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# DETERMINATION OF DAMAGES UNDER PRE-CONTRACTUAL LIABILITY

Master Thesis

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# INTRODUCTION

Nowadays as contracts turn out to be more complex and detailed, the civil circulation is becoming more complicated and as a result parties have to deal with extended time lines for reaching the agreement. According to the fundamental principle of civil relationships – *pacta sunt servanda* – negotiations for concluding a contract could be broken off at any time. However, the misleading negotiations are prohibited according to a good faith and fair dealing principles – it is forbidden to embark on negotiations without any intent to reach the final agreement. Moreover, parties have a duty not to break off well-developed negotiations without any just reason. Nevertheless, it is common that negotiating parties rely that the final agreement will be concluded and make some reliance investments in order to increase the surplus of the future contract. Thus, the pre-contractual negotiations of the parties are becoming more significant, especially if the final contract is not concluded and there is a need to define compensatory damages under pre-contractual liability.

**Novelty of the research.** On the one hand, in Lithuania, various problems in relation to pre-contractual liability have been discussed by legal scholars, however it has not been done in great detail. For example, Dangutė Ambrasienė and Solveiga Cirtautienė[1] analyzed the problem of qualification of pre-contractual liability; the before-mentioned topic was also briefly studied by Simona Selelionytė-Drukteinienė[2]; Julija Kiršienė and Natalja Leonova[3] examined qualification of pre-contractual liability and the value of lost opportunity; the value of lost opportunity was as well analyzed by Andrius Ivanauskas[4]; furthermore, only short chapter in relation to pre-contractual liability was written in the civil texbook[5], however, it mostly concentrated on the issues connected to the preliminary agreement. The most exhaustive analyzes was done by the professor Valentinas Mikelėnas[6], however it should be noted that most of it had been written before the new Civil Code of the Republic of Lithuania came into force. Concequently, none of the Lithuanian legal scholars have provided an exhaustive analysis of

[1] Ambrasienė D., Cirtautienė S. Ikisutartinės atsakomybės kvalifikavimo problema: sutartinė, deliktinė ar *sui generis*. *Jurisprudencija.* 2008, 10(112)
[2] Selelionytė-Drukteinienė S. Deliktinės ir sutartinės atsakomybės konkurencija. *Justitia*. 2008, 1(67)
[3] Kiršienė J., Leonova N. Qualification of Pre-contractual Liability and the Value of Lost Opportunity as a Form of Losses. *Jurisprudencija.* 2009, 1(115)
[4] Ivanauskas A. Prarastos galimybės piniginė vertė. *Justitia.* 2007, 1(63)
[5] Ambrasienė D., Baranauskas E., Bublienė D., Cirtautienė S., Galvėnas R., Laurinavičius K., Norkūnas A., Papirtis L. V., Rudzinskas A., Skibarkienė Ž., Stripeikienė J., Švirinas D., Toločko V., Usonienė J. *Civilinė teisė. Prievolių teisė.* Vilnius: Mykolo Romerio Universiteto Leidybos centras, 2006
[6] Mikelėnas V. *Civilinės atsakomybės problemos: lyginamieji aspektai*. Vilnius: Justitia, 1995; Mikelėnas V. *Sutarčių teisė. Bendrieji sutarčių teisės klausimai: lyginamoji studija*. Vilnius: Justitia, 1996; Mikelėnas V. *Lietuvos Respublikos civilinio kodekso komentaras. Šeštoji knyga. Prievolių teisė. T1*. Vilnius: Justitia, 2003

compensatory damages under pre-contractual liability.[7] Furthermore, none of the Lithuanian legal scholars, who analyzed possibility of compensation of damages under pre-contractual liability, had intergrated economic theories into their analysis in order to determine, which kind of damages could be awarded to an aggrieved party.

On the other hand, foreign legal scholars discussed various problems in relation to pre-contractual liability in greater detail. Various matters were analyzed by Allan E. Farnsworth[8], Albert H. Kritzer[9], Diane Madeline Goderre[10], Alan Schwartz and Robert E. Scott[11], Tess Wilkinson-Ryan[12], Lucian A. Bebchuk and Omar Ben-Shahar[13] and others. Nonetheless, most of foreign legal scholars focused on one problem in relation to pre-contractual liability.

Therefore, to our mind, there is a great need to provide deep analysis of genesis of pre-contractual liability and to determine compensatory damages under pre-contractual liability. The author of this master thesis will analyze UNIDROIT Principles of International Commercial Contracts, United Nations Convention on Contracts for the International Sale of Goods, the Civil Code of the Republic of Lithuania, legal acts of other European countries and case law of various European judicial institutions.

Finally, the topic is relevant due to the fact that there are scarely any articles by Lithuanian scholars, which would analyze compensatory and non-compensatory damages under pre-contractual liability, moreover, there are none, which would use economic and law theories in order to do so.

**Academic problem.** What kind of damages might be compensated for an aggrieved party in case final and legally binding agreement is not concluded?

The **goal of the research** is to analyze genesis of pre-contractual liability and to determine the types of damages a plaintiff could claim under pre-contractual liability. Thus, the **object of the research** is compensatory and non-compensatory damages under pre-contractual liability. In order to reach the above-mentioned goal, the author aimed to achieve such **tasks**:

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[7] Julija Kiršienė and Natalja Leonova as well as Andrius Ivanauskas analyzed possibility of compensation of lost opportunity under pre-contractual liability. Loss of a chance damages are only part of compensatory damages under pre-contractual liability.

[8] Farnsworth E. A., Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations. *Columbia Law Review*. 1987, 87(2)

[9] Kritzer A. H., Pre-contract formation. Available at: <http://www.cisg.law.pace.edu/cisg/biblio/kritzer1.html> Accessed: 26 February 2012

[10] Goderre D. M. International Negotiations gone sour: precontractual liability under the United Nations Sales Convention. Available at: <http://www.cisg.law.pace.edu/cisg/biblio/goderre.html> Accessed: 24 February 2012

[11] Schwartz A., Scott R. E. Precontractual liability and preliminary agreements. *Harvard Law Review*. 2007, 120(3)

[12] Wilkinson-Ryan T. Do Liquidated Damages Encourage Breach? A Psychological Experiment. *Michigan Law Review*. 2010, 180(5)

[13] Bebchuk L. A., Ben-Shahar O. Precontractual reliance. *The University of Chicago Journal of Legal Studies*. 2001, 30(2)

1. To reveal the applicability of principle of good faith under different national and international legal acts as well as rulings of various European judicial institutions and to determine the nature of pre-contractual liability;

2. To use economic and law theories in order to reveal negotiating parties' conduct during pre-contractual stage and to determine compensatory and non-compensatory damages under pre-contractual liability.

**Defending statements:**

1. The pre-contractual liability should be determined not as tortious or contractual liability but as *sui generis* type of liability.

2. Under pre-contractual liability an aggrieved party might recover reliance damages, which consist of direct damages and loss of opportunity, as well as liquidated damages or forfeits; nevertheless, an aggrieved party might not generally recover expectation damages, i.e. lost profits.

3. If characterized and understood by the parties as liquidated damages clause, the provision should be lawful and enforceable, i.e. the amount stipulated in the preliminary agreement should not be mitigated by the court; however, if characterized as forfeits clause, the amount stipulated in the preliminary agreement might be reduced or increased by the judge.

In collecting and processing the necessary information for this master thesis, the following **methods** were used:

- Method of qualitative analysis of documents was used to critically analyze legal acts, case law and doctrine related to the pre-contractual liability.

- Comparative method was used for the analysis of different legal acts and case law of various European judicial institutions. This method was also used in order to compare various publications and arguments of legal scholars who analyzed the most problematic issues related to the topic of this master thesis.

- Linguistic method was applied in order to determine the content of the private law provisions on the basis of the formulations provided in the legal acts. This method was also used in the analysis of the decisions of the European judicial institutions.

- Historical method was used in order to clarify historical circumstances, which influenced the content of international legal acts and legal principals.

- Logical methods, such as systemic and analytical methods, were used in order to reveal the content and correlation of legal documents, case law and doctrine related to the pre-

contractual liability.

The critical analysis of this paper is divided into two chapters – first, the genesis of pre-contractual liability will be analyzed. The author of this master thesis will analyze the applicability of good faith principle under different legal acts and determine the nature of pre-contractual liability. Second, the author will analyze parties' conduct under pre-contractual stage in relation to pre-contractual reliance investments and will determine compensatory and non-compensatory damages under pre-contractual liability. The purpose of highlighting these problems is to contribute to the discussion concerning parties' reliance in pre-contractual stage and consequences, which arises if an aggrieved party's reliance is breached and final and legally binding contract is not concluded.

