The Design of Staged Contracting

Albert Choi and George Triantis*

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Abstract

In negotiating complex business transactions, parties decide whether, when and how to invite legal enforcement of the rules that govern their relationships, particularly in their use of intermediate agreements that reflect some agreement on a number of provisions but contemplate further negotiation (variously labelled memorandum of understanding, agreement in principle, letter of intent, term sheet). Under the common law of most U.S. jurisdictions, the parties have an intermediate option between enforcement and no-enforcement of such intermediate agreements: a duty to bargain or negotiate in good faith or with best efforts. Law firms warn their clients about the risk of inadvertently bringing on this type of enforcement but with care, this risk is small. Rather, the parties are often unclear about the freedom they prefer for themselves or their counterparties to deviate from the terms of their intermediate agreements. They expect these terms to be sticky to some degree, but do not think through how much and by what means to achieve this. Judges and commentators identify the protection of specific investments as the principal goal of the commitment to bargain or negotiate. We suggest, however, that the benefit of the flexible standard of good faith or best efforts comes more broadly from mid-stream regulation of the negotiation process. The parties need flexibility in optimizing their deal, while also efficiently constraining value-claiming behavior and allocating exogenous risks during their negotiations. Building on our earlier work on strategic ambiguity, we also show that concerns about the uncertainty of such flexible standards can be addressed.

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*University of Virginia Law School and Stanford Law School, respectively. Acknowledgements to be added. Comments are welcome to albert.choi@virginia.edu and gtriantis@law.stanford.edu.

Introduction

Contract formation in commercial transactions can be a time-consuming and complex process involving multiple stages and players, and significant investments in expertise and information. In the design of the process, the parties face a core decision of *whether*—how much and in what respects—to invite legal enforcement of the rules that govern their relationships, and *when* to do so. Complex commercial negotiations are typically sequenced, with a subset of issues being addressed at each stage and by numerous agents with different expertise. The parties frequently enter into intermediate agreements—labelled memoranda of understanding, agreement in principle, letter of intent, term sheet—that reflect some agreement on a number of provisions but contemplate further negotiation of remaining terms, as well as subsequent approvals and formalization of their contract. An important part of designing the negotiation agenda should be the determination of the nature and degree of legal enforcement at this intermediate stage. This question seems essential to the broader decision as to why and how to divide the negotiations into stages.

Commercial actors often do not think through this part of the negotiation agenda, and consequently (consciously or not) leave it to the courts ex post to determine the degree and nature of enforcement that they implicitly intended or would have intended if they had thought about it. Far from giving negotiating parties clear default rules to accept or opt out of, the law remains vague and in flux, even in the business-savvy jurisdictions of New York and Delaware.[1] Law firm client letters and surveys of commercial parties reflect confusion about the legal significance of intermediate agreements. Unless parties explicitly address the impact of their intermediate agreement, they face a risk of legal sanction for failure to complete their negotiations.[2] Law firms warn their clients about this risk and caution them to express clearly their intentions. With care, the legal risk is low. Yet, it appears that the parties are often unclear about the freedom they prefer for themselves or their counterparties to deviate from the terms of their intermediate agreements. They expect these terms to be sticky to some degree, but do not think through how much and by what means to achieve this.

If a court finds that the parties intended to create a binding contract irrespective of further negotiations, then the court would likely fill in the gaps that the parties left for future negotiation with legal default provisions and award the usual measure of expectation damages. Short of such full enforcement, a court may find instead that the parties promised each other to continue negotiating up to some standard, such as good faith or best efforts, and most jurisdictions enforce this promise. The parties may have expressly agreed to do so in their intermediate agreement or the court may otherwise find manifestations of such intent in the language of the document and surrounding context. This raises three fundamental questions at this intermediate level of enforcement. First, how do the courts find the requisite intent for a good faith duty to negotiate, including the weight they give to the presence or absence of an express promise? Second, when

[1] See, e.g., E. Allan Farnsworth, *Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations*, 87 Colum. L. Rev. 217, 259-60 (1987) ("[i]t would be difficult to find a less predictable area of contract law").
[2] Although this does not appear to be a deliberate judicial policy, it might be a plausible middle-ground approach between full and no enforcement. See *infra* notes – and accompanying text.

negotiations break down and one party walks away, what constitutes bad faith? What effort or investment in negotiations is expected from each party? Is one party's insistence on terms that deviate from the intermediate document's provisions bad faith? When do changed circumstances or new information justify a party from terminating negotiations? Third, what is the appropriate remedy for the breach of the good faith duty? Reliance damages are the most common remedy, but injunctive and expectation remedies have been mentioned in narrow set of circumstances. A couple of courts, notably and recently the Delaware Supreme Court in *SIGA Technologies v. PharmAthene*,[3] have held that expectation damages might be awarded when there is sufficient evidence to determine the agreement that would have been entered into but for the breach.

As with most contract law doctrine, the judicial approach is to find manifestation of the parties' intent. Given the fact that intent is often unclear, it is worthwhile to identify and examine the factors that guide parties in the sequencing of negotiations, their memorialization of earlier stages, the constraints they choose to impose on later stages and the means by which those constraints will be enforced. Important scholarly contributions have been made to understanding this process in the fields of economics, law and negotiation, as well as by courts and practitioners, and we seek to build on them. There is a broad consensus on several points. First, the staging of negotiations is often necessary because of the complexity of the transactions. Second, a mid-stream memorialization of agreed-upon terms is valuable because it offers protection for the investments that parties make in the process that could leave them vulnerable to opportunistic hold-up in subsequent stages of negotiation. Third, this protection comes largely from non-legal constraints such as moral suasion, relational and reputational sanctions. Fourth, there is general consensus that parties should be able to opt into regulation of their negotiation through contracts to negotiate in good faith or with best efforts.[4] The law invites the parties to contract for legal enforcement, and it is desirable to give them an option of a middle-ground between no enforcement and full contract enforcement. Legal scholarship has identified a variety of legal approaches that could protect the reasonable reliance investment of the parties: from a simple implied promise to pay the reasonable reliance to a more complicated standard governing negotiations.[5]

This essay suggests several other factors beyond encouraging specific investment and preventing hold-up that could motivate intermediate agreements. First, we suggest that this agreement is a tool for regulating other aspects of the negotiation process by discouraging inefficient value-claiming behavior (in addition to encouraging value creating investment). It is noteworthy in this respect that express promises to negotiate in good faith or use best efforts to negotiate, are often seen in agreements side-by-side with exclusivity promises not to shop an offer or negotiate with any other prospective party before a deadline. Second, a legal standard such as good faith or best efforts is useful to preserve flexibility to adjust to new information and changes in circumstances that alter the optimal deal terms or render the deal inefficient. Third,

[3] *SIGA Technologies, Inc. v. PharmAthene, Inc.*, 132 A.3d 1108 (S.C.Del. 2015).
[4] E.g., Farnsworth, supra note --; Charles L. Knapp, *Enforcing the Contract to Bargain*, 44 N.Y.U.L.Rev. 673 (1969) (arguing in favor of a duty to bargain in order to protect reliance); Leon E. Trakman & Kunal Sharma, *The Binding Force of Agreements to Negotiate in Good Faith*, 73 Cambridge L.J. 598 (2014) (criticizing English courts' reluctance to enforce agreements to negotiate in good faith).
[5] A handful are described infra notes – and accompanying text.

the intermediate agreement can also be a mechanism by which the parties can efficiently allocate some risks of changed circumstances that would affect the distribution of surplus from the deal.

We argue that a contextual standard—whether good faith or reasonable efforts—is well-suited to address this multi-faceted regulation of the negotiation process that parties often wish to invoke. Drawing from prior work on how parties can exploit the benefits of standards and avoid the potential costs of litigation and judicial error, we respond to the concerns of lawyers and scholars about the use of vague standards. The paper is organized as follows. Part I summarizes the relevant common law and judicial policy. As applied by the courts, good faith in negotiations is a standard that is focused on protecting specific investments and imposes some duty of fidelity to the terms settled in the intermediate agreement. Aside of these general observations, there is a widely held view that the judicial approach remains uneven and sometimes incoherent. Part II provides guidelines for the parties design of staged contracting, as well as their use of formal intermediate agreements to give some degree of stability to the terms settled in the early stage and regulate the remainder of their negotiation process. Part III describes the benefit of legal standards such as good faith or best efforts to support the parties' objectives in staged negotiations. A legal standard is likely to yield superior results to either a regime of full contract enforcement or no legal enforcement. The Appendix demonstrates the advantage of a duty to negotiate in good faith for both (ex ante) efficient investment and (ex post) efficient contract terms.

