profit" provided insufficient compensation.[80]

IV. IMPLEMENTING THE REVISED WISDOM

Incorporating the competition-based motivation into the economic theory entails that a more nuanced approach is required in assessing the appropriate scope of protections provided to negotiators who invest in gathering information. The basic premise is that competition-based motivation may well provide sufficient incentives to invest, such that protecting the investing party's interests is not necessary in order to induce efficient information-gathering. The required assessment should thus focus on the scope of the competition-based motivation in different contexts. Rather than conducting a detailed, case-specific analysis, we offer here some general observations, along the two dimensions discussed above—the extent of leak of information to competitors, and the distinction between "conventional" and "exceptional" investments.

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[79] There is extensive economic literature that analyzes the characteristics of the dealers who are expected to exit the market in such cases. See, e.g., Paolo G. Garella & Yves Richelle, *Exit, Sunk Costs and the Selection of Firms*, 13 ECONOMIC THEORY 643 (1999).

[80] The above argument supports the claim that a given "normal profit" generates, through the competition-based motivation, a certain level of "conventional" investments in gathering information. Yet, it does not indicate that this "conventional" level is also the socially efficient level of investment. Indeed, the "conventional" level of investment in gathering information may be deficient, adequate or excessive, depending on the size of the "normal profit" in the given market. Consequently, in some markets "exceptional" investments in information gathering will always be inefficient (markets that induce an adequate or excessive level of "conventional" investment), but in other markets some of them may be efficient (markets that induce a deficient level of "conventional" investment).

A. EXCLUSIVITY OF ACQUIRED INFORMATION

As indicated, competition-based motivation provides a potential buyer with incentives to invest in acquiring information to the extent that the investment generates sufficient competitive advantage. Thus, it is important to assess the scope of the exclusivity of use of the acquired information vis-à-vis competing potential buyers. We must evaluate the portion of the acquired information that can be expected to leak to competitors and at what cost.

One relevant factor in this respect is whether a price offer submitted by an informed bidder is made public. When the bidder is required to make her offer public, the concern arises that competitors will be able to infer the acquired information. In contrast, when the price offer is submitted only to the seller, the risk of leak of information is less significant, due to verifiability costs. A second important factor is the ability to deduce from the price offer what positive facts have been discovered about the asset's value. The relevant assessment in this respect is the scope of "subjective" elements that may affect the informed bidder's evaluation. Inference is less reliable when the asset may have diverse uses or when it does not have a well defined market price.

These elements can justify a distinction between the legal rules that apply to negotiation of sale transactions and those that govern tender offers. In the former case, there is good reason to assume that the flow of information from one potential buyer to her competitors is rather limited. Buyers are not required to make their offers public, and offers may even be submitted through a seal-bid process. The seller may convey to other buyers information about price offers that he receives and relevant facts that the he learns from the bidder, but such information is typically costly to verify. In addition, buyers' evaluations of the asset may be based on subjective elements, especially when the asset can be used for different purposes (*e.g.* consumption or financial investment). As a result, it seems that as a general matter, competition-based motivation may well provide substantial incentives to invest in acquiring information about most assets (land, movables etc.).

In contrast, in the case of tender offers, the concern that information will leak to competitors seems much more substantial. As elaborated above,[81] tender offers are made public, as well as the fundamental information on which the offer is based. Given that the markets for shares are well

[81] *See supra* note 36 and accompanying text.

organized, it is relatively easy to observe a tender offer, and infer a large part of the information that it represents. Furthermore, the subjective elements in evaluating firms are less accentuated in this case, since shares are typically purchased as a financial investment, and since the bidder is required to provide information concerning her intentions and future plans.

Therefore, accounting for the limited nature of competition-based motivation in the case of tender offers, it is justified to expect under-investment, and therefore it may be necessary to support the use of break-up fees as a means to provide incentive to invest.[82] Still the remaining competition-based motivation, however limited, casts doubts on the view that buyers should be exempt from the duty to disclose to the seller any positive information acquired about the asset. The competitive advantage may provide substantial motivation to invest, even if the buyer cannot expect to extract the entire benefit generated by her investment due to the imposition a disclosure duty.

These considerations also reveal that the concern of under-investment in the context of franchise agreements is unsubstantiated. The pre-contractual investment of the potential franchisee in training enables the franchisor to collect information about the potential franchisee's competence. Thus, when the pre-contractual investment generates positive information about the franchisee, it increases the likelihood that a contract will be formed. Here there is no substantial risk of leak of information to competitors, since the information that the investment generates is mostly about the specific franchisee's characteristics, which has no value to competing potential franchisees. Indeed, as we argue below (Section IV.C), in the case of a franchise, the main concern must be over-investment in pre-contractual reliance.