# I. GENESIS OF PRE-CONTRACTUAL LIABILITY

Nowadays contracts turn out to be more complex and detailed, thus the civil circulation is becoming more complicated and as a result parties have to deal with extended time lines for reaching an agreement. There are various reasons that might delay a binding agreement. For instance, one of the most famous legal scholars on contracts from United States of America Allan E. Farnsworth observes that "first, an offeree may inquire about more favorable terms or make a counteroffer. Second, even if the offeree plans to accept the offer and enter into a contract based on its terms, the offeree may want to delay the acceptance notice."[14] Moreover, professor at Harvard Law School Lucian Arye Bebchuk and professor at the University of Chicago Law school Omri Ben-Shahar observes that "the offeree, or for that matter either one of the parties, may wish to prepare formal documents (for example, final draft of the contract, etc.) for the "closing", to further negotiate in order to reach understanding over some elements of the agreement that are still missing, to confirm profit values or acquire additional information about the desirability of contracting, or to get formal approval from their principals".[15]

As it was mentioned above, the formation of contract might be not only time-consuming but it should be also noted that during the negotiations parties are under no obligation to actually reach the final agreement. Thus, as it is correctly perceived by professor at Oxford University John Cartwright and professor at University of Amsterdam Martijn Hesselink that "before entering into a binding contract, parties retain some freedom to change their mind, to negotiate with other prospective parties, to acquire information, to verify the profitability of the proposed transaction, and to hold out if changes in the circumstances or some other aspect of the transaction make it unprofitable".[16] Thus even though it is argued that parties retain some freedom to change their mind before entering into final and legally binding contract, parties involved into negotiations have a duty to negotiate in good faith and cannot break off – not only advanced – negotiations in bad faith. If party is acting in bad faith during negotiations, the pre-contractual liability might be implied.

[14] Farnsworth E. A., Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations. *Columbia Law Review*. 1987, 87(2): 249

[15] Bebchuk L. A., Ben-Shahar O. Precontractual reliance. *The University of Chicago Journal of Legal Studies*. 2001, 30(2): 443

[16] Cartwright J., Hesselink M. *Precontractual liability. European Private Law*. London: Cambridge University Press, 2008, p. 431

Despite the fact that damages under pre-contractual liability might usually be awarded, as it is observed by the professor L. Engler and Susan B. Heyman[17], under theories of promissory estoppel[18], breach of the duty of good faith[19], and breach of a preliminary commitment[20], or, as it is observed by legal scholar Rodrigo Novoa[21], under theories of unjust enrichment[22], misrepresentation[23], specific promise[24], general obligation[25], due to the restricted extent of this paper, we will focus on possibility of compensation of damages under the theory of general obligation[26] as this theory is most common in continental law jurisdictions. To this end, in the following sections of this chapter, the analysis of duty of good faith will be provided. Firstly, the general duty of pre-contractual good faith under continental law and common law countries' laws, Draft of the Common Frame of Reference and UNIDROIT Principles of International Commercial Contracts will be analyzed. Secondly it will be analyzed if a general duty of pre-contractual good faith exists under and if the pre-contractual stage falls within the scope of United Nations Convention on Contracts for the International Sale of Goods. Finally, it will be analyzed what type of liability is the pre-contractual liability – tortious, contractual or *sui generis* type of liability.

[17] Engler M. L., Heyman S. B. The missing elements of contract damages. *Temple Law Review, Forthcoming; Roger Williams University Legal Studies Paper No. 113; Cardozo Legal Studies Research Paper No. 349*. 2011

[18] This theory is used in common law countries (mostly in United States of America). Promissory estoppel – the principle that a promise made without consideration may nonetheless be enforced to prevent injustice if the promisor should have reasonably expected the promisee to rely on the promise and if the promisee did actually rely on the promise to his or her detriment. *See* Black's Law Dictionary, Ninth Edition, West: Thomson Reuters business, 2009

[19] It could be also understood as breach of a duty to negotiate in good faith.

[20] It could be also understood as a breach of a concluded preliminary agreement.

[21] Novoa R. Culpa in contrahendo: a Comparative Law Study: Chilean Law and the United Nations Convention on Contracts for the International Sales of Goods (CISG). *Arizona Journal of International and Comparative Law.* 2005, 22(3)

[22] Unjust enrichment – a benefit obtained from another, not intended as a gift and not legally justifiable, for which the beneficiary must make a restitution or recompensate. *See* Black's Law Dictionary, Ninth Edition, West: Thomson Reuters business, 2009. Furthermore, according to legal scholar Rodrigo Novoa, unjust enrichment – the duty to make restitution of benefits received during negotiations – is perhaps the most fundamental ground for pre-contractual liability. A negotiating party may not with impunity unjustly appropriate such benefits to its own use. To prevent such unjust enrichment, the law imposes liability measured by the injured party's restitution interest. Claims to restitution commonly involve either ideas disclosed or services rendered during negotiations. *See* Novoa R., *op. cit.* (footnotes omitted)

[23] Misrepresentation – the act of making a false or misleading assertion about something, usually with the intent to deceive. *See* Black's Law Dictionary, Ninth Edition, West: Thomson Reuters business, 2009; Furthermore, according to legal scholar Rodrigo Novoa, misrepresentation is another fundamental basis of pre-contractual liability, and it has been no more popular with claimants than restitution has been. A negotiating party may not with impunity fraudulently misrepresent its intention to come to terms. Such an assertion is one of fact–of a state of mind – and if fraudulent, it may be actionable in tort. *See* Novoa R., *op. cit.* (footnotes omitted)

[24] It is understood as promissory estoppel. *See supra note* 18

[25] It should be understood as a general duty to act in accordance with good faith during negotiations.

[26] As to our mind, Rodrigo Novoa's provided theory "general obligation" consists of two theories provided by Mitchell L. Engler and Susan B. Heyman: breach of a duty of good faith and breach of a preliminary commitment.

## 1.1. General duty of pre-contractual good faith

*Good faith is the prime mover and*
*life giving spirit of commerce.*[27]

Many civil codes of different countries as well as international conventions or agreements establish a duty for the parties to conduct themselves in accordance with good faith principle. However, legal scholars argue that there is an immediate contrast between the civil law jurisdiction and the common law, since the common law imposes no general duty of pre-contractual good faith.[28] As we undertook to determine damages under pre-contractual liability in this master thesis, therefore we are going to analyze if pre-contractual relationships are determined and pre-contractual good faith is established in different legal sources and different legal systems. Hence, in order to understand the principle of pre-contractual good faith, although the definition of duty of pre-contractual good faith is not provided in any legal documents[29], we have to analyze UNIDROIT Principles of International Commercial Contracts (hereinafter – "UNIDROIT PICC")[30], Draft of the Common Frame of Reference (hereinafter – "DCFR")[31], Civil Code of the Republic of Lithuania (hereinafter – "Lithuanian CC")[32], BGB of Federal Republic of Germany (hereinafter – "German BGB")[33], Civil Code of the Republic of France (hereinafter – "French CC")[34] and United Nations Convention on Contracts for the International

[27] Zimmermann, R., Whittaker, S. *Good Faith in European Contract Law.* Cambridge: Cambridge University Press, 2000, p. 18

[28] Beale H., Fauvarque-Cosson B., Rutgers J., Tallon D., Vogenauer S. *Cases, Materials and Text on Contract Law*. Oxford: Hart, 2010, p. 372

[29] Although the definition of duty of pre-contractual good faith is not given in the mentioned legal documents, some common examples of behavior considered contrary to the principle of good faith might be distinguished: (1) negotiating without an intention to conclude a contract, (2) parallel negotiations, (3) breaking off negotiations, (4) knowingly entering into an invalid contract, (5) disclosing confidential information. *See* Beale H., Fauvarque-Cosson B., Rutgers J., Tallon D., Vogenauer S., *op. cit.*, p. 372

[30] UNIDROIT PICC have been the model for many national codifications, for example, they have been used as a model while creating Lithuanian CC. Moreover, as they are becoming increasingly essential in arbitrations of disputes arising out of international contracts, either as directly applicable law and either as a source for the interpretation of other laws governing the contracts, such as especially CISG, as UNIDROIT PICC is well recognized, therefore we assume that it is utmost important to analyze it.

[31] As DCFR was prepared exclusively by European legal scholars, as it is an 'academic tool' and not a political act, as DCFR might become part of *acquis communautaire*, i.e. applicable in all European Union member states, we assume that it is utmost important to analyze it.

[32] As this master thesis is written in Lithuania, we decided to analyze Lithuanian CC and to provide the Supreme Court's of the Republic of Lithuania case law in this particular area.

[33] As Germany is the biggest national economy in Europe and world's second largest exporter, as this leads to numerous contracts and pre-contracts concluded in Germany, as *culpa in contrahendo* doctrine (*see supra note* 50) was established in Germany, we assume that it is utmost important to analyze Germany's national legal acts and legal doctrine.

[34] As France is the second biggest national economy in Europe, as it can be assumed that numerous contracts and pre-contracts are concluded in France, as *culpa in contrahendo* doctrine was amended by well-known French author Raymond Saleilles (*see supra note* 50), we assume that it is utmost important to analyze France's national legal acts and legal doctrine.

Sale of Goods (hereinafter – "CISG")[35] and interpretation of it. Thus, in following parts of this master thesis, the duty of pre-contractual good faith under different legal acts will be analyzed.