I. The Modern Law of Preliminary Agreements

The modern law in most U.S. jurisdictions is based on a taxonomy of three types of agreements. The first is an agreement to agree which reflects an insufficient meeting of the minds and is not legally enforceable. The second is an agreement with open terms to which the parties intend to be bound, even if the parties contemplate an unrealized formalization of the agreement. This agreement is enforceable and the courts will fill in the missing terms, even price.[6] The third is a contract to negotiate (which is alternatively referred to as a contract to bargain or a type II agreement) in which the parties agree to a course of conduct during negotiations, usually by invoking a standard such as good faith or best (or reasonable) efforts.[7] In addressing these intermediate agreements—whether labelled as MOUs, LOIs, term sheets, or agreements in principle—courts and scholars have gravitated to the middle ground between full and no contract enforcement.[8] Most have converged on a duty to negotiate in good faith[9] but, in

[6] See, e.g., *Brown v. Cara*, 420 F.3d 148 (2d Cir. 2005); *Lippert v. Windsortech, Inc.*, 865 A.2d 1282 (Del. Ch. 2004). If there are open terms, the court can fill the gaps. See, e.g., *Vsoske v. Barwick*, 404 F.2d 495 (2d Cir. 1968); *Berg Agency v. Sleepworld-Willingboro*, 136 N.J. Super. 369 (1975); *Larwin-Southern California v. JGB Ent.*, 101 Cal. App. 3d 626 (1979); *Arnold Palmer Golf Co. v. Fuqua Industries, Inc.*, 541 F. 2d 584 (6th Cir. 1978); and UCC 2-305 (price gap-filler).
[7] Farnsworth, *supra* note --, at 253, 263.
[8] This has been a movement in the U.S. away from the historical common law position that agreements to agree are not binding. *Ridgeway v. Wharton*, 10 Eng. Rep. 1287 (House of Lords 1857) is a classic statement that agreement to agree is not enforceable. For decades contract scholars have been calling for middle ground with good faith standard. E.g., Knapp, supra note --; Farnsworth, supra note --. The modern trend is described in *Keystone Land & Dev. Co. v. Xerox Corp.*, 353 F.3d 1093, 1097 (9th Cir. 2003) and B*urbach Broad Co. of Del. v. Elkins Radio Corp.*, 278 F.3d 401, 408-9 (4th Cir. 2002).
[9] E.g., *Teachers Ins. & Annuity Assoc. of Am. v. Tribune Co.*, 670 F. Supp. 491 (S.D.N.Y. 1987); *Brown v. Cara*, 420 F. 3d 148 (2d Cir. 2005)(NY law); *Venture Assocs. Corp. v. Zenith Data Sys. Corp.*, 96 F.3d 275 (7th Cir. 1996)

contrast to some civil law jurisdictions, this duty must be found in the objective intent of the parties to be bound rather than being triggered simply by the start of negotiations.[10] Allan Farnsworth explained the policy behind the absence of wholesale regulation of negotiation in the U.S. as follows:

> "The difficulty of determining a point in the negotiations at which the obligation of fair dealing arises would create uncertainty. An obligation of fair dealing might have an undesirable chilling effect, discouraging parties from entering into negotiations if chances of success were slight. The obligation might also have an undesirable accelerating effect, increasing the pressure on parties to bring negotiations to a final if hasty conclusion."[11]

These downsides—chilling and acceleration—are avoided when the parties themselves choose when to invite the court to police their negotiations.

Most courts are inclined to enforce clear and express language agreeing to or disclaiming good faith duty. But, sometimes the language is ambiguous or rendered ambiguous by other evidence, including: (a) the parties' intent as revealed in the language of the agreement; (b) the context of the negotiations; (c) the existence of open terms or lack of clarity, particularly essential, material or major terms; (d) the conduct of the parties, including partial performance; and (e) the customary use of formalities in this type of transaction.[12] Even if the parties express their intent to have no binding obligations, extrinsic statements (including internal communications within one party's organization) or conduct may lead the fact finder to hold that the parties intended to have good faith duty. Given the highly fact-dependent nature of the inquiry and the immaturity of the good-faith doctrine in this area, commentators have noted that the case law is characterized by inconsistent results and lawyers warn clients about the consequent traps for the unwary in letters of intent and similar documents.

Although courts are no strangers to standards of good faith or best efforts, commentators have noted that the content of this standard remains unclear.[13] One important factor seems to be fidelity to the terms settled in the intermediate agreement. For example, in *Teachers Ins. & Annuity Assoc. of Am. v. Tribune Co.* (S.D.N.Y. 1987), Judge Leval stated that "parties can bind themselves to a concededly incomplete agreement in the sense that they accept a mutual commitment to negotiate together in good faith in an effort to reach final agreement within the

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(Ill. law); *Newharbor Partners v. F.D. Rich Co.*, 961 F.2d 294 (1st Cir. 1992)(Rhode Island); *Channel Home Ctrs. V. Grossman*, 795 F.2d 291 (3d Cir. 1986)(Pa law); *Copeland v. Basking Robbins*, 117 Cal. Rptr. 2d 875 (Cal. Ct. App. 2002); *SIGA Techs., Inc. v. PharmAthene, Inc.*, 67 A.3d 350 (Del. 2013); *Logan v. D.W. Sivers Co.*, 169 P.3d 1255 (Or. 2007) (en banc). It seems that less than a dozen have yet to enforce agreements to negotiate. [List here]

[10] The good faith and fair dealing in the UCC and Restatement Second does not extend to pre-contract negotiations. See infra note – and accompanying text.

[11] E. Allan Farnsworth, CONTRACTS (4th Ed. 2004) §3.26 at 199.

[12] See *Teachers' Ins. & Annuity*, supra note—at --.

[13] E.g., Farnsworth, *supra* note --; Ronald J. Gilson, Charles F. Sabel and Robert E. Scott, *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice and Doctrine*, 110 Colum. L. Rev. 1377, 1427 (2010)("the courts' experience so far provides little normative guidance concerning the breadth of the enforceable obligation"); Alan Schwartz and Robert E. Scott, *Precontractual Liability and Preliminary Agreements*, 120 Harv. L. Rev. 661, 675 (2007) ("This modern approach provides too little normative guidance.")

scope that has been settled in the preliminary agreement."[14] Under this agreement, a party may demand that its counterparty "negotiate the open terms in good faith toward a final contract incorporating the agreed terms."[15] *Itek Corp. v. Chicago Aerial Indus. Inc.* (Del. 1968 and applying Illinois law) is perhaps the opinion that initiated the trend toward judicial enforcement of contracts to negotiate.[16] In that case, the letter of intent stated that parties "shall make every reasonable effort to agree upon and have prepared as quickly as possible a contract providing for the foregoing purchase…embodying the above terms and such other terms and conditions as the parties shall agree upon."[17] Intermediate agreements often reflect the parties' intention to limit the freedom of the parties to depart from terms settled therein and the courts are willing to enforce this intent in their application of the good faith (or best efforts) standard.[18]

The predominant policy goal, as stated in federal and state court opinions, is to protect and encourage efficient transaction-specific investments and minimize the risk of opportunistic hold-up behavior. An example is the statement in a recent First Circuit opinion that "modern transactions often involve significant up-front investments in deal structuring and due diligence and parties may wish to protect those investments in some measure…without such protection, a rapacious counter-party may attempt to take advantage of the other party's sunk investment by trying to retool the deal at the last minute."[19] Some reliance investment seems essential. Judicial enforcement of a contract to negotiate is unlikely—even in the face of bad faith—if there is no significant reliance in between the stages; these are likely to be treated as mere agreements to agree.[20]

Nevertheless, there are divergent opinions about the role of legal enforcement in promoting reliance. Contrast, for example, the opinions of two judges who are also contract law scholars, Judge Posner and Judge Easterbrook. In justifying legal enforcement, Judge Posner wrote:

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[14] *Supra* note --, at 498.
[15] *Id.*
[16] 248 A.2d 625 (Del. 1968). A third party bid higher and the seller terminated negotiations even though the buyer agreed to all additional terms proposed by the seller, including price adjustments and other concessions.
[17] *Id.*, at 627.
[18] After the release of the Delaware Supreme Court's opinion in SIGA, supra note --, lawyers at Fried Frank wrote "[t]he obligation of good faith would be breached by abandonment of negotiations, insistence on terms materially inconsistent with the LOI; breach would be more likely if there is evidence of regret, and less likely if there is a material disagreement over a term not in the LOI" Andrew J. Colosimo et. al., *Practice Points for Term Sheets, Letters of Intent, and Undertakings to Negotiate in Good Faith—Based on Delaware Supreme Court's SIGA Decision*, Fried Frank Private Equity Briefing (Feb. 8, 2016), available at: http://www.friedfrank.com/siteFiles/Publications/FINALv8-2-8-2016-Practice%20Points%20on%20Use%20of%20Term%20Sheets%20and%20Letters%20of%20Intent.pdf. Lawyers at Lincoln Gustafson wrote that the good faith obligation would be breached by "attempt[s] to change fundamental points of the deal in order to take advantage of changing external conditions and extract more favorable terms than were initially agreed upon in the letter of intent." Patrick Klingborg, *When a "Non-Binding" Letter of Intent Is Binding After All*, Lincoln Gustafson & Cercos, LLP (Jun. 1, 2016), available at: http://www.lgclawoffice.com/when-a-non-binding-letter-of-intent-is-binding-after-all/.
[19] E.g., *Butler v. Balolia*, 736 F.3d 609 (1st Cir. 2013). See *Burbach Broadcasting Co. of Del. v. Elkins Radio Corp.*, supra note -- ("many state courts have recognized the pragmatism and commercial necessity of recognizing such agreements"); *Brown v. Cara*, supra note --; *Copeland v. Baskin Robbins*, supra note --.
[20] E.g., *Burbach Broadcasting Co. of Del. v. Elkins Radio-Corp.*, supra note --; *Skycom v. Telstar*, 813 F.2d 810 (7th Cir. 1987)(raising concern about making transactions riskier without need to protect reliance).