B. Compensation for Pre-Contractual Investment through the Market's "Normal Profit"

As discussed above, competition-based motivation is positively correlated to the amount of "normal profit" in a given market. Hence, the amount of "normal profit" in each relevant market should be evaluated when considering the appropriate scope of legal protection to pre-contractual investments in information gathering. Concurrently, one should distinguish between different

[82] Naturally, this is only a preliminary appraisal and not a final conclusion. One might argue, for example, that although acquirers are required to make most of the information they collect public, friendly acquirers still gain a considerable competitive advantage by submitting tender-offers due to the existence of a large binding range. Compare *supra* note 73 and accompanying text.

types of investments in information-gathering; a given amount of "normal profit" should provide sufficient incentives to make certain types of investments ("conventional" ones) but not others ("exceptional" investments). The economic reasoning justifies exempting parties from disclosing socially valuable information that was acquired as a result of "exceptional" investments but not information that was acquired by "conventional" investment.[83]

For illustration, assume that a painting is offered for sale, and it is highly probable that its value is $1,000. There is however a remote chance that the painting is an original painting of an important artist. Assume that the owner of the painting is unaware of its actual value, and he is willing to sell it to a professional art dealer for $1,000. The dealer recognizes that the painting is an original Picasso, worth millions. Must the buyer inform the seller of the actual value of the painting?[84] If the purchaser's superior knowledge results from an art dealer's conventional activity, a nondisclosure rule is not needed to facilitate sufficient incentives to invest in this case. The dealer is sufficiently motivated through the prospect of extracting the "normal profit" in the art market to invest the amount necessary for a "conventional" appraisal of the painting. The opposite is true in the case of information gathered as a result of unique and exceptional investment—such as investing in hiring a specialist in the work of a certain painter or in retrieving lost paintings. Given that there is only a marginal probability that the inquiry will reveal positive information about the value of the painting, the "normal profit" in the art market is not high enough to compensate the dealer for such investments. If it is socially desirable that such inquires are made at the pre-contractual stage, the law must secure for the dealer the added value generated by the investment (or to require the seller to reimburse the dealer for its investment) in order to motivate her to make such investments.

An additional example can be drawn from the case of *Venture Assocs. v. Zenith Data Sys*.[85] The parties privately negotiated for several months based on the statement of the defendant, ZDS, that it was willing to sell its subsidiary for $11 million. Negotiations failed after ZDS raised the

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[83] Notice that both types of information were "deliberately" acquired, and thus should receive protection according to the conventional wisdom.

[84] Such a case was discussed in Estate of Nelson v. Rice, 12 P.3d 238 (Ariz., 2000), but the court accepted the purchaser's factual argument that he was not aware of the picture's actual value, and thus rejected the seller's claim to rescind the transaction. In France, litigation in a case similar to our hypothetical one ended after 15 years in a judgment in favor of the seller. For details about this long litigation, see BERNARD RUDDEN, A SOURCE-BOOK ON FRENCH LAW 331-332 (3rd ed., 1991); Hoffman F. Fuller, *Mistake and Error in the Law of Contracts*, 33 EMORY L.J. 41, 88 (1984).

[85] 96 F.3d 275 (7th Cir. 1996).

price to $14 million. The court rejected Venture's argument that ZDS acted in bad faith and should thus reimburse it from its pre-contractual investments. Judge Posner explained: "Not having locked itself into the $11 million price, ZDS was free to demand as high a price as it thought the market would bear, provided that it was not trying to scuttle the deal...or to take advantage of costs sunk by Venture in the negotiating process."[86] The facts in this case indicate that Venture was a repeating player in the relevant market of private acquisitions. As such, the market price is expected to compensate Venture for its investment through "normal profit," and thus to motivate it to make such investments.[87] Given this competitive incentive to invest, legal intervention was indeed unwarranted.

C. EXCESSIVE INVESTMENT

Taking competition-based motivation into account reveals that in certain cases the actual concern should not be under-investment but excessive funding for collecting information. Consider the cases of an employer or franchisor who negotiates with several job candidates or potential franchisees, respectively. Each of the job candidates or potential franchisees is required to invest, at the negotiations stage, in acquiring relationship-specific knowledge (*e.g.*, to participate in an un-paid training period or to pay for the air fair to an interview). These investments are valuable to the employer or the franchisor, since they serve, primarily, as a screening device that enables it to choose the best worker or franchisee.[88] A rational job candidate or potential franchisee will enter the negotiation process only if she expects that the "normal profit" will be sufficient to compensate her for her investment, given her likelihood of success. However, the employer or the franchisor has an interest in encouraging excessive participation in the negotiation process. He can induce job candidates or potential franchisees to enter the negotiation and to invest in acquiring relationship specific knowledge by convincing them that their likelihood of success is greater than they perceive. For example, if potential employees are inexperienced and tend to take optimistic statements by potential employers at face value, employers might use such "cheap talk" to encourage participation in their recruitment procedures.