### *1.1.1. Duty of pre-contractual good faith under different countries' national laws and UNIDROIT PICC*

Article 1.7 of UNIDROIT PICC[36] establishes a general duty for the parties to act in accordance with good faith and fair dealing. It is obvious that such duty is imposed not only for the performance of the contract but also during the negotiations process. In the official comment of UNIDROIT PICC it is established that 'good faith and fair dealing' is as a fundamental idea underlying UNIDROIT PICC and is applied to pre-contractual stage.[37] Moreover, the commentary of UNIDROIT PICC provides that "the obligation to 'act' in accordance with good faith and fair dealing in Article 1.7 is extremely broad. It extends to all phases of the life of a contractual relationship, from the start of the negotiations, through the course of the performance and to the consequences of non-performance. It continues to apply during the enforcement of the contract. As such, the obligation is primarily addressed to the contracting parties".[38] However, even though Article 1.7 of UNIDROIT PICC establishes the requirement for the parties to act in accordance with the good faith and fair dealing and this requirement, according to the official comment of UNIDROIT PICC, is applicable to the negotiations process, Article 2.1.15 of UNIDROIT PICC[39], as a special rule, establishes the requirement to act not accordingly to the principle of good faith and fair dealing but to act not in bad faith. The official comment of UNIDROIT PICC states that the right to break off negotiations also is subject to the principle of good faith and fair dealing.[40] Nonetheless, lecturer in law at London School of Economics and co-editor on Commentary on the UNIDROIT PICC Jan Kleinheisterkamp and professor at Oxford University and co-editor on Commentary on the UNIDROIT PICC Stefan Vogenauer argue that from a literal point of view, the obligation not to act in 'bad faith' cannot simply be

[35] The purpose of CISG is to provide a modern and uniform regime for contracts for the international sale of goods. As it is broadly used convention, as CISG is applicable in 77 countries situated in all continents, therefore we assume that it is utmost important to analyze this convention.
[36] Article 1.7 of UNIDROIT PICC (*Good faith and fair dealing*) establishes that:
'(1) Each party must act in accordance with good faith and fair dealing in international trade. (2) The parties may not exclude or limit this duty'.
[37] UNIDROIT Principles of International Commercial Contracts 2010. Rome: Unidroit, 2011
[38] Kleinheisterkamp J., Vogenauer S. *Commentary of the UNIDROIT principles of international commercial contracts (PICC).* Oxford: Oxford University Press, 2009, p. 169
[39] Article 2.1.15 of UNIDROIT PICC (*Negotiations in bad faith*) states that:
'(1) A party is free to negotiate and is not liable for the failure to reach an agreement. (2) However, a party who negotiates or breaks off negotiations in bad faith is liable for losses caused to the other party. (3) It is bad faith, in particular, for a party to enter into or continue negotiations when intending not to reach an agreement with the other party'.
[40] UNIDROIT Principles of International Commercial Contracts 2010., *op. cit.*

equated to the obligation to act in 'good faith' that is recognized in Article 1.7 of UNIDROIT PICC.[41] In our opinion, there is an obvious disagreement between the explanations of Article 1.7 and Article 2.1.15 provided in the official comment and commentary of UNIDROIT PICC. According to Article 1.7 of UNIDROIT PICC and to the official comment of it, it is stated that parties must act in accordance with the principle of good faith and fair dealing during the negotiations and performance of the contract, though in Article 2.1.15 of UNIDROIT PICC and in it's commentary it is stated that parties can not act in bad faith. Moreover, as it was mentioned above, 'act in accordance with good faith' does not have the same meaning as 'not to act in bad faith'. Jan Kleinheisterkamp and Stefan Vogenauer imply that the exact wording of Article 2.1.15 of UNIDROIT PICC ('bad faith' not 'good faith') was chosen on purpose. According to Jan Kleinheisterkamp and Stefan Vogenauer "if the wording of Article 2.1.15 of UNIDROIT PICC would have been 'a party who negotiates or breaks off negotiations contrary to good faith and fair dealing is liable', it would have meant stating a general obligation to negotiate in good faith in international commercial transactions, i.e. a position which is incompatible with the position in most common law countries. Furthermore, the choice of a notion that so strongly alludes to moral standards as 'bad' shows that, unless the parties agree differently, more is needed than just 'negligence'. 'Bad faith' requires more than just the simple lack of 'faithfulness' in the sense of faithful fulfillment of implied obligations. In the absence of any specific circumstances or agreement of the parties that indicate otherwise, only acts or omissions that qualify as manifestly dishonest or vexatious can give rise to liability".[42] As explanations of Article 1.7 and Article 2.1.15 of UNIDROIT PICC contradicts to each other, the obvious question arises: should parties act in accordance with good faith during the negotiations or should parties not act in bad faith during the negotiations, or there is no difference between those two concepts? Even though to our mind Jan Kleinheisterkamp and Stefan Vogenauer's arguments are reasonable and to their mind a concept 'bad faith' requires more than just a simple lack of faithfulness, however, we should state that UNIDROIT PICC does not separate those two concepts. As it could be concluded, in our opinion concept of 'in bad faith' is part of 'contrary to good faith' or, as it is well observed by Emily Houh, theory of good faith is the notion that it is defined as the negative corollary of bad faith[43]. On the other hand, Lithuanian CC, which is based on UNIDROIT PICC, does not separate those two concepts either. Part 1 of Article 6.163 of Lithuanian CC states that 'in the course of pre-contractual relationships, parties shall conduct

[41] Kleinheisterkamp J., Vogenauer S. *Commentary of the UNIDROIT principles of international commercial contracts (PICC)*. Oxford: Oxford University Press, 2009, p. 302
[42] *Ibid.*
[43] Houh E. The Doctrine of Good Faith in Contract Law: A (Nearly) Empty Vessel? Available at: <http://scholarship.law.uc.edu/fac_pubs/103> Accessed: 3 March 2012

themselves in accordance with good faith'. Part 3 of the same article declares that 'a party who begins negotiations or negotiates in bad faith shall be liable for the damages caused to the other party. It shall be considered bad faith for a party to enter into negotiations or continue them without intending to reach an agreement with the other party, likewise any other actions that do not conform to the criteria of good faith'. As it can be assumed from the literal point of article 6.163 of Lithuanian CC, 'bad faith' means actions that do not conform to the criteria of 'good faith'[44]. Moreover, the Supreme Court of the Republic of Lithuania (hereinafter – "the Supreme Court of Lithuania") has not distinguished concepts of 'contrary to good faith' and 'in bad faith' either. For example, the Supreme Court of Lithuania stated that parties which are in the pre-contractual relationships, as well as the parties of the contract, has a duty to act in accordance with the principle of good faith.[45] In other case the Supreme Court of Lithuania stated that parties are free to start negotiations and negotiate and they are not liable if the final agreement is not reached. However, if during negotiations one party acted in bad faith and a final agreement was not reached, civil liability should be implied. A party who negotiates in bad faith should compensate damages suffered by the aggrieved party.[46] Thus, Lithuanian CC and the Supreme Court of Lithuania have not distinguished two different concepts – 'contrary to good faith' and 'in bad faith' either. In our opinion, good faith principle is a general principle, which should be always followed and it should be understood as the notion that it is defined as the negative corollary of bad faith. To our mind, in order to avoid confusion between notions 'contrary to good faith' and 'in bad faith', the Supreme Court of Lithuania should clarify and separate those two concepts. Furthermore, we assume that it would be reasonable to relinquish concept 'in bad faith' and to declare that parties should be under obligation not to act contrary to the principle of

[44] Actions, which do not conform to the criteria of good faith, could be understood as: parallel negotiations, breaking off negotiations, knowingly entering into an invalid contract, disclosing confidential information. Parallel negotiations – the duty of pre-contractual good faith prohibits for a party to negotiate the same contract with several parties without informing them about it, i.e. negotiating parties are obliged to conduct parallel negotiations in accordance with good faith principle. Breaking off negotiations – no party is under a duty to reach an agreement, however, in exceptional cases a party might be liable for breaking off negotiations in a manner contrary to good faith. Knowingly entering into an invalid contract – a party who knows that a contract would be invalid nevertheless concludes it without warning the other party might be liable to pay reliance damages. This liability differs from liability for breaking off negotiations in that here an agreement is reached. Disclosing confidential information – the duty of pre-contractual good faith could imply a duty to treat information obtained during negotiations as confidential; a party might violate this duty by divulging the information to the public or by using it for his own purposes. If a party enters into negotiations for the sole purpose of obtaining knowledge of another company's secrets, he not only would be liable for an eventual breach of a duty of confidentiality, but he also would have to reimburse the other party for the expenses incurred in negotiating. *See* Beale H., Fauvarque-Cosson B., Rutgers J., Tallon D., Vogenauer S. *Cases, Materials and Text on Contract Law*. Oxford: Hart, 2010, p. 371-426

[45] Ruling as of 11 August 2008, Civil Case Division of the Supreme Court of Lithuania (case No. 3K-3-366/2008); Ruling as of 29 September 2009, Civil Case Division of the Supreme Court of Lithuania (case No. 3K-3-363/2009); Ruling as of 28 March 2011, Civil Case Division of the Supreme Court of Lithuania (case No. 3K-3-129/2011); Ruling as of 21 December 2011, Civil Case Division of the Supreme Court of Lithuania (case No. 3K-3-530/2011)

[46] Ruling as of 22 June 2010, Civil Case Division of the Supreme Court of Lithuania (case No. 3K-3-279/2010)

good faith. Moreover, in our opinion, it would be reasonable specifying Lithuanian CC.[47] Part 3 of Article 6.163 of Lithuanian CC should declare that 'A party who begins negotiations contrary to good faith shall be liable for the damages caused to the other party'. The necessity of such adjustment of article 6.613 of Lithuanian CC, i.e. the renunciation of concept 'in bad faith', is also supported by the fact that DCFR, which is created by European legal scholars and might be directly applicable in Lithuania as part of *acquis communautaire*, does not use a notion 'in bad faith', instead it uses a notion 'contrary to good faith'[48].

In Article 1134 of French CC[49] it is declared that: 'agreements lawfully entered into take the place of the law for those who have made them. They may be revoked only by mutual consent, or for causes authorized by law. They must be performed in good faith'. From a literal point of view this provision directly establishes the duty for the parties to act in accordance with good faith only in the performance of the contract. It would seem – if we could say so – quite strange that in the country, which amended *culpa in contrahendo* doctrine[50], the pre-contractual good faith principle would not be applicable. However, in France *culpa in contrahendo* is recognized by analogy of law and by the case law. In spite of the silence of the French CC on the

[47] Article 6.163 of Lithuanian CC declares that: '(1) In the course of pre-contractual relationships, parties shall conduct themselves in accordance with good faith. (2) Parties shall be free to begin negotiations and negotiate, and shall not be liable for failure to reach an agreement. (3) A party who begins negotiations or negotiates in bad faith shall be liable for the damages caused to the other party. It shall be considered bad faith for a party to enter into negotiations or continue them without intending to reach an agreement with the other party, likewise any other actions that do not conform to the criteria of good faith. (4) The parties shall be bound to disclose to each other the information they have and which is of essential importance for the conclusion of a contract.'

[48] II. – 3:301 of DCFR (*Negotiations contrary to good faith and fair dealing*) establishes that: '(1) A person is free to negotiate and is not liable for failure to reach an agreement. (2) A person who is engaged in negotiations has a duty to negotiate in accordance with good faith and fair dealing and not to break off negotiations contrary to good faith and fair dealing. This duty may not be excluded or limited by contract. (3) A person who is in breach of the duty is liable for any loss caused to the other party by the breach. (4) It is contrary to good faith and fair dealing, in particular, for a person to enter into or continue negotiations with no real intention of reaching an agreement with the other party'.

[49] The Civil Code of the Republic of France. 99th edition. Paris: Dalloz, 2000

[50] Literally *culpa in contrahendo* means fault in negotiations, inapproriate behavior of the parties during the negotiations process. The theory is that contracting parties are under a duty to act in good faith during negotiations, so that a party who acts improperly in preventing the culmination of an agreement is liable to the injured party. *See* Goderre D. M. International Negotiations gone sour: precontractual liability under the United Nations Sales Convention. Available at: <http://www.cisg.law.pace.edu/cisg/biblio/goderre.html> Accessed: 24 February 2012.
Later on, in the beginning of the twentieth century doctrine of *culpa in contrahendo* was interpreted and amended by well-known French author Raymond Saleilles. Thus, it is observed by legal scholars Friedrich Kessler and Edith Fine that "the German doctrine of *culpa in contrahendo*, as amended by Saleilles, is that contracting parties are under a duty <…> to deal in faith with each other during the negotiation stage, or else face liability, customarily to the extent of the wronged party's reliance". *See* Kessler F., Fine E. Culpa in Contrahendo, Bargaining in Good Faith and Freedom of Contract: A Comparative Study. *Harvard Law Review*. 1964, 77(3): 401. Furthermore, it is observed that Raymond Saleilles suggested that good faith principle should be applicable during entire pre-contractual stage. In accordance with the principle of good faith, parties engaged into negotiations should act fairly and cannot terminate negotiations without valid and due reason. *See* Kucher A. N. Pre-contractual liability: Protecting the Rights of the Parties Engaged Into Negotiations. Available at: <http://www.nyulawglobal.org/fellows scholars/forums/papers/Kucher-paper.pdf> Accessed: 24 February 2012. It should be noted that most civil law countries, for example France, Italy, Lithuania, adopted the French approach.

question of pre-contractual liability, there is a large body of case law[51]. According to legal scholars, insofar as pre-contractual negotiations are concerned, French courts usually infer three types of duties from this general obligation of good faith, which are duty to inform, a duty of confidentiality and a duty not to behave inconsistently during the negotiations.[52] Therefore, we can conclude that even though French CC does not directly establish a duty of pre-contractual good faith, however, pre-contractual good faith principle is applicable as applicability of good faith principle during negotiations process is established in the jurisprudence of French courts.

In section 241 part 2 of German BGB[53] it is declared that: 'an obligation may also, depending on its contents, oblige each party to take account of the rights, legal interests and other interests of the other party'. In section 311 part 2 it is declared that: 'an obligation with duties under section 241 (2) also comes into existence by (1) the commencement of contract negotiations, (2) the initiation of a contract where one party, with regard to a potential contractual relationship, gives the other party the possibility of affecting his rights, legal interests and other interests, or entrusts these to him, or (3) similar business contacts'.[54] In Germany the *Reichsgericht*[55] had already accepted that, by taking up negotiations, parties enter into a legal relationship, similar to a contractual relationship, that gives rise to several duties between the negotiating parties, for example depending on the case, duties not to harm the other party's person or property, to provide him with certain types of information and not to break off very advanced negotiations.[56] It had been stated that the violation of such duty makes a party liable for *culpa in contrahendo*. *Bundesgerichtshof*[57] has continued the same explanation of pre-contractual good faith.[58] Thus, consequently, in Germany the pre-contractual good faith principle is implemented into national laws and acknowledged by German courts.

Consequently, continental law jurisdictions have recognized the general duty of pre-contractual good faith. *Culpa in contrahendo* doctrine, developed by German Rudolf Von Jhering and later on amended by French Raymond Saleilles, is recognized in many

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[51] For example, ruling as of March 24, 1958, Cour de Cassation; ruling as of 14 January 1969, Cour d'appel de Pau; ruling as of 20 of March 1972, Cour de Cassation; ruling as of 3 October 1972, Cour de Cassation; ruling as of 12 April 1976, Cour de Cassation; ruling as of 22 April 1997, Cour de Cassation; ruling as of 6 January 1998, Cour de Cassation, etc. *Translated by* Beale H., Fauvarque-Cosson B., Rutgers J., Tallon D., Vogenauer S. *Cases, Materials and Text on Contract Law*. Oxford: Hart, 2010, p. 371-426

[52] Beale H., Fauvarque-Cosson B., Rutgers J., Tallon D., Vogenauer S., *op. cit.*, p. 374

[53] BGB of Federal Republic of Germany. Available at: <http://www.gesetzeiminternet.de/englisch_bgb/englisch_bgb.html#p1005> Accessed: 24 February 2012

[54] It is quite interesting that even though the doctrine of *culpa in contrahendo* was established in Germany, the duty to act in good faith in the German BGB was incorporated only in 2002.

[55] Court of the German Empire, which was the highest court of the *Deutsches Reich*.

[56] Ruling as of 7 December 1911, Reichsgericht. *Translated by* Beale H., Fauvarque-Cosson B., Rutgers J., Tallon D., Vogenauer S., *op.cit.*, p. 374

[57] The Federal Supreme Court of Germany.

[58] For example, *see* ruling as of 10 July 1970, *Bundesgerichtshof*. *Translated by* Beale H., Fauvarque-Cosson B., Rutgers J., Tallon D., Vogenauer S., *op. cit.*, p. 383-384

different countries. In some countries[59] general obligation to act in good faith is implemented into national laws and acknowledged by national courts, in others[60] – not directly implemented, however well-developed by national courts.

### *1.1.2. Duty of pre-contractual good faith in the common law jurisdictions*

Famous legal scholar Michael Joachim Bonell observes that "common law systems are traditionally reluctant to restrict freedom of negotiations and favour an 'aleatory' view of negotiations according to which parties are at risk until a contract has actually been formed".[61] Michael Joachim Bonell argument is based on the most famous English precedent *Walford and Others v. Miles and Another*[62]. In *Walford and Others v. Miles and Another* the House of Lords stated that "the concept of a duty to carry on negotiations in good faith is inherently repugnant to the adversarial position of the parties when involved in negotiations. Each party to the negotiations is entitled to pursue his (or her) own interest, so long as he avoids making misrepresentations. To advance that interest he must be entitled, if he thinks it appropriate, to threaten to withdraw from further negotiations or to withdraw in fact in the hope that the opposite party may seek to reopen the negotiations by offering him improved terms. <…> A duty to negotiate in good faith is as unworkable in practice as it is inherently inconsistent with the position of a negotiating party. <…> In my judgment, while negotiations are in existence either party is entitled to withdraw from these negotiations, at any time and for any reason".[63] Therefore, it is correctly assumed by Allan Farnsworth that "common law judges hold that a party that enters negotiations hoping to gain from a resulting contract bears the risk of any loss that would be incurred if the other party breaks off the negotiations".[64]

Differently from civil law countries where pre-contractual good faith principle is implemented into national laws or recognized as a general principle by the case law of national courts, in common law systems the general principle of good faith or doctrine of *culpa in contrahendo* is not acknowledged[65]. Nevertheless, it observed by some legal scholars[66] that

[59] For example, in Lithuania, Germany, Portugal, Greece, Italy.
[60] For example, in France.
[61] Bonell M. J. *International Restatement Of Contract Law: The UNIDROIT Principles Of International Commercial Contracts* [e-book]. 2005, p. 139-140. Available from: eBook Collection (EBSCOhost), Ipswich, MA. Accessed: February 24, 2012
[62] Ruling as of 23 January 1992, House of Lords. Available at: <http://www.dpsd.unimi.it/fonti/921.pdf> Accessed: 26 February 2012
[63] *Ibid.*
[64] Farnsworth E. A. Duties of good faith and fair dealing under the UNIDROIT principles, relevant international conventions, and national laws. Available at: <http://www.trans-lex.org/122100> Accessed: 26 February 2012
[65] In case *Walford and Others v. Miles and Another* (*see supra note* 62) it was affirmed that under English law there is no such thing as a general duty to negotiate in good faith.
[66] McKendrick E. *Contract Law. Text, Cases and Materials*. Oxford: Oxford University Press, 2008, p. 518

common law would sooner or later acknowledge the doctrine of good faith. However, even though *culpa in contrahendo* doctrine is not yet acknowledged in common law countries, Michael Joachim Bonell correctly observes that "even in the civil law systems, notwithstanding the general principle of *culpa in contrahendo*, it is difficult to find cases that actually impose pre-contractual liability where most common law courts would not do so on the other grounds".[67] Thus, from the analysis provided above, we could make a conclusion that general principle of good faith is not yet acknowledged in common law countries, and, contrary to civil law jurisdictions, negotiating parties do not have an obligation to act in accordance with good faith principle, however it is does not mean that negotiating parties would not face pre-contractual liability as it would be imposed on the other grounds.

### *1.1.3. Duty of pre-contractual good faith under DCFR*

DCFR was prepared by the study group on a European Civil Code and the research group on EC Private Law (*Acquis Group*) and was based in part on a revised version of the Principles of European Contract Law, also known as PECL. DCFR contains principles, definitions and model rules of European private law.

DCFR was prepared exclusively by the European legal scholars, which expertise in private law, comparative law and European Union law. One purpose of the DCFR, which is, as it was mentioned above, 'an academic tool', is to serve as a draft for drawing up a 'political' Common Frame of Reference (hereinafter – CFR). DCFR does not contain a single rule or definition or principle which has been approved or mandated by a politically legitimated body at European or national level[68] as it was prepared not by European politicians but by European legal scholars. It should be noted that as for today DCFR is only 'theoretical, academic tool', which could be helpful for legal scholars, law students or even judges, however, in the near future DCFR might be carried over at least in part into the CFR. Thus, DCFR might become a part of European Union legal tool, which might be directly applicable in European Union member states or might change European Union member states' national legislation.[69]

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[67] Bonell M. J. *International Restatement Of Contract Law: The UNIDROIT Principles Of International Commercial Contracts* [e-book]. 2005, p. 140. Available from: eBook Collection (EBSCOhost), Ipswich, MA. Accessed: February 24, 2012

[68] Principles, Definitions and Model Rules of European Private Law. Draft Common Frame of Reference (DCFR). Outline Edition. Available at: <http://ec.europa.eu/justice/contract/files/european-private-law_en.pdf> Accessed: 15 April 2012

[69] For more information about DCFR study groups, creation procedure and purpose *see* Principles, Definitions and Model Rules of European Private Law. Draft Common Frame of Reference (DCFR). Outline Edition., *op. cit.*; Communication from the Commission to the European Parliament, the Council, the European Economic and Social

Article II. – 3:301 of DCFR[70] implies the duty to negotiate in accordance with good faith and fair dealing principle and establishes that a person who breached this duty is liable for any loss caused to the other party by that breach. Thus, European legal scholars, who prepared DCFR, chose continental law approach as good faith and fair dealing principle is directly applicable on the parties during pre-contractual stage. Even though DCFR is still a 'theoretical tool', however it might become[71] or be a background for a European Union legal tool[72], which would be directly applicable in European Union member states or European Union member states would have to change their national laws in order to comply with DCFR. Thus, an obvious problem arises: how the duty to negotiate in accordance with good faith and fair dealing principle could be applicable in the United Kingdom as it is obvious that such an approach deviates from English contract law? However, at this stage it is hardly possible to find one solution to this problem, as it is very difficult to know how DCFR would be applied in practice. Nevertheless, in our opinion there are only two solutions: first, the United Kingdom would be forced to change their national laws and to apply continental law approach in this particular area; second, provisions, which would not comply with common law jurisdiction, would not be applicable in the United Kingdom. As to our mind, DCFR should be directly applicable in all European Union member states; United Kingdom should have to change their national laws. Otherwise, DCFR would be another 'soft law', which probably would not be used in practice.[73]

### *1.1.4. Duty of pre-contractual good faith under CISG*

According to a data provided by United Nations Commission on International Trade Law[74] (hereinafter – "UNCITRAL") today there are 77 states, which have adopted CISG, such as, for example, Lithuania, France, Germany, Switzerland, United States of America, Canada, PRC of China. CISG was adopted after long-term negotiations between different countries and

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Committee and the Committee of the Regions. A Common European Sales Law to facilitate cross-border transactions in the single market. Available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0636:FIN:en:PDF> Accessed: 16 April 2012

[70] *See supra note* 48

[71] As European legal scholars – if we could state so – best European legal academics, prepared DCFR, we assume that DCFR will not remain as only 'theoretical tool' as to our mind it will become an European legal tool, i.e. part of *acquis communautaire*. However, we cannot be certain how and when it will be transformed into a legal act as it depends on various political decisions.

[72] It might be used for creating CFR or any other kind of common European legal act on Contracts.

[73] As to our mind, there is no need for another 'soft law' act as there is already enough of it, such as for example UNIDROIT PICC.

[74] United Nations Commission on International Trade Law. Status of United Nations Convention on Contracts for In ternational Sales of Goods. Available at: <http://www.uncitral.org/uncitral/en/uncitral_texts/sale_goods/1980CISG_status.html> Accessed: 25 February 2012

different legal systems[75]. In order to understand different interpretations of good faith principle under CISG, which will be provided further on, firstly, we must shortly analyze CISG creation procedure.

Delegates, which were apointed to create CISG, were divided into several groups while resolving the question whether good faith principle should be incorporated in the text of CISG. Some delegates suggested that such principle should not be incorporated in the text of CISG as it is very moral and declerative. For example, some delegates disapproved of the provision because the term 'good faith' is exclusively moral in nature and, therefore, does not belong in an international treaty.[76] Moreover, it was stated that "the requirement of acting in good faith was implicit in all laws regulating business activity and it was consequently unnecessary to include the requirement in any specific text".[77] On the other hand, other delegates suggested to incorporate the requirement of a pre-contractual and contractual duty of good faith in the text of CISG. Lawyers from continental law jurisdictions argued for the incorporation of a good faith principle in the text of CISG, for example, delegates who supported the provision argued that "good faith is a universally recognized principle because many national commercial codes contained similar good-faith obligations which had been instrumental in the development of trade rules".[78] Furthermore, it was stated that incorporation of general duty of pre-contractual good faith was needed in international trade, especially in relation to trade with developing countries. Moreover, it was also pointed out that "the concept of good faith was well recognized in public international law and was referred to in the Charter of the United Nations".[79] Consequently, after long negotiations delegates reached a final solution and a general duty of good faith in application of CISG was incorporated in the final text of CISG.[80]

It is argued by legal scholars that "the text is the result of a compromise between those who wished to see good faith as a positive obligation directed to the parties' behavior in the formation and performance of the contract (as is found in many civil law countries) and those who thought that there should be no such general duty on the ground that it would lead to great uncertainty in determining rights and obligations of the contracting parties (as approach

[75] UNCITRAL wanted to create a universally accepted convention, which would represent majority of countries and their attitude.
[76] Novoa R. Culpa in contrahendo: a Comparative Law Study: Chilean Law and the United Nations Convention on Contracts for the International Sales of Goods (CISG). *Arizona Journal of International and Comparative Law*. 2005, 22(3)
[77] Kritzer A. H., Pre-contract formation. Available at: <http://www.cisg.law.pace.edu/cisg/biblio/kritzer1.html> Accessed: 26 February 2012
[78] Novoa R., *op. cit.*
[79] Kritzer A. H., *op. cit.*
[80] Part 1 of article 7 of CISG declares that 'in the interpretation of this Convention, regard is to be had to its international character and to the need to promote uniformity in its application and the observance of good faith in international trade'.

associated with common lawyers in general and English lawyers in particular)".[81] Thus, as such wording of Article 7 of CISG was chosen, there is no clear answer if duty of good faith is applicable to the parties engaged into contractual relationships, moreover, it is even more unclear if principle of good faith is applicable during pre-contractual stage. The answer to this question depends on the interpretation of this article. According to legal scholars, there are three views on meaning of principle of good faith incorporated in CISG:

1. Principle of good faith does not impose any positive duty on the parties. Professor John Honnold, who was a chief of the legal staff of the UNCITRAL during the preparation of CISG, states that "the Convention rejects 'good faith' as a general requirement and uses 'good faith' solely as a principle for interpreting the provisions of the Convention".[82] According to this view of interpretation of principle of good faith, parties are not obliged to act in accordance with good faith principle during negotiations, formation or performance of the contract. Moreover, only judges hearing the case would be obliged to interpret the provisions of CISG in accordance with good faith principle. This point of view is hardly comprehensible in continental law countries where parties are obliged to act in accordance with good faith principle in the formation of the contract, i.e. during the negotiations, and in the performance of the contract, however, this point of view of the interpretation of Article 7 of CISG is compatible with common law systems where, as we concluded in previous part of this master thesis, *culpa in contrahendo* doctrine is not acknowledged.

2. Article 7 of CISG imposes a positive duty of good faith on the parties engaged into the contract. Legal scholars argue that "in favor of this view is the proposition that it is not possible to draw a clear line of distinction between good faith duty that is directed to the interpretation of the Convention and a duty that is directed to the interpretation and enforcement of the contract of sale itself".[83] According to this point of view of the interpretation of CISG, good faith principle is applicable in two cases: first of all, CISG should be interpreted according to principle of good faith. Secondly, parties are obliged to act in accordance with good faith principle. However, a duty to act according to the principle of good faith is imposed only on the parties engaged into the contract, i.e. only a general duty of contractual good faith principle, therefore, parties do not have a general duty of pre-contractual good faith.

3. Good faith, declared in CISG imposes a general duty for the parties to act in accordance with the general principle of good faith. It is observed by legal scholars that "if it can

[81] Goode R., Kronke H., McKendrick E. *Transnational commercial law: Text, Cases and Materials*. Oxford: Oxford University Press, 2007, p. 278
[82] Excerpt from Honnold J. O. *Uniform Law for International Sales under the 1980 United Nations Convention*, 1999. Available at: <http://cisgw3.law.pace.edu/cisg/biblio/ho7.html> Accessed: 26 February 2012
[83] Goode R., Kronke H., McKendrick E., *op. cit.*, p. 281

be established that 'good faith' is a general principle upon which the Convention is based, such a duty will be imposed on the parties by Article 7 (2)[84], rather than 7 (1)".[85] According to this point of view of the interpretation of CISG, parties are obliged to act in accordance with good faith principle during formation of contract, negotiations and performance of it. This point of view is very tempting for lawyers from continental law system; however, lawyers from common law systems could not accept this interpretation of Article 7 of CISG[86].

We can conclude from the provided analysis that there is no unilateral view if good faith principle falls within the scope of CISG. Moreover, there is no unilateral opinion even if pre-contractual stage is regulated by CISG. If pre-contractual relationships are not regulated by CISG, no general duty of pre-contractual good faith could be imposed on the parties. First of all, it is argued by Albert H. Kritzer that "when a matter is governed by CISG but not expressly settled in it, Article 7 (2) of CISG outs private international law whenever applicable general principles can be properly deduced from the Convention. Formation of the contract is a matter governed by the Convention (Article 4[87]). Is not pre-contract formation a part of formation of the contract?"[88] Thus, if the answer is positive and pre-contract formation is a part of formation of the contract, this means that pre-contractual relationships are within the scope of CISG. In such case, pre-contractual stage is a question concerning matters governed by CISG, which is not expressly settled in it and should be settled in conformity with the general principles on which it is based. Again, the question of existence of good faith principle in the text of CISG arises. If general duty of good faith exists under CISG, it should be applicable in pre-contractual stage. Moreover, it could be argued that if there is no general principle of good faith under CISG, UNIDROIT PICC could be applicable. As it is established in the preamble of UNIDROIT PICC, UNIDROIT PICC might be applied when the parties have agreed that their contract is governed by general principles of law, as it is declared in Article 7 (2) of CISG, or UNIDROIT PICC might be used to interpret or supplement international uniform law instruments, as CISG is the international uniform law instrument. The before-mentioned statement is also uphold by Stefan

[84] Part 2 of Article 7 of CISG declares that 'questions concerning matters governed by this Convention which are not expressly settled in it are to be settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the law applicable by virtue of the rules of private international law'.
[85] Goode R., Kronke H., McKendrick E. *Transnational commercial law: Text, Cases and Materials*. Oxford: Oxford University Press, 2007, p. 283
[86] Lawyers from common law systems could not accept this kind of interpretation of CISG yet. As it was observed in the previous part of this master thesis, some legal scholars argue that the good faith principle sooner or later will be recognized in common law jurisdictions. Thus, it could be assumed that after good faith principle is recognized in common law jurisdictions, lawyers from common law countries will accept this kind of interpretation of CISG.
[87] Article 4 of CISG declares that 'this Convention governs only the formation of the contract of sale and the rights and obligations of the seller and the buyer arising from such a contract. In particular, except as otherwise expressly provided in this Convention, it is not concerned with: *(a)* the validity of the contract or of any of its provisions or of any usage; *(b)* the effect which the contract may have on the property in the goods sold'.
[88] Kritzer A. H. Pre-contract formation. Available at: <http://www.cisg.law.pace.edu/cisg/biblio/kritzer1.html#12> Accessed: 26 February 2012

Kröll, Loukas Mistelis and Perales Viscasillas[89] who state that modern trends in the interpretation of the CISG allow considering the *lex mercatoria*, UNIDROIT PICC and to a lesser extent the PECL, as a means of interpreting and supplementing CISG when no general principles within CISG are found. Nevertheless, according to other point of view, it is argued that pre-contractual stage falls outside the scope of CISG. German jurisprudential scholar professor Peter Schlechtriem stated that "the Conference rejected a proposal by the German Democratic Republic, which would have introduced a general *culpa in contrahendo* (= pre-contractual liability). The proposal was especially intended to cover those cases in which contract negotiations have already progressed so far that one side relying on the belief that a contract would materialize has made considerable expenditures. The motion by the German Democratic Republic failed. Damages caused by one party to the other in the course of contract negotiations, therefore, remain subject to regulation by the domestic law applicable according to conflict rules".[90] Furthermore, it is argued by Michael Joachim Bonell that "the fact – it is argued – that all proposals aiming at the adoption of a general provision on pre-contractual liability were rejected, clearly demonstrates that the drafters of the Convention preferred to leave the issue to the existing non-unified laws. Consequently it will be up to each single national legal system to determine if and the extent to which a party is liable *vis-à-vis* the other party for its conduct during the negotiations".[91] Furthermore, according to the commentary of CISG, "liability for breach of obligations arising out of negotiations thus largely remains outside the scope of the CISG. Claims for damages either for infringement of the negotiations partner's legal interests, or for culpable termination of negotiations are therefore governed solely by the relevant contract or tort statute, depending on the claim's qualification according to the applicable international private law".[92] Nevertheless, it is implied by legal scholars[93], who provided the newest commentary on CISG, that despite the legislative history of this provision and its present placement, the better view is that the principle of good faith permeates the whole text of CISG, deriving from its specific duties and rights to the parties, i.e. regulates parties' conduct even during contract formation.

Thus, there are basically two different opinions – some scholars argue that pre-contractual stage and a general principle of good faith falls within the scope of CISG; others

[89] Kröll S., Mistelis L., Viscasillas P. *UN Convention on Contracts for the International Sale of Goods (CISG): commentary*. München: Hart Publishing, 2011, p. 125
[90] Schlechtriem P. Uniform Sales Law - The UN-Convention on Contracts for the International Sale of Goods. Available at: < http://www.cisg.law.pace.edu/cisg/biblio/schlechtriem.html#a34> Accessed: 26 February 2012
[91] Bonell M. J., Formation of Contracts and Precontractual Liability Under the Vienna Convention on International Sale of Goods. *ICC Publishing Pub*. 1990, 440(9): 167
[92] Schlechtriem P., Schwenzer I. *Commentary on the UN Convention on the international sale of goods (CISG)*. Oxford: Oxford University Press, 2005, p. 751-752
[93] Kröll S., Mistelis L., Viscasillas P., *op.cit.*, p. 121

argue that it does not. Therefore, even though Peter Schlechtriem's position and John Honnold's arguments are reasonable and we should agree that the intention was to reject the idea of incorporation of a general principle of good faith, which would govern parties' conduct during formation and performance of the contract, in the text of CISG, however, in our opinion, because of the evolution of legal relationships and new tendencies on the interpretation of CISG, nowadays the situation started to change and good faith principle might be applicable directly on the parties during pre-contractual and contractual stages. This position is also supported by various courts and tribunals, which imply general duty of good faith on the parties.[94]

In addition, Article 1 of CISG states that CISG is applicable to contracts of sale of goods. Obligations regarding the parties' conduct during negotiations are not contractual obligations insofar as they are not based on an express or implied preliminary contract.[95] Hence, it follows that if negotiations became advanced and during the pre-contractual stage parties managed to conclude a preliminary contract, it will definitely fall within the scope of CISG.

In conclusion, it is universally argued if pre-contractual stage falls within the scope of CISG and whether principle of good faith is applicable during negotiations. It could be stated that there is no unilateral opinion on this matter. On the one hand, it is argued that creators of CISG did not incorporate a general duty of pre-contractual good faith in the text of CISG on purpose. The regulation of pre-contractual relationships was left for the regulation of private international conflict rules. On the other hand, it is argued that good faith principle is a general principle established in the CISG and on the basis of this principle it could be stated that pre-contractual good faith falls within the scope of CISG. However, we should agree with the position that initially principle of pre-contractual good faith was not incorporated into CISG, nonetheless, despite the legislative history, nowadays the interpretation of CISG started to change and some courts and tribunals imply the general duty of pre-contractual good faith on the parties. However, as to today, if parties did not sign any preliminary agreement, not all courts or

[94] For example, in the ruling as of 31 May 2010, Foreign Trade Court attached to the Serbian Chamber of Commerce, it was stated that "<…> the tribunal found that the seller's failure to deliver the agreed machine to the buyer, while at the same time continuously promising the buyer that the delivery will occur and requesting further extensions of the time for delivery, constituted behavior contrary to the principle of good faith, since it was obvious from the seller's behavior that it never had true and honest intentions to perform its part of the bargain. Case available at: <http://cisgw3.law.pace.edu/cases/100531sb.html> Accessed: 8 March 2012; in ruling as of 27 May 2005, Tribunal of International Commercial Arbitration at the Russian Federation Chamber of Commerce and Industry, it was stated that "the Tribunal considers that [Seller]'s conduct does not comply with the principle of good faith (art. 7(1) CISG) and finds it possible to regard this conduct as a *de-facto* unilateral refusal to fulfill the contract". Case available at: < http://cisgw3.law.pace.edu/cases/050527r1.html> Accessed: 8 March 2012; in ruling as of 23 April 2003, Appellate Court Hof 's-Gravenhage, it was stated that "<…> a company secret should not be protected *in jure* if good faith demands that there is a duty to inform the other party". Case available at: < http://cisgw3.law.pace.edu/cases/030423n1.html> Accessed: 8 March 2012

[95] Schlechtriem P., Schwenzer I. *Commentary on the UN Convention on the international sale of goods (CISG)*. Oxford: Oxford University Press, 2005, p. 751-752

tribunals would impose a general duty of pre-contractual good faith – this would depend on the view of the judge[96]. Nevertheless, it should be stressed that if parties have managed to conclude a preliminary agreement, i.e. parties have reached an advanced stage of negotiations, it will definitely fall within the scope of CISG. Thus in the following chapter of this master thesis, the possibility of compensation of damages will be analyzed only in the light then a preliminary contract is concluded.

## 1.2. Placing the pre-contractual liability: contract, tort or *sui generis*?

It is very important in imposing liability in pre-contractual stage to determine the form of liability. The question of the nature of liability for breaking off negotiations – contract or tort,[97] or *sui generis*[98] – is relevant for several reasons. It is observed by various legal scholars[99] that the question of determining the type of applicable civil liability is important, because contractual and tortious liability provide for different limitation periods, different burden of proof, different rules for determination of jurisdiction and applicable law in cross-border cases; professor Valentinas Mikelėnas observes[100] that contractual liability may occur in a form of compensation of damages or fofeits, however, tort liability may occur only in a form of compensation of damages[101]. Nonetheless, it is observed by John Cartwright and Martijn Hesselink that even though in most of the legal systems a distinction is drawn between the nature of contract and tort, however, for example, there is no formal demarcation in Danish

[96] We assume that in the near future all courts and tribunals will acknowledge that good faith principle falls within the scope of CISG and judges will impose this duty on the parties.

[97] Contract and tort are typically perceived as incompatible with each other, it is usually assumed that tort liability arises than parties did not conclude any kind of contract. However, professor Christian von Bar and professor Ulrich Drobnig claim that "contract law is the basis for the increase of a party's patrimony by receipt of money, goods or services, whereas tort law protects persons and the preservation of their patrimony; both of these fields of law would be senseless without the other". *See* Von Bar C., Drobnig U. *The Interaction of Contract Law and Tort Law and Property Law in Europe: a comparative study*. München: Sellier European Law Publishers, 2004

[98] *Sui generis – (in latin)* of its own kind or class; the only one of its own kind; peculiar. *See* Black's Law Dictionary, Ninth Edition, West: Thomson Reuters business, 2009

[99] *See* Ambrasienė D., Cirtautienė S. Ikisutartinės atsakomybės kvalifikavimo problema: sutartinė, deliktinė ar *sui generis*. *Jurisprudencija*. 2008, 10(112); Beale H., Fauvarque-Cosson B., Rutgers J., Tallon D., Vogenauer S. *Cases, Materials and Text on Contract Law*. Oxford: Hart, 2010; Cartwright J., Hesselink M. *Precontractual liability. European Private Law*. London: Cambridge University Press, 2008; Kiršienė J., Leonova N. Qualification of Pre-contractual Liability and the Value of Lost Opportunity as a Form of Losses. *Jurisprudencija.* 2009, 1(115)

[100] Mikelėnas V. *Civilinės atsakomybės problemos: lyginamieji aspektai*. Vilnius: Justitia, 1995, p. 51-52

[101] Contract law protects expectation interest; tort law protects reliance interest. Expectation interest means that party expects to be in a position in which it would have been if the contract had been properly fulfilled. Reliance interest means that the party expects to remain in the same position, i.e. the party expects that it's position will not become worse. Therefore, aim of contractual liability is to ensure that promise will be fulfilled and the aim of tort liability is to ensure *status quo*. *See* Van Gerven W., Larouche P., Lever J. *Cases, Materials and Text on National, Supranational and International Tort Law*. Oregon: Hart Publishing, 2000, p. 32-33

law in the law of damages between contract and tort; moreover, the Dutch Code provides single regime for all types of liability[102].

Roman law qualified pre-contractual liability as a special type of contractual liability. Alyona N. Kucher observes that Roman law recognized two grounds for imposing pre-contractual liability: sale *res extra commercium* and sale of non-existent inheritance; in both cases Roman law adhered to a position that invalidity of such agreements did not entail the impossibility of using all elements of the agreement, in particular, liability arising out of such agreement continued to apply.[103] However, nowadays academics cannot unilaterally determine pre-contractual liability. On the one hand, legal scholars argue that according to *pacta sunt servanda* principle, parties are free to negotiate and are not liable for failure to reach and agreement, i.e. parties are under no obligation until an agreement is reached. It is well observed by Jan Kleinheisterkamp that "this follows from the very nature of an agreement, which is based on the presumption of freedom to, and freedom from, contract".[104] Thus, according to the general principle of *pacta sunt servanda*, obligation to act in accordance with good faith principle arises from law not from the contract, i.e. pre-contractual liability should be imposed according to the tort law. On the other hand, Alyona N. Kucher argue[105] that pre-contractual liability should be qualified as: (1) contractual or quasi-contractual liability imposed for breach of the implied agreement to act fairly at the pre-contractual stage[106]; (2) tort liability[107]; or (3) liability for breach of a promissory estoppel[108]. However, other legal scholars[109] suggest that pre-contractual liability should be determined as *sui generis* type of liability. For instance, John Cartwright and Martijn Hesselink observes that "the contract is not yet concluded, and so it is not obvious that the regime for precontractual liability should be the contractual regime. <…> And so if the law of tort is perceived as being aimed at the protection against loss inflicted outside the context of a pre-existing legal relationship, then the pre-contractual phase does not quite fit the model of tort either".[110] Hence, the obvious problem arises – should pre-contractual liability be imposed based on contract law, tort or something in between contract and tort – *sui generis*? In order to determine pre-contractual liability we should analyze various legal systems.

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[102] Cartwright J., Hesselink M. *Precontractual liability. European Private Law*. London: Cambridge University Press, 2008, p. 457 (footnotes omitted)
[103] Kucher A. N. Pre-contractual liability: Protecting the Rights of the Parties Engaged Into Negotiations. Available at: <http://www.nyulawglobal.org/fellowsscholars/forums/papers/Kucher-paper.pdf> Accessed: 19 February 2012
[104] Kleinheisterkamp J., Vogenauer S. *Commentary of the UNIDROIT principles of international commercial contracts (PICC)*. Oxford: Oxford University Press, 2009, p. 299
[105] Kucher A. N., *op. cit.*
[106] For example, this position is adhered by Germany.
[107] For example, in French law.
[108] In common law systems.
[109] Ambrasienė D., Cirtautienė S. Ikisutartinės atsakomybės kvalifikavimo problema: sutartinė, delktinė ar *sui generis*. *Jurisprudencija*. 2008, 10(112); Cartwright J., Hesselink M., *op.cit.*, p. 457
[110] Cartwright J., Hesselink M., *op. cit.*, p. 457

In Germany if the party breaks off negotiations, contractual liability would be implied. It is observed by legal scholars that "the very reason why the courts have developed the doctrine of *culpa in contrahendo* lies in the shortcomings of German tort law"[111]. In France, on the one hand, if the party broke off negotiations, tortious liability would be implied. Academics observe that "there are various cases on this subject and some rules can be inferred from those cases; although both parties have the right to break off negotiations at any stage, a party who abuses the right can be liable in tort"[112]. On the other hand, if parties have signed pre-contractual documents, damages would be awarded according to the rules of contractual liability.[113] In European Union with reference to *acquis communautaire* if a party breached a duty to act honestly and in good faith, tortious liability would be implied. The European Court of Justice in a *Tacconi v Heinrich Wagner Sinto Maschinenfabrik GmbH (HWS)* case ruled that "in circumstances <…> characterised by the absence of obligations freely assumed by one party towards another on the occasion of negotiations with a view to the formation of a contract and by a possible breach of rules of law, in particular the rule which requires the parties to act in good faith in such negotiations, an action founded on the pre-contractual liability of the defendant is a matter relating to tort, delict or quasi-delict within the meaning of Article 5(3) of the Convention of 27 September 1968 on Jurisdiction and the Enforcement of Judgments in Civil and Commercial Matters".[114] It is observed by legal scholars[115] that such position is also reflected in the European enactments[116]. However, as the European Court of Justice stated that "since pre-contractual liability does not derive from obligations freely assumed by one party towards another, it is a matter relating to tort, delict or quasi-delict"[117], we can assume that in case parties freely undertook certain obligations towards each other, it would not be a matter related to tort, i.e. contractual liability would be implied. Nevertheless, legal scholars observe that "this is not necessarily the end of the matter, however, because it might be argued that for both jurisdiction and the substantive rules of liability, and the remedies to be awarded for breach of precontractual duties, it is not sufficient that the selection is limited to the established rules of private

[111] Beale H., Fauvarque-Cosson B., Rutgers J., Tallon D., Vogenauer S. *Cases, Materials and Text on Contract Law*. Oxford: Hart, 2010, p. 385
[112] *Ibid.* p. 387
[113] Kiršienė J., Leonova N. Qualification of Pre-contractual Liability and the Value of Lost Opportunity as a Form of Losses. *Jurisprudencija.* 2009, 1(115): 234
[114] Judgment as of 17 September 2002, the European Court of Justice (case No. C-334/00)
[115] Beale H., Fauvarque-Cosson B., Rutgers J., Tallon D., Vogenauer S., *op. cit.*, p. 383
[116] Regulation (EC) No. 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I), where pre-contractual liability is not qualified as contractual, but as *culpa in contrahendo* in Regulation (EC) No. 864/2007 of the European Parliament and of the Council of 11 July 2007 on the law applicable to non-contractual obligations (Rome II).
[117] Judgment as of 17 September 2002, the European Court of Justice (case No. C-334/00)

international law for either contract or tort, and that a *tertium quid* should be devised"[118]. In Lithuania a party who negotiates of breaks off negotiations in bad faith is liable in tort. The Supreme Court of Lithuania declared that the nature of the civil liability implied for the breach of the duty to negotiate in good faith is tortious liability.[119] However, if parties undertook certain obligations in respect with each other and concluded a preliminary agreement, contractual liability would be implied. The Supreme Court of Lithuania supports the above-mentioned position. In cases when parties have signed a preliminary agreement, the Supreme Court of Lithuania ruled that parties are bound by contractual legal relationship.[120] For example, "in 19 October 2007 parties signed a preliminary agreement of land purchase-sale. Parties agreed that the final agreement would be concluded until 21 December 2007. The buyer agreed to buy the land for 2 117 000 LTL, moreover, on the day when the preliminary agreement was signed, the buyer paid the seller 50 000 LTL as advanced payment. The final agreement was not concluded and the buyer requested the seller to return 50 000 LTL. The Supreme Court of Lithuania held that the buyer refused to conclude the final agreement, i.e. he is liable for not concluding a legally binding contract, therefore, the contractual liability arises – the buyer had to pay for the seller 50 000 LTL as a penalty".[121] In Switzerland if party breaks off negotiations contrary to good faith, *sui generis* type of pre-contractual liability is implied. It is observed by legal scholars that "in accordance with an emerging opinion in academic writing the Swiss Federal Court holds that *culpa in contrahendo* is neither contractual not tortious but a liability by virtue of law, a liability *sui generis* with its own rules"[122]. In Greece if a party infringes principle of good faith and *lex mercatoria* during the negotiations, *sui generis* type of liability is imposed. It is observed by legal scholars[123] that under Greek law the pre-contractual liability is considered to be a *sui generis* type of liability and this is supported by the autonomous regulation of pre-contractual liability in the GCC[124].

Therefore, according to the above provided analysis, usually pre-contractual relationships are divided into two forms: first, parties negotiate and sign a preliminary

[118] Cartwright J., Hesselink M. *Precontractual liability. European Private Law*. London: Cambridge University Press, 2008, p. 460
[119] Ruling as of 29 September 2009, Civil Case Division of the Supreme Court of Lithuania (case No. 3K-3-363/2009)
[120] For example, ruling as of 22 June 2010, Civil Case Division of the Supreme Court of Lithuania (case No. 3K-3-279/2010); ruling as of 2 November 2010, Civil Case Division of the Supreme Court of Lithuania (case No. 3K-3-428/2010); ruling as of 28 March 2011, Civil Case Division of the Supreme Court of Lithuania (case No. 3K-3-129/2011), ruling as of 22 December 2011, Civil Case Division of the Supreme Court of Lithuania (case No. 3K-3-534/2011)
[121] Ruling as of 2 November 2010, Civil Case Division of the Supreme Court of Lithuania (case No. 3K-3-428/2010)
[122] Cartwright J., Hesselink M., *op. cit.*, p. 459
[123] *Ibid.*
[124] Greek Civil Code

agreement; second, parties negotiate, but do not sign any preliminary agreement. Thus, usually, in the first form of pre-contractual stage the contractual liability is implied[125], although in the second form of pre-contractual stage the tortious liability is implied. In our opinion, application of different pre-contractual liability according to division of pre-contractual stage is irrational. To our mind it would be reasonable not to divide pre-contractual liability according to the forms of pre-contractual stage and to apply one type of liability. In order to avoid uncertainty and confusion, it would be more rational to determine pre-contractual liability as *sui generis* type of liability as it is obvious from our analysis that the pre-contractual liability cannot be exclusively called neither contractual nor tortious liability. To our view pre-contractual liability is something in between contract and tort – *sui generis*. Therefore, we assume that it would be reasonable for the Supreme Court of Lithuania to embrace from Swiss Federal Court and to acknowledge that pre-contractual liability is neither contractual not tortious but a liability by virtue of law, a liability *sui generis* with its own rules. Therefore we recommend for the Supreme Court of Lithuania to adopt a special explanation and to declare that pre-contractual liability is *sui generis* type of liability with its own rules, furthermore, as to our mind, the Supreme Court of Lithuania should define this 'own rules', i.e. the burden of proof, limitation periods, the rules for determination of jurisdiction and applicable law in cross-border cases, which would be applicable if *sui generis* type of liability was implied.

[125] In Lithuania if party breaches a preliminary agreement and contractual liability is implied, however party cannot ask for a specific performance. Such exception is developed by the case law. *See* ruling as of 21 December 2011, the Civil Case Division of the Supreme Court of Lithuania (case No. 3K-3-530/2011); ruling as of 6 October 2008, the Civil Case Division of the Supreme Court of Lithuania (case No. 3K-3-455/2008); ruling as of 26 February 2007 the Civil Case Division of the Supreme Court of Lithuania (case No. 3K-3-72/2007); ruling as of 15 February 2006, the Civil Case Division of the Supreme Court of Lithuania (case No. 3K-3-124/2006). In Germany and in France a party who broke off negotiations contrary to good faith cannot be ordered to continue negotiations or to conclude a final contract; in Netherlands the duty of pre-contractual good faith might give rise to a duty to continue negotiations, and where that duty is not complied with, a court might order that the relevant negotiations should take place. Some scholars