> "[S]uppose the prospective buyer spends $100,000 on research, planning and consultants during the negotiation, money that will have bought nothing of value if the negotiation falls through, while the seller has spent nothing and at the end of the negotiations demands an extra $50,000, threatening to cancel the deal unless the buyer consents."[21]

In contrast, Judge Easterbrook held in another case that:

> "Empro [the buyer of business assets] claims that it is entitled at least to recover its 'reliance expenditures,' but the only expenditures it has identified are those normally associated with pre-contractual efforts: … 'negotiating with defendants, in investigating and reviewing defendants' business, and in preparing to acquire defendants' business'. Outlays of this sort cannot bind the other side any more than paying an expert to tell you whether the painting at the auction is a genuine Rembrandt compels the auctioneer to accept your bid".[22]

We return to two facets of this contrast in the analysis in Part II. In particular, it may reflect a different view of the well-known tradeoffs in contract theory between protecting investment and providing flexibility to reach efficient agreements. In addition, it suggests that there may not be a uniform approach to protecting all types of investment and that it is helpful to have a taxonomy.

Given that the protection of specific investment motivates the arguments for contract to negotiate, reliance is the usual measure.[23] A few courts have indicated, however, that expectation damages may be appropriate in the rare case in which the plaintiff makes the case that good faith efforts would have led to an agreement and the terms of that hypothetical agreement are clear enough that damages could be calculated.[24] The Delaware Supreme Court's opinion in *SIGA Technologies, Inc. v. Pharmathene, Inc.*[25] held that the trial court could award expectation damages if it found that the parties would have reached an agreement if negotiations were conducted in good faith. Nevertheless, consistent with the case law described above, the Delaware court seemed to require some reliance, reflecting that this continues to be the motivating concern.[26]

II. Designing Staged Contracting

[21] *Venture Associates Corp.*, supra note – at 278.
[22] *Empro Manufacturing Co., Inc. v. Ball-Co Manufacturing, Inc.*, 870 F.2d 423, 426 (7th Cir. 1989).
[23] Farnsworth, CONTRACTS, *supra* note --, at --.
[24] E.g., *Venture Associates Corp.*, supra note – at 278 ("if the plaintiff can prove that had it not been for the defendant's bad faith the parties would have made a final contract, then the loss of the benefit of the contract is a consequence of the defendant's bad faith, and, provided that it is a foreseeable consequence, the defendant is liable for that loss – liable, that is, for the plaintiff's consequential damages.")
[25] *Supra* note --.
[26] The SIGA opinion triggered renewed calls for care in drafting intermediate agreements. Philip Richter, a partner at Fried Frank, advises being more explicit either deny any obligation to negotiate in good faith, or providing for reliance or some kind of liquidated damages in lieu of expectation. Philip Richter, *Negotiation in Good Faith – SIGA v. PharmAthene*, (Jan 27, 2016), available at https://corpgov.law.harvard.edu/2016/01/27/negotiation-in-good-faith-siga-v-pharmathene/.

Two challenges face commercial parties in designing staged contracting. The first is whether a court will accurately find manifest intent to create or disclaim a contract to negotiate. This challenge is the focus of lawyers' advice to clients, but the easier of the two. The second is what effect do the parties wish to assign to their intermediate agreement? In many cases, the parties give this question insufficient consideration, and they are often confused or of two minds. They may want simply to bind their counterparty while preserving their own freedom to walk. Or, they would like some mutual constraint but are unsure about how much and how to combine legal with nonlegal means to achieve it.

A. Why and How to Sequence Negotiations

The negotiation agenda, including the sequencing of issues, can affect the deal outcome and indeed, may be the subject of bargaining over process.[27] In many cases, negotiations are sequenced and a subset of issues is addressed at each stage. If nothing else, sequencing is a response to cognitive barriers to negotiating all issues at once. There is a tradeoff between the benefit of being able to logroll across issues to exploit differences in preferences and endowments, and the cognitive load of doing so.[28] When deals are broken up into manageable parts, *how* the issues are divided and sequences is a distinct and important question. One approach is that of gradualism or incrementalism, under which easier issues are settled first in order to build trust and a positive atmosphere, to create momentum to face the more difficult issues in subsequent stages.[29] The terms that are more difficult to resolve are more likely to be the major terms that, in turn, courts are more likely to require in an enforceable contract to negotiate.[30]

An alternative strategy moves in the opposite direction, tackling first the potential roadblocks associated with essential terms before time is spent on the easier matters. This seems to be more common sequence in business transactions. This sequencing is reinforced by the need for costly lawyers, accountants, architects and other experts. It makes sense to have the essential elements of the bargain reflect the prospect of a profitable transaction before these investments are incurred. Although the first stage addresses the major terms—such as what is

[27] Game theorists have shown that the decision to negotiate issues simultaneously or sequentially is likely to have an effect on the probability of success and the negotiated outcome. See, e.g., Thomas C. Schelling, THE STRATEGY OF CONFLICT 31 (1960); Chaim Fershtman, *The Importance of the Agenda in Bargaining*, 2 Games & Econ. Behav. 224 (1990); Younghwan In and Roberto Serrano, *Agenda Restrictions in Multi-issue Bargaining*, 53 J. Econ. Behav. & Org. 385 (2004); P.V. Balakrishnan, Charles Patton, Phillip A. Lewis, *Toward a Theory of Agenda Setting in Negotiations; Mehmet Bac and Horst Raff, Issue-by-Issue Negotiations: The Role of Information and Time Preference* (1996) (noting, for example, that the American Automobile Association recommends buyers focus first on negotiating price of the car and defer discussing of financing, factory rebates, and the trade-in-allowance).

[28] Howard Raiffa, NEGOTIATION ANALYSIS: THE SCIENCE AND ART OF COLLABORATIVE DECISION MAKING -- (2002).

[29] This is a common approach in international negotiations or agreements in legislative law making [*add cites*]. It is less common but nevertheless occurs in business transactions as well. See Ben-Shahar, *"Agreeing to Disagree"*, supra note --, at 390 ("leaving issues that were difficult to resolve for future completion. In these situations, contractual incompleteness is neither a result of haste nor of unforeseeability, but rather a deliberate choice to temporarily disagree over some matters, to side-step difficult issues over which consensus could not be reached.")

[30] *Supra* note – and accompanying text.

being sold and at what price—the second stage is not trivial. Even if the second stage consists of lawyers hammering out representations and warranties, covenants, closing conditions, remedies and termination rights, these can contribute significant value to the transaction.[31]

The sequencing of the monetary price of a transaction is particularly interesting, especially to the degree that it is difficult to revise a settled price because of the enforcement discussed below.[32] Price is a unique deal term in two important respects. First, it is likely to be the most divisible consideration in a contract: it can be adjusted by dollars while a quality measure cannot. Second, it is typically the distributional term in the contract with the least impact on the contracting surplus. Although price terms are usually determined after the nonprice terms have been set, this is not always the case, especially when significant specific investments are called for during the negotiations. For example, in commercial loans, private equity investments, and corporate acquisitions, many terms are agreed upon after the price is settled: representations and warranties, covenants, termination rights, choice of law and forum, and so on.[33] In the first stage of negotiations, the parties agree to price and key nonprice provisions, often without their lawyers, and then turn over the second stage to their lawyers to work out these contractual details. These terms, though valuable, are usually settled without adjustment to price. This arrangement leads to a peculiar process in the second bargaining stage between lawyers in which the parties are limited to bartering non-price provisions.[34] Thus, the stickiness of price constrains the ability of the parties to maximize the efficiency of their contract design, particularly when the parties are not using standard or market terms.[35]

B. Purpose of Intermediate Document

Parties to complex transactions are likely to engage in back-and-forth proposals of deal terms and, at some point, to memorialize the settled terms for the benefit of future negotiations and communications with internal and external constituencies. One view held by deal lawyers is that intermediate agreements are "signposts—they mark a moment in the deal's lifecycle when enough uncertainty and complexity has been resolved that the deal is likely to go forward…[They are] markers for the accumulation of deal momentum."[36] Rather than being

[31] Although the value that lawyers contribute is difficult to quantify, the fact that they can command significant hourly rates for work performed after intermediate documents suggests that the market values their contributions to contracts in the second stage. [add cites]
[32] See Albert Choi and George Triantis, *The Effect of Bargaining Power on Contract Design*, 98 Va. L. Rev. 1665, 1690-6 (2012).
[33] See., e.g., James C. Freund, ANATOMY OF A MERGER: STRATEGIES AND TECHNIQUES FOR NEGOTIATING CORPORATE ACQUISITIONS 53-60 (1975).
[34] It is interesting in this respect to contrast two types of debt contracts that settle price early or late in the process. In a typical commercial bank loan, the parties first negotiate a term sheet that contains the maturity, interest rate and other fees, in addition to a handful of major terms. The interest rate is rarely changed subsequently during the negotiation of the covenants, etc. In contrast, in the sale of a bond or debenture, the covenants are settled before the price is determined. Given the advantages of the price term and constraints on nonprice bartering identified in the text, one might speculate that, all else equal, the design of bond covenants would be more efficient. One might also anticipate more innovation in the provisions of non-bank debt, where the market can reward valuable contract terms with a lower yield.
[35] Moreover, it is generally perceived that the second round presents the opportunity for the party with the bargaining power to seize more rents because the price cannot be reopened. See Choi and Triantis, *Bargaining Power on Contract Design*, supra note --.
[36] Cathy Hwang, *Deal Momentum*, U.C.L.A. L. Rev. (forthcoming).

binding, their presence indicates that momentum has been achieved so that a completed deal is in prospect along the lines of the agreed upon terms. The parties use this information as a sign that they can proceed to incur negotiation costs.[37] Indeed, these intermediate documents serve as evidence and information to the deal team of lawyers, accountants, and other advisers, as well as lenders, investors and other third parties who will contribute to the project.[38] In this respect, commentators sometimes refer to these intermediate documents as mechanisms for "organizing" these third parties.[39] Of course, the signal of momentum is not a particularly reliable one in the economic sense, because it is relatively cheap (or even costless) to send unless there is some sanction, legal or nonlegal, on the party that deviates from the terms of the agreement, thereby rendering them "sticky" to some degree.

C. Stickiness of Settled Terms in Intermediate Document

1. Efficient Flexibility

Many, if not most, preliminary agreements are not intended to be fully enforceable because the parties contemplate another stage in negotiation.[40] The law regulates more closely the modification of a contract than the completion of staged negotiations, even under a contract to negotiate.[41] Given that the court's decision to police negotiations is founded on the objective intent of the parties, it is worthwhile to consider how sticky the parties themselves would want the terms to be in the intermediate agreement and based on what factors. To motivate this analysis, consider first the various reasons that the parties would want to be free to walk away from negotiations. The parties would be constrained in their flexibility to adjust to new information or changes in circumstances. These new circumstances or information could impact the efficiency of the deal as a whole or the optimal transaction terms. The ability to avoid an inefficient transaction and to opt for terms that maximize the surplus in the event the transaction closes is extremely valuable, especially when the parties are not well informed at the time of the intermediate agreement and operate in volatile environment. To the extent that the settled terms are sticky, the ability to negotiate for the optimal remaining terms may be constrained by

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[37] See, e.g., ABA MODEL PURCHASE AGREEMENT WITH COMMENTARY, v 2, 107 (2001) ("to test the waters for the prospects of a definitive agreement before incurring the costs of negotiating a definitive agreement").

[38] Included in these third parties are regulators whose approvals are condition precedent to the closing of the deals and who need the time to review (e.g. antitrust review). See ABA MODEL ASSET PURCHASE AGREEMENT, v. 2. at 107. Regarding the agency problems associated with having lawyers and other experts negotiate the second stage, see Albert Choi and George Triantis, *Multi-stage contracting in complex transactions* (working paper February 2014).

[39] See Ralph B. Lake, *Letters of intent: A Comparative Examination under English, U.S., French and West German Law*, 18 Geo. Wash. J. Int'l L. & Econ. 331, 332 (1984)("bringing order to complexity"); ABA MODEL ASSET PURCHASE AGREEMENT, v. 2. at 107; Hwang, *supra* note --.

[40] Eg., Hwang, *supra* note – ("most preliminary agreements in M&A deals are signed, but specifically designated to be non-binding"). Hwang also notes that "deals are sticky even though enforcement for breach is weak").

[41] Under the Uniform Commercial Code, an enforceable contract modification requires not only mutual assent but also good faith which, between merchants, includes observance of reasonable commercial standards of fair dealing in the trade. U.C.C. 2-209, ct 2. "The effective use of bad faith to escape performance on the original contract terms is barred, and the extortion of a 'modification' without legitimate commercial reason is ineffective as a violation of the duty of good faith. Nor can a mere technical consideration support a modification made in bad faith" Id. The common law rule, as reflected in section 89 of the Restatement (Second) of Contracts requires either fresh consideration or that the modification be fair and equitable in view of circumstances not anticipated by the parties when the contract was made.

limitations in logrolling against the terms in stage 1. This ability should not be surrendered without very substantial benefit from imposing some weight on settled terms. This is likely to be the reason for the court's reluctance to enforce contracts to negotiate without sufficient reliance investments.[42]

The ability of the parties to agree on the optimal terms may be impeded by asymmetric information about the relevant parameters, such as the value of the term to one party and the cost to the other. In the Appendix, we present a model of such asymmetry in which a nonbinding intermediate agreement is more likely to lead to efficient terms than a fully binding one.[43] Furthermore, regulation of the bargaining process through a standard of good faith or best efforts may in fact improve on the efficiency, by policing the better informed party's ability to extract rent from the less informed. We return to this benefit from a legal standard of good faith in Part III.

2. Efficient Stickiness—Encouraging Efficient Investment

Although enforcement of preliminary terms may interfere with the ex post efficiency of a negotiated deal, the decision to sequence negotiations presumably requires that the first stage terms would have to be somewhat settled before beginning the second stage. Otherwise, how would you maintain the psychological benefits of a gradual compromise or the fragmentation of complex issues? What would be the value of addressing roadblocks first if they could reappear late in the negotiations? Moreover, parties would negotiate more seriously before the intermediate agreement if they knew that there would be a cost to renegotiating or walking away from its terms. At the same time, excessive stickiness would chill negotiations and defer the memorialization of negotiations.[44] Similarly, if the purpose of the memorialization of a term sheet is to commence discussions with a lender or other third party, this purpose would be also be undermined if the parties could later change the major terms. Of course, these benefits and the ones described below would need to be weighed against the benefits of flexibility discussed above: adjusting to new information and changed circumstances and logrolling between terms across the stages.

While lawyers warn their clients against agreeing inadvertently to binding terms in the intermediate documents, it is clear that parties do contemplate some form of commitment. Commentators observe that parties tend not to depart from the terms in the intermediate agreement and that the second stage usually leads to completed contracts.[45] How the stickiness is achieved in a matter of some speculation but it is often phrased in non-legal terms. Frequently

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[42] Supra note—and accompanying text.

[43] Compare Jason Scott Johnston, *Default Rules/Mandatory Principles: A Game Theoretic Analysis of Good Faith and the Contract Modification Problem*, 3 S. Cal. Interdisc. L.J. 337 (1993)(analyzing bargaining in the shadow of contractual entitlements and the law's policing of good faith).

[44] Ben-Shahar, *"Agreeing to Disagree": Filling Gaps in Deliberately Incomplete Contracts*, 2004 Wis. L. Rev. 389, 404-5 (also noting in the context of negotiations between states, a bargaining norm of no-retraction from preliminary understandings).

[45] E.g. "Dealmakers [that were interviewed] with a wide breadth of experience – at firms and in-house, working with repeat players and one-off deal parties, in private and public deals, in a variety of firms and cities, representing financing parties and strategic parties – report that preliminary agreements have exceptional binding power." Hwang, *supra* note --, at f54.

commentary suggests that parties use them to bind counterparties "morally," "psychologically," or "ethically."[46] Of course, some business entities hope to use intermediate agreements to bind their counterparty while retaining freedom for themselves to withdraw with impunity.[47] It is also possible that the reputation of lawyers provides the discipline discouraging the parties from walking or demanding unwarranted changes in settled terms.

As indicated earlier, the dominant reason given for (partial) enforcement of intermediate agreements as contracts to negotiate is to protect and encourage specific investments that would increase the expected deal surplus or avoid an inefficient deal. Often, the investment contemplated by courts, scholars and lawyers, is the negotiating and contracting over the terms of the deal, and the retaining of experts to advise on performance (lenders, architects, etc.).[48] The classic concern of contract theory is that if price is negotiated after one party has made such reliance investment, the other party may engage in hold-up during negotiations of the price to deprive the former party of its investment. If the terms have not been settled, this hold-up hazard is unchecked and the parties may wish that the courts police it through a promise to negotiate in good faith.

A related category of investment is in diligence to assess *whether* deal is efficient. This investment may occur before and after the intermediate agreement. In fact, from a survey of counsel to merger and acquisition deals, Cathy Hwang observes that although "[s]cholars assume that preliminary agreements are first steps…before investigation and before making relationship-specific investments. In reality, parties sign preliminary agreements slightly later in the deal process, after most initial investigation is done."[49] Their ability to continue conducting diligence can be enhanced in intermediate agreements by binding promises to provide one's counterparty with access to records and related materials, share of expenses and adhere to non-disclosure requirements. In a different context, Schwartz and Scott examine incentives in "exploratory" preliminary agreements, under which the parties agree to make simultaneous investment in information that would indicate whether and which of a set of contemplated projects would be profitable to pursue.[50] For example, a seller would investigate its cost of delivering a good and

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[46] ABA MODEL ASSET PURCHASE AGREEMENT at 107 ("The parties may also feel morally, if not legally, obligated to key terms [in a letter of intent] if those terms are set down in writing"); Farnsworth, supra note -- at 258; Knapp, supra note --, at 679 (business persons consider themselves bound, if not legally, at least morally or ethically); Freund, supra note – at – ("antirenegotiation insurance"); Lena G. Goldberg and Mary Beth Findlay, Just an MOU or a Real Deal? Harvard Business School Publishing Note 9-312-018 (2011) at p. 3 ("Unless there has been a material adverse change, it may be difficult, psychologically, to renegotiate terms that are expressly included in an MOU.)"

[47] See Mark K. Johnson, *Enforceability of Precontractual Agreements in Illinois: The need for a middle ground*, 68 Chi.-Kent L. Rev. 939, 939 (1993).

[48] *Teachers' Ins. & Annuity*, supra note – at 14 : "without such an agreement, parties may spend enormous sums negotiating every detail of contract wording without knowledge whether they have an agreement, and if so, on what terms." Hwang: "enforcing a preliminary agreement means that the parties can rely on their preliminary bargains as they engage in the costly process of solving for deal complexity." In client letters, law firms advise clients to "determine whether they have a meeting of the minds on the material terms of a deal before proceeding with the more detailed, prolonged, and costly effort of definitive documentation". Fried Frank, supra note --. And, to "make sure they are on the same page as to the significant points of a deal before they undertake the time and expense to prepare a detailed contract to express their complete agreement." Lincoln Gustaffson, supra note --.

[49] *Supra* note --, at --.

[50] See Vladimir Smirnov & Andrew Wait, *Holdup and Sequential Specific Investments*, 35 RAND J. ECON. 386 (2004).

the buyer would investigate the value it would receive, and the parties may agree that they would then share the acquired information to determine whether the transaction is efficient. Without enforcement of the promise to invest, each party has the incentive to cheat: to let the other party invest first and decide later whether to invest. The authors believe that the good faith duty can encourage investment by ordering the reneging party to pay the reasonable costs of the performing party's preliminary investment. Scott and Schwartz remark that the predominant legal approach, via the contract to negotiate, "is deficient, however, because it is unnecessary to require the parties to bargain in good faith. As we show, efficiency would be enhanced if the law were simply to protect the promisee's reliance interest." In their analysis, they assume that the reliance expenditure is ultimately verifiable, as is its reasonableness, so the good faith standard is an unnecessarily indirect means to create the efficient investment incentive.

3. Efficient Stickiness—Discouraging Inefficient Investment

Negotiation experts list several approaches to value-claiming: a strategy to capture a larger share of the surplus by changing the perceived bargaining range between the parties' reservation prices. First, a party can improve its alternatives to the agreement (known as BATNA), raise its reservation price and thereby improve its share of the surplus.[51] It can do so by seeking and developing alternative parties. Of course, investing in alternatives can reveal a more efficient deal elsewhere; but the motivation of concern here is to improve bargaining power. Second, one party's selfish interest is served by becoming better informed about its counterparty's reservation price and changing its counterparty's perception of its own.[52] Of course, the counterparty has the corresponding incentive to conceal that value. Expenditures incurred to conceal one's own or reveal one's counterparty's reservation price do not contribute to efficiency, unless they produce information relevant to whether the deal and its terms are optimal. Third, a party may take actions to hurt the counterparty's no-agreement alternative or BATNA and thereby change the bargaining range in the former party's favor.

The joint goal of deterring value-claiming investments is distinct from encouraging value-creating investments. As Schwartz and Scott point out, incentives for surplus-creating investments can be created by a simple promise to share expenses or reimburse if the deal falls through, because the party incurring the cost has the incentive to provide evidence that they were made and were reasonable. It is much more difficult to deter value-claiming investments because they are both difficult to observe and verify. It is not surprising, therefore, that intermediate agreements often have no-shop, no-talk or other restrictions on developing alternatives, alongside the contract to negotiate in good faith.[53] As is the case with many legal standards, the court's investigation into the good faith or best efforts of each party can police value-claiming behavior not caught by these specific prohibitions. For example, it is easier to verify the seller's marketing of an asset than the buyer's search for alternative acquisitions.

[51] David A. Lax and James K. Sebenius, THE MANAGER AS NEGOTIATOR: BARGAINING FOR COOPERATION AND COMPETITIVE GAIN 55, 251-2 (1986).
[52] G. Richard Shell, BARGAINING FOR ADVANTAGE 104-5 (2006).
[53] For example, in *Channel Home Centers v. Grossman*, 795 F.2d 291 (3d Cir. 1986), the letter of intent covered most of the significant shopping mall lease terms and provided that the prospective lessor would "withdraw the Store from the rental market and only negotiate… the leasing transaction to completion".

4. Risk allocation

A final but important reason that parties may prefer stickiness in their intermediate agreement terms—also separate from reliance—is to manage the risk of changes in the environment. Risk allocation is a well-known, core function of contracts. Even if a deal is not completely negotiated, some risk allocation of changes in circumstances during the negotiation period is efficient and there may be gains to putting this allocation in place sooner rather than later. If the parties incorporate terms that assign such a risk, either explicitly or implicitly, the court should enforce that allocation. In this light, good faith may be breached when a party attempts to escape the adverse materialization of a risk allocated to it under the intermediate agreement, by breaking off negotiations or demanding an unreasonable modification of the settled terms.

III. The Use of Legal Standards to Vindicate the Goals of Staged Contracting

Intermediate agreements are best viewed as formal instruments that govern the parties' negotiation process. Their focus goes beyond the protection of specific investments of various types. They create value by establishing parameters for negotiation to promote the following objectives discussed in the previous section: (a) encourage efficient investment, (b) preserve relative bargaining power by deterring value-claiming investment, (c) enforce the risk allocation desired by the parties during the negotiations and (d) allow flexibility to use new information and expertise to build surplus from the deal.[54] Under full contract enforcement, the court would fill the open terms in the intermediate agreement with the legal defaults and typically award expectation damages to the plaintiff. However, this would not balance well the multiple goals that often motivate the parties in the intermediate agreement and the optimal enforcement is something short of the full contract enforcement. While there is a broad consensus in favor of a middle-ground, there are a range of approaches suggested by legal scholar, many of which combine legal and non-legal enforcement.

At one end of the spectrum, as mentioned above, Cathy Hwang observes that the terms of intermediate agreements are sticky even though enforcement by either courts or reputational sanctions is likely to be weak. She suggests that lawyers may be the gatekeepers whose reputations are harmed when a party walks away from such an agreement contrary to the parties' expectations. As described in the previous Part, Alan Schwartz and Robert Scott advocate for protection of specific investment through reliance damages, particularly in the specific context they describe, in which parties commit to making simultaneous investments. Under their approach, the party who fails to make their investment must reimburse the nonbreacher's investment costs. In a subsequent article, Ronald Gilson, Charles Sabel and Robert Scott advocate for this scheme of reliance damages as "low-powered" legal enforcement, which can

[54] See *Butler v. Balolia*, supra note --, at – ("binding themselves sufficiently such that they feel comfortable investing resources into the deal, but without inextricably committing themselves to a transaction that is still inchoate. Contracts to negotiate can satisfy this need."); Ben-Shahar, *supra* note --, at 407 ("The precontractual commitment enables a party to commit to a specific partner and a specific negotiation protocol without committing to specific terms.")

combine with extralegal forces to implement the desired degree of freedom from the substantive terms of the contemplated deal.[55]

Jonathan Barnett describes an interesting alternative configuration of legal and extralegal discipline. He examines the context of Hollywood movie deals and suggests that parties are disciplined by a combination of industry norms and the *possibility* that a plaintiff would succeed in obtaining enforcement from a court. He refers to these deals as "soft contracts" that are possibly but not certainly subject to legal liability. Parties can achieve their preferred level of enforcement and, conversely, transactional flexibility by calibrating the level of formalization used to memorialize the terms, and therefore the probability that they will be legally binding. Barnett describes that "parties face a calculated tradeoff—with respect to each deal element, deal stage, and deal participant – that weighs the marginal transactional flexibility [from the ability to walk away] and cost savings from reduced formalization against the marginal increased risk of holdup and other forms of counterparty opportunism".[56]

Omri Ben-Shahar focuses on incomplete agreements where the parties deliberately leave terms to be agreed upon later.[57] Instead of having the court police the specific investments of the parties, he advances a novel proposal that the party seeking enforcement of a deliberately incomplete agreement would have an option to enforce the transaction under the agreed-upon terms supplemented by terms that are the most favorable (within reason) to the defendant. Ben-Shahar argues that this facilitates sequential negotiations and deters unilateral retractions or threats to precontractual investments.[58]

Although practitioners, courts and scholars are all aware of the existence of nonlegal sanctions that visit the party who unreasonably withdraws from negotiations or makes outlandish demands. Sometimes, these extralegal forces achieve the desirable combination of commitment and flexibility. For example, in his discussion of soft contracts between Hollywood movie studios and star actors, Jonathan Barnett reports that there are norms deterring the most egregious forms of hold-up that are available once a studio has begun filming with a star. He observes that "[i]n practice, nothing close to this extreme form of holdup behavior actually occurs: even in the absence of a signed deal, talent attorneys report that they renegotiate open terms following production but refrain from renegotiating the fixed compensation."[59] This is consistent with the good faith negotiations that are sometimes required in intermediate commercial agreements which impede the renegotiation of settled terms but provide flexibility in the negotiation of open terms.

In other contexts, however, lawyers and scholars acknowledge that nonlegal sanctions do not completely deter such behavior and might be paired with some degree of legal enforcement. Scott Baker and Albert Choi observe that many extralegal sanctions impose costs on both the party that metes the sanction and the one that receives it.[60] To impose a meaningful relational or

[55] Gilson, Sabel and Scott, *supra* note --.
[56] Id., at 644.
[57] Ben-Shahar, *supra* note --.
[58] Id., at 392.
[59] Barnett, *supra* note – at 641.
[60] Scott Baker and Albert Choi, *Contracts Role in Relational Contract*, 101 Va. L. Rev. 559 (2015).

reputational sanction, the enforcer must forego a profitable transaction or relationship with the transgressor, with a corresponding loss in social welfare. In contrast, the outcome of legal enforcement is a payment (e.g. of reliance damages) between the parties, with some deadweight loss for litigation. The parties, ex ante, may prefer the latter system. In addition, in many contexts, the legal system is a reasonably effective producer of information about the conduct of the alleged bad actor, with access to different and sometimes superior information than the counterparty and to third parties in the reputational community. The fact finding of the courts may inform the discretion of these parties to impose nonlegal sanctions.

The use of a standard—such as good faith or reasonable efforts—to police the negotiation process seems an appropriate mechanism for legal enforcement of intermediate agreements. We have identified several goals that the parties may seek to promote in regulating their negotiation process, beyond the protection of reasonable reliance investment. These require a highly contextual approach that befits a standard. Good faith and best efforts are familiar standards in contract and commercial law. Lawyers and scholars are often critical of vague standards that call for fact-specific determinations because they introduce the costs of unpredictability, judicial error and litigation cost. Noting that contracting parties regularly agree to standards of conduct when more precise rules are available, we have addressed these concerns in other work. In brief, the costs of litigation and judicial error are, of course, avoided when parties settle their dispute, as they often do. Moreover, they can be mitigated and a more efficient incentive can be implemented, when the standards are combined with contract provisions that calibrate litigation costs and liquidated damages for breach. Whether the parties adopt a negotiation standard of good faith or best efforts, the parties can realize the benefits of their contextual application while avoiding the downsides.[61]

Regulating negotiations with a standard such as good faith promotes the various objectives of the party. In particular, the analysis in the Appendix herein demonstrates that the standard is superior to either of the alternatives of full enforcement or no enforcement. Full contract enforcement of intermediate agreements yields the worst incentives for either investment or contract term production; no enforcement is superior. The analysis shows that judicial enforcement of a duty to negotiate in good faith creates the optimal level of stickiness to promote both ex post flexibility and ex ante investment. Achieving optimal flexibility can coincide with achieving optimal investment. In fact, in our model, there is no tradeoff: the parties need to anticipate ex post efficiency (efficient flexibility) to be able to achieve ex ante efficiency (reliance investment).

In the Appendix, a party invests in information that could indicate which of alternative provisions left to the second stage would be efficient. The analysis there conceptualizes bad faith behavior as a party attempting to renegotiate the terms of the agreement solely for the purpose of extracting more rent from the counter party even though the party has reason to know that the renegotiated term will not increase the surplus from trade. By imposing duty to negotiate in good faith, backed by court enforcement that is costly to obtain, the contracting parties can discourage such opportunistic behavior. Moreover, when the parties are reassured

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[61] In this sense we are allied with Barnett, supra note --, who similarly sees virtue in probabilistic enforcement; but we endorse the use of a substantive standards in the terms (good faith, best efforts) rather than the uncertainty from incomplete formalization of the deal.

that opportunistic behavior is deterred, it is easier for them to modify the terms when they are, in fact, more efficient.

Conclusion

[To come]

Appendix

We build a simple game-theoretic model to examine the effect of staged contracting. With respect to the initial agreement, three legal regimes are explored: (1) the initial agreement is fully binding; (2) the initial agreement is fully non-binding; and (3) the initial agreement is non-binding but imposes an obligation to negotiate in good faith. In terms of maximizing the contractual surplus, the two hurdles that the parties face are: (1) achieving ex post efficiency by modifying the agreement only when additional surplus can be obtained; and (2) providing proper incentive to the parties to make costly, unobservable investment. As we will show, the three legal regimes operate differently in terms of achieving these two objectives.

The section presents two important findings from the model. First, entering into a fully binding agreement in the initial stage would often be suboptimal because this guarantees a positive return for the parties (they still have a contract even when renegotiation fails) and this reduces the incentive to renegotiate to optimal terms. Second, the parties would often want to enter into a non-binding preliminary agreement but with the duty to negotiate in good faith so as to reduce the incentive for the informed party from attempting to renegotiate solely to extract more surplus from the counter-party and to better adopt the optimal terms. We will consider two different ways of enforcing the duty to negotiate in good faith through an adjudication system that is both costly and error-prone.[62]

A. The Setup

Suppose there is a buyer and a seller, $i \in \{b, s\}$, who are negotiating over a transaction. We remain agnostic about the type of transaction, which can be mergers and acquisitions, sales, service, debt financing, but to fix ideas, imagine that this is a sales transaction in which the buyer agrees to purchase an asset or a widget from the seller. The contract they are negotiating over has two categories of terms: price and quality (non-price). Let $k = (p, q)$ represent the contract. The quality (non-price) term (q) determines the surplus of the transaction while the price term (p) determines how that surplus will be split between the parties. For the sake of simplicity, we will initially assume that both parties' reservation values are equal to zero: $r_b = r_s = 0$. We will relax this assumption later in the paper.

With respect to the contract terms, we assume that the optimal non-price terms are unknown initially but the parties can enter into either a binding contract or a preliminary agreement that uses default terms. We will call the default agreement as $k_0 = (p_0, q_0)$. Under the default terms, the buyer is certain to receive the value of $v_0 > 0$; the seller is certain to incur the cost of $c_0 \geq 0$ in producing and delivering q_0; and the surplus is strictly positive: $v_0 - c_0 > 0$.[63] Using the sales example, we can think of the default contract as a contract that obligates the

[62] See Choi and Triantis (2008) for a more detailed conceptualization of "costly verification" and its impact on contract formation.

[63] The assumptions that the default surplus is strictly positive and both parties' reservation values are zero imply that they should always trade. Because of strategic/opportunistic renegotiation behavior, and depending on whether the initial agreement is binding, the parties may still fail to close the deal. The positive surplus assumption can perhaps be justified based on the fact that by the time the parties enter into a preliminary agreement, there is sufficient "deal

seller to deliver a widget with "standard" attributes and no additional features. With respect to the additional features, suppose that there are (potentially infinitely) many possible attributes, $q_j \in \{q_1, q_2, \dots, q_T\}$ where $T \gg 0$. With respect to $T-2$ of the additional attributes, they generate no additional surplus for the pair: $c_j = c_0$, $v_j = v_0$, so that $v_j - c_j = v_0 - c_0$. The assumption that the additional attributes generate no additional surplus is made for simplicity.

At the same time, one out of T possible features will generate an extra surplus. We assume that there always exists a $j^* \in \{1,2,\dots,T\}$ such that $v^* - c^* > v_0 - c_0$. But, the parties initially do not know which j^* is optimal. The large surplus can come from (1) higher valuation for the buyer ($v^* > v_0$); (2) lower cost for the seller ($c^* < c_0$); or (3) both. We consider all possibilities. Furthermore, there also exists a $j^{**} \in \{1,2,\dots,T\}$ where $j^{**} \neq j^*$ and $v^{**} - c^{**} \ll v_0 - c_0$, $v^{**} < v_0$, and $c^{**} > c_0$. The attribute j^{**}, therefore, represents a terrible (the worst) option for the parties. Similar to j^*, which one of the attributes constitutes j^{**} is also initially unknown. Buyer's values and the seller's costs are such that, if they were to choose one of T attributes at random, the buyer expects to realize $E(v_j) \equiv v_1$ and the seller will incur $E(c_j) \equiv c_1$, where $v_0 - c_0 > v_1 - c_1$. Hence, if they do not know the identities of j^* and j^{**}, staying with the default option remains optimal. Finally, we assume that $v^* - c^* > v^* - c_1 > v_0 - c_0$. This assumption is made to make the analysis more interesting. The first inequality ensures that the parties will have an incentive to find the optimal terms;[64] while the second inequality ensures that even when the default terms are optimal, the seller (who is better informed) will have an incentive to attempt to renegotiate the terms solely to extract more rent from the buyer.

Turning to the investment problem, although the best and the worst options are initially unknown to the parties, the seller can make an investment to identify the attributes (i.e., identify j^* and j^{**}). Suppose the seller can make an unobservable investment of $l_s \geq 0$ at cost $\psi(l_s)$, and the seller discovers the best and the worst options with probability $\alpha(l_s) \in (0,1)$.[65] As is conventional, we assume that: $\alpha'(l_s) > 0$, $\alpha''(l_s) < 0$, $\psi'(l_s) > 0$, $\psi'(0) = 0$, and $\psi''(l_s) > 0$ $\forall l_s$. That is, the larger the investment, the more likely will the seller be able to identify the best and the worst options, but the higher the marginal cost. If $c^* < c_0$ and $v^* \leq v_0$, we can think of the investment as being "selfish" in nature. If $c^* \geq c_0$ and $v^* > v_0$, on the other hand, the investment is "cooperative." If the optimal contract has both lower cost and higher value ($c^* < c_0$ and $v^* > v_0$), the investment has both components.[66] With probability $\alpha(l_s) \in (0,1)$, therefore, the seller discovers that delivering q^* is optimal; and with probability $1 - \alpha(l_s)$, the seller discovers nothing and, given that choosing some additional feature at random will produce a lower surplus in expectation (due to the presence of worse option j^{**}), the standard features (q_0) remain optimal (in expectation) for the buyer and the seller.

momentum" or sufficient confidence that they should continue with the negotiation with the expectation that a deal will be executed in the near future. Nevertheless, we will relax this assumption to allow for possible non-trade later in the section.

[64] Note that the first inequality is also equivalent to the assumption that $c^* < c_1$, so the optimal terms have some cost advantage compared to choosing one of the additional attributes at random.

[65] Even with no investment, the seller still has a positive chance of finding the optimal terms. We can also assume that α does not depend on l_s, in which case the objective of the legal regime is solely to achieve ex post efficiency (or efficient renegotiation).

[66] Another way to think about the investment that the investment (at least weakly) increases the buyer's value and lowers the seller's cost but this is realized only with probability $\alpha(l_s)$.

In terms of the informational aspects, the discovered knowledge is private to the seller. This implies that, depending on the information learned by the seller, we can divide the seller into two types: the "high-type" seller ($\theta = h$), who knows that the optimal term is given by q^* and with whom the buyer should modify the contract to $k^* = (p^*, q^*)$; and the "low-type" seller ($\theta = l$), who knows that the optimal term remains q_0 and with whom the buyer should trade under the default terms of $k_0 = (p_0, q_0)$. (We will also, on occasion, call θ the "state of nature.") The buyer does not observe which type of seller she is facing but knows that the probability is given by $\alpha(l_s) \in (0,1)$. As we will see shortly, the fact that the seller only knows the realized state of the world (and the buyer does not) will impose a significant barrier against efficient renegotiation.

With respect to the sequence of the game, there are four periods with no time discount: $t \in \{1,2,3,4\}$. At $t = 1$, the buyer and the seller enter into an agreement $k_0 = (p_0, q_0)$ that contains the default terms (with standard attributes). The agreement can be (1) fully binding; (2) fully non-binding; or (3) non-binding but impose the duty to negotiate in good faith. These represent the three legal regimes that we will analyze in turn. We assume that, throughout the game, the seller gets to make a take-it-or-leave-it offer to the buyer; and the buyer gets to either accept or reject the offer. This will allow the seller to "costly" signal her information to the buyer. At $t = 2$, the seller can make an investment (l_s) to find out the optimal attributes with probability $\alpha(l_s) \in (0,1)$ at cost $\psi(l_s)$. As mentioned above, the information is private to the seller, and depending on the realization, the buyer faces two types of seller: "high-type" seller ($\theta = h$) with whom the buyer should trade under $k^* = (p^*, q^*)$ or "low-type" seller ($\theta = l$) with whom the buyer should trade using the default terms of $k_0 = (p_0, q_0)$.

At $t = 3$, the parties attempt to "renegotiate" the agreement. We assume here, just as in $t = 1$, the seller makes a take-it-or-leave-it modification offer and the buyer either accepts or rejects the modification offer. What happens to the relationship depends on the status of the initial agreement. If the initial agreement ($k_0 = (p_0, q_0)$) is fully binding (a contract), when the buyer rejects the modification offer, the parties will trade under the initial terms. If the initial agreement is fully non-binding (a non-binding, preliminary agreement), the initial agreement becomes "irrelevant" and the buyer's rejection leads to no trade. Finally, if the initial agreement is non-binding but imposes the duty to negotiate in good faith, the seller's "opportunistic" offer and the buyer's rejection (or acceptance) can lead to a possible remedy for the buyer. We will come back to this issue later in the paper. Finally, at $t = 4$, the parties trade (or not, if there is no contract) and the value and the cost are realized. In case the parties entered into a preliminary agreement with duty to negotiate in good faith, the buyer (under certain conditions) may bring a lawsuit against the seller to recover damages.

B. The First Best

If the social planner were to choose the type of trade and the amount of investment, the planner will choose q^* whenever the optimal additional feature has been identified or q_0 otherwise. In terms of the seller's investment, the planner will choose l_s to maximize

$$\alpha(l_s)(v^* - c^*) + \big(1 - \alpha(l_s)\big)(v_0 - c_0) - \psi(l_s)$$

This objective function supposes that whenever the optimal attribute is discovered (which happens with probability $\alpha(l_s)$), the seller will produce and deliver the good with the additional attributes. Otherwise, they will trade the default widget. Maximization yields the following first order condition:

$$\alpha'(l_s)\big((v^* - c^*) - (v_0 - c_0)\big) = \psi'(l_s)$$

Given the assumptions, we get a unique l_s from the condition. This is intuitive. The amount of investment done by the seller should maximize the expected return from producing the additional surplus (given by $(v^* - c^*) - (v_0 - c_0)$) and equate that to the marginal cost of investment (given by $\psi'(l_s)$). Let $l_s^* > 0$ represent the first-best level of investment.

C. Fully Binding Agreement

Suppose, at $t = 1$, the buyer and the seller enter into a fully binding agreement using the default terms: $k_0 = (p_0, q_0)$. An important implication of entering into a fully binding agreement is that if renegotiation fails, the parties are still obligated to trade under the initial terms. This, in turn, also determines the parties' incentive in terms of renegotiating the contract at $t = 3$. With respect to the initial contract, given that the seller has the power to make a take-it-or-leave-it offer to the buyer, the seller will set the price slightly below the buyer's reservation value: $p_0 = v_0 - \varepsilon$ where $\varepsilon \approx 0$. Going forward, to simplify the analysis, we will drop the notation of ε. The buyer will accept the offer.

Skipping over the investment period for the moment, let's examine the parties' incentive over renegotiation at $t = 3$. As noted before, the seller is divided into two types: "high-type" seller who has discovered (at $t = 2$) that the optimal terms for the contract should be q^* and "low-type" seller who knows that the optimal contract should contain the default terms of q_0. The buyer, on the other hand, only knows that she is facing the "high-type" seller with probability $\alpha(l_s) \in (0,1)$. Will the "high-type" seller and the buyer be able to successfully renegotiate the contract? The answer, unfortunately, is no. The fact that the low-type seller is guaranteed to receive the return of $v_0 - c_0$ in case the renegotiation fails (in case the buyer rejects the renegotiation offer), implies that the low-type has basically nothing to lose by mimicking the high-type seller. (Given that the low-type seller does not know which additional attribute is optimal for the parties, the low-type seller will randomly choose an attribute, among $q_j \in \{q_1, q_2, \dots, q_T\}$, and opportunistically claim that this will produce a larger value for the buyer.) The buyer, rationally expecting this, will reject all renegotiation offer and the parties will be stuck with the default terms. We will state the result first and provide a simple analysis.

Proposition 1. Suppose the initial agreement entered into by the buyer and the seller is fully binding. In equilibrium, the seller makes no investment ($l_s = 0$) and the parties always trade under the default terms (q_0).

At the renegotiation stage ($t = 3$), imagine the high-type seller makes the offer of $p = v^*$ and $q = q^*$. Suppose also that the buyer accepts this offer with probability $\beta \in [0,1]$. For the low-type seller, she faces (de facto) two choices: either (1) also make the same renegotiation offer of $p = v^*$ and $q = \tilde{q} \in \{q_1, \dots, q_T\}$ and pretend that this is optimal for the buyer; or (2) not make a renegotiation offer and stay with the default terms. Let's think about the low-type seller's incentive over these two choices. If she were to remain with the default terms, she will realize a profit of $p_0 - c_0 = v_0 - c_0$. If she were to make the same renegotiation offer as the high-type seller, on the other hand, she realizes a profit of:

$$\beta(v^* - c_1) + (1 - \beta)(v_0 - c_0)$$

That is, with probability β, the buyer accepts the renegotiation offer, in which case the low-type seller realizes a profit of $v^* - c_1$; and with probability $1 - \beta$, the buyer rejects the offer and the low-type seller realizes a profit of $v_0 - c_0$. Since $v^* - c_1 > v_0 - c_0$,[67] we get:

$$\beta(v^* - c_1) + (1 - \beta)(v_0 - c_0) > v_0 - c_0 \ \forall \beta > 0$$

In other words, if the buyer were to accept the renegotiation offer with some positive probability, it is strictly better for the low-type seller to mimic the high-type. For the buyer, because there is a possibility that the offer made by the low-type seller is the worse option (of j^{**}), the buyer will be strictly better off by not accepting the renegotiation offer: setting $\beta = 0$.[68] Furthermore, the result that the buyer will never accept the renegotiation offer from the seller also implies that, at $t = 2$, the seller has no incentive to make an investment to discover the optimal terms.

D. Fully Non-Binding Agreement

Now, let's suppose that the initial agreement at $t = 1$ is fully non-binding. In this case, for the purposes of "renegotiation" at $t = 3$, the initial agreement is basically irrelevant. Furthermore, in case the buyer rejects the seller's "renegotiation" offer at $t = 3$, there would be no trade at $t = 4$. Unlike the previous case where the seller could fall back to enforcing the initial default agreement, however, the fact that the seller will not be able to sell any product to the buyer (in case of renegotiation failure) actually produces more incentive to the seller (in particular, the low-type seller) to become honest. This, in turn, will create: (1) a higher possibility that the parties will trade under the (respectively) optimal terms; and (2) a bigger incentive for the seller to make the investment in $t = 2$. We first start with the general statement and then provide sketches of the proof, combined with a more intuitive, non-technical explanation.

Proposition 2. Suppose the initial agreement entered into by the buyer and the seller is fully non-binding. In a separating equilibrium, the low-type seller always trades with the buyer with optimal terms (q_0) but the high-type seller trades with the buyer with optimal terms (q^*) with less than one probability. The seller makes a positive, but suboptimal, investment ($0 < l_s < l_s^*$).

[67] If this condition is not satisfied, the low-type seller has no incentive to mimic the high-type and we will get full ex post efficiency. For instance, given that $c_1 > c_0$, if $v^* \le v_0$, the low-type seller has no incentive to mimic the high-type by offering a lower price to the buyer.

[68] We will include a regularity condition later so that the pooling equilibrium, in which both the high-type and the low-type seller get to renegotiate, will not be feasible. Even if it were, this leads to other inefficiencies.

Let's again start from the renegotiation stage at $t = 3$ and construct a separating equilibrium. Given that the initial agreement ($k_0 = (p_0, q_0)$) entered into at $t = 1$ is fully non-binding, when the seller makes a "renegotiation" offer and the buyer rejects the offer, we can assume that there is no contract between the parties and there is no trade at $t = 4$.[69] This is an important difference compared to the previous, fully-binding initial contract regime. Now, suppose at $t = 3$, the high-type seller, who has discovered the optimal terms (q^*) offers (v^*, q^*) to the buyer, and the buyer accepts that offer with probability $\gamma \in [0,1]$. Suppose, at the same time, if the seller were to make the default offer of (p_0, q_0), the buyer accepts that offer with probability one. For the high-type seller to be making this offer, rather than sticking with the default terms of $k_0 = (v_0, q_0)$, we need $\gamma(v^* - c^*) \geq v_0 - c_0$ or $\gamma \geq \frac{v_0 - c_0}{v^* - c^*}$.

On the other hand, in order for the low-type seller to make the offer of (v_0, q_0), we need $v_0 - c_0 \geq \gamma(v^* - c_1)$ or $\gamma \leq \frac{v_0 - c_0}{v^* - c_1}$. Given that $c^* < c_1$ and that $v^* - c^* > v_0 - c_0$, we can find a γ that satisfies both conditions:

$$\frac{v_0 - c_0}{v^* - c^*} \leq \gamma \leq \frac{v_0 - c_0}{v^* - c_1}$$

Note that since $v^* - c_1 > v_0 - c_0$, we get $\frac{v_0 - c_0}{v^* - c_1} < 1$. Furthermore, since $v^* - c^* > v^* - c_1$,[70] we get $\frac{v_0 - c_0}{v^* - c^*} < \frac{v_0 - c_0}{v^* - c_1}$. If we were to focus on the largest possible γ, in equilibrium, the buyer will accept the offer of (v^*, q^*) with probability $\gamma = \frac{v_0 - c_0}{v^* - c_1}$ while accepting the offer of (v_0, q_0) with probability one. Finally, given that the seller makes a strictly positive return by discovering the optimal non-price terms, the seller makes an investment l_s that is strictly positive but less than the first best level.

The reason why the parties are able to successfully, at least with some positive probability, renegotiate the deal and implement the optimal terms stems from two sources. First, unlike the case with fully binding contract, the low-type seller is no longer guaranteed of earning a positive profit in case the renegotiation fails. For the low-type seller (who is not informed of the optimal attributes for the buyer), mimicking the high-type becomes a risky venture, since the buyer's rejection will lead to zero profit. Second, the high-type seller (who is aware of the optimal terms) earns a strictly larger profit by offering the optimal terms. This implies that the high-type seller has a stronger incentive to offer the optimal terms than the low-type seller. With these two incentives in place, the parties are able to at least partially separate based on the seller type and implement the optimal terms.

E. Non-Binding Agreement but Duty to Negotiate in Good Faith

[69] We can think of this "no contract" regime as a default regime and consider other possibilities. For instance, rejection by the buyer could make the initial agreement binding or "partially" binding. Such regimes, however, would not be too different from the "good faith" obligation considered in the next part.
[70] If this condition is not satisfied, the high-type buyer would rather choose one of the additional attributes at random and still offer the high price of v^*. This will, in turn, undermine the seller's investment incentive.

Now, let's examine the case where the initial agreement remains non-binding but the parties impose an obligation to negotiate in good faith towards a contract. The primary reason why the parties are unable to fully realize the potential surplus from renegotiation is that the low-type seller has a strong incentive to mimic the high-type simply to extract a larger rent from the buyer. In other words, we can think of the low-type seller to be making a "bad faith" (renegotiation) offer to the buyer since she knows that the buyer does not value the additional features more and also that the additional features (in expectation) do not generate more surplus. On the other hand, we can consider the high-type seller to be making a "good faith" renegotiation offer to the buyer since the high-type seller knows that the additional features are valued more by the buyer and also generate more surplus. Hence, one way of capturing the duty to negotiate in good faith is by allowing the buyer to recover damages from the seller when the buyer, at $t = 4$, realizes that the seller made a "bad faith" offer in $t = 3$ simply to extract more surplus from the buyer. There are two ways of allowing the buyer to recover damages from the seller: (1) letting the buyer recover damages when the buyer discovers that the additional features are worth less after the contract has been performed by the seller; or (2) allowing the buyer to recover damages when the renegotiation is unsuccessful. While either approach will produce the qualitatively similar result, we will focus on the first scenario.

Determining whether the seller indeed acted in "good faith" requires some contextual determination by the court and this involves costly verification. We can think of two possible components in the cost: (1) court error (both type I and type II); and (2) the cost of litigation. To make the analysis simple, let's suppose that the court renders the correct judgment with probability $\lambda \in (1/2, 1)$. In other words, in case the low-type seller makes an offer of $(v^*, \tilde{q})$ and the buyer brings suit (after the contract has been performed and the valuation has been realized), the court determines that the seller acted in "bad faith" with probability λ. At the same time, the court exonerates the seller with probability $1 - \lambda$. Similarly, in case the buyer (opportunistically) brings suit against the high-type seller, the court determines that the seller acted in "good faith" with probability λ and finds the seller liable with probability $1 - \lambda$. On average, therefore, the court's determination is better than a coin toss and is informative of the true behavior of the seller. Finally, let's assume that the litigation costs the buyer and the seller $\phi_b = \phi_s = \phi > 0$.

Given that the court's determination is at least partially informative, if the damages $(d > 0)$ are set at the right level, the parties can induce only the legitimate suit to be filed. For instance, for the buyer who has been cheated by the low-type seller, the buyer will bring suit only if $\lambda d - \phi \geq 0$. The buyer who purchased from the high-type seller, on the other hand, will (opportunistically) bring suit if $(1 - \lambda)d - \phi \geq 0$. To induce the buyer to bring suit only when she has been serviced by the low-type seller, therefore, we need

$$\frac{\phi}{\lambda} \leq d < \frac{\phi}{1 - \lambda}$$

Since $\lambda > 1 - \lambda$, we know that this range exists. Suppose also that either the parties or the legal system sets d such that $\frac{\phi}{\lambda} \leq d < \frac{\phi}{1-\lambda}$. When the damages are appropriately chosen, litigation based on breach of duty to negotiate in good faith can produce an effective means against the low-type seller from mimicking the high-type. (It is straightforward to show that even if $d \geq$

$\frac{\phi}{1-\lambda}$, the duty to negotiate in good faith regime will perform better in achieving optimal contract terms, albeit at a larger expected litigation cost.)

Proposition 3. Suppose the initial agreement entered into by the buyer and the seller is non-binding but imposes the duty to negotiate in good faith. Compared to the cases of fully non-binding agreement, the parties implement the optimal term with a strictly larger probability. When d is sufficiently large, the parties may be able to implement the optimal terms with probability one. The seller also makes a larger investment.

As in the case of fully non-binding preliminary agreement, let's construct a separating equilibrium in which (1) the high-type seller offers (v^*, q^*); (2) the low-type seller offers (v_0, q_0); and (3) the buyer accepts (v_0, q_0) with probability one while accepting (v^*, q^*) with probability $\delta \in [0,1]$. Looking at the renegotiation stage of $t = 3$, for the high-type seller to offer (v^*, q^*), we need $\delta(v^* - c^*) \geq v_0 - c_0$. While there is a possibility of litigation at $t = 4$, the high-type seller knows that the buyer has an insufficient incentive to bring suit. For the low-type seller, however, the story is different, since she knows that if she were to mimic the high-type and the buyer were to accept, she will face a lawsuit by the buyer to collect d in $t = 4$. With that litigation possibility in mind, for the low-type seller to offer (v_0, q_0), we need

$$v_0 - c_0 \geq \delta(v^* - c_1 - \lambda d - \phi)$$

The right hand side of the inequality represents the low-type seller's expected return from mimicking the high-type. Note that, compared to before, the expected return is lowered (in the parenthesis) by the expected loss from litigation $(\lambda d + \phi)$. To achieve separation, therefore, we need

$$\frac{v_0 - c_0}{v^* - c^*} \leq \delta \leq \frac{v_0 - c_0}{v^* - c_1 - \lambda d - \phi}$$

Compared to the case of fully non-binding preliminary agreement, now the buyer can accept the (v^*, q^*) offer with a higher probability. Depending on the parameters, it may be feasible to have $\frac{v_0 - c_0}{v^* - c_1 - \lambda d - \phi} \geq 1$, in which case the buyer can accept the (v^*, q^*) with probability one.

Finally, before we close this section, suppose, instead, the duty to negotiate in good faith allows the buyer to collect damages from the seller in case renegotiation is unsuccessful. If the low-type seller were to mimic the high-type seller and offer $(v^*, \tilde{q})$, the seller expects to realize the profit of

$$\delta(v^* - c_1) - (1 - \delta)(\lambda d + \phi)$$

The second expression represents the fact that, in case the buyer rejects the renegotiation offer from the low-type seller, the buyer is able to collect damages of d with probability λ. In order for the low-type seller to be truthful and offer (v_0, q_0), we need $v_0 - c_0 \geq \delta(v^* - c_1) - (1 - \delta)(\lambda d + \phi)$. When we simply the expression, we get

$$\delta \leq \frac{v_0 - c_0 + (\lambda d + \phi)}{v^* - c_1 + (\lambda d + \phi)}$$

Since $\lambda d + \phi > 0$, we know that $\frac{v_0 - c_0 + (\lambda d + \phi)}{v^* - c_1 + (\lambda d + \phi)} > \frac{v_0 - c_0}{v^* - c_1}$. That is, compared to the regime where the initial agreement is fully non-binding, the duty to negotiate in good faith regime produces the higher chances that the optimal terms will be chosen. However, since $v^* - c_1 > v_0 - c_0$, we know that $\frac{v_0 - c_0 + (\lambda d + \phi)}{v^* - c_1 + (\lambda d + \phi)} < 1$ and, in equilibrium, there will be some inefficiency.