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[86] *Ibid*, at 279-280.
[87] A private offer to acquire a fully owned subsidiary does not seem to have the unique characteristics that make tender offers different from regular sale contracts. See *supra* Section IV.A.
[88] *See* Section II.C *supra*.

The case of *Hoffman v. Red Owl Stores*[89] can serve to illustrate this problem. As indicated above, the conventional reading of this case in the law and economics literature is as an example of the law's concern with the danger of *under-investment* in gathering information due to holdup problems.[90] We, in contrast, view *Hoffman v. Red Owl* as demonstrating the problem of *over-investment*. The Hoffmans' pre-contractual reliance would create value for the Hoffmans only if a franchise agreement was formed. Therefore, the assessment of the efficiency of this early investment must be calculated based on the risk that a contract will not be reached. It seems that the couple, being inexperienced and naive, were not fully aware of this risk, whereas Red Owl, as an experienced repeating player, was (or should have been) conscious of it. However, Red Owl did not have sufficient incentives to account for this risk because it did not bear the costs of wasted investment in acquiring relationship specific knowledge, and because it could rely on the Hoffmans to invest well above what was needed, given the couple's partial information set.[91] The Hoffmans' excessive investment was valuable to Red Owl mainly as a screening device. In such cases, the main concern of the law should be preventing franchisers from encouraging would-be franchisees to over-invest.

Preventing excessive investment in information-gathering creates a new dilemma for law makers. On the one hand, it is clearly not viable to directly prevent the "naïve" and uninformed party (*e.g*., job candidates or potential franchisees) from spending money on collecting information prior to contracting. Similarly problematic, regulating "cheap-talk" of experienced party (*e.g.* the employer or the franchisor) is costly to enforce, and may lead to inefficiencies.[92] Given this dilemma the best solution may be to switch the costs of gathering information to the experienced party. Such an intervention would provide the experienced party with incentives to efficiently regulate the amount of research and training done by the inexperienced party. We suggest that this is exactly what the court did in *Hoffman v. Red Owl.* Holding Red Owl

[89] 133 N.W.2d 267 (Wis. 1965).
[90] *See supra* note 65.
[91] Compare Thomas M. Scanlon, *Promises and Contracts, in* THE THEORY OF CONTRACT LAW (Peter Benson ed., Cambridge University Press, 2001) 86, 103 ("Red Owl was required to compensate Hoffman for losses resulting from actions that they knew he was taking in the expectation, which they knew to be unrealistic, that he was going to get a Red Owl franchise…"); Duhl, *supra* note 61, at 306 ("The court in *Red* Owl recognized that franchisors could abuse their bargaining power without risk to themselves and provided a mechanism in promissory estoppel to induce franchisors to live up to their precontractual assurances and representations").
[92] *See* Johnston, *supra* note 59 (highlighting the costs of limiting "cheap talk" by over-regulation of the negotiation stage).

responsible for reimbursing the Hoffmans for their reliance costs shifted the pre-contractual costs to the informed party. Consequently, the informed party internalizes the risk of unwarranted investment, and is thus motivated to prevent over-investment by would-be franchisees such as the Hoffmans.

CONCLUDING REMARKS

Reaching an efficient level of investment in gathering information during the pre-contractual stage is problematic for two reasons: *first,* like any investment in information, it is susceptible to the risk of appropriation by competitors that would free-ride on the investor's efforts; *Second*, like any investment in the pre-contractual stage, it is vulnerable to hold-up attempts by the other negotiating party.

In one of his most important contribution to economic theory, the late Jack Hirshleifer demonstrated, with respect to the investment in discovering new technological knowledge, that the *first* market failure—the free-rider problem—need not concern us since access to superior information is expected to provide due private value. In the prologue to his celebrated paper, Hirshleifer described his project as follows:

> The traditional position has been that the excess of the social over the private value of new technological knowledge leads to underinvestment in inventive activity. The main reason is that information, viewed as a product, is only imperfectly appropriable by its discoverer. But this paper will show that there is a hitherto unrecognized force operating in the opposite direction. What has been scarcely appreciated in the literature, if recognized at all, is the *distributive* aspect of access to superior information. It will be seen below how this advantage provides a motivation for the private acquisition and dissemination of technological information that quite apart from—and may even exist in the absence of—any social usefulness of the information.[93]

Our project follows basically the same idea, but with respect to the *second* market failure—the hold-up problem. We demonstrated that the existing literature had failed to take into account the private value of acquiring information—in our case the competitive advantage that holding superior information might provide. Accounting for this private value (the competitive-based motivation) can substantially change both the way we evaluate the adequacy of the incentives to

[93] Hirshleifer, *supra* note 7, at 561.

invest in gathering information, and the method by which we shape the legal norms that affect them. Eventually, it might even show that in most cases we actually have good reasons to know what we need to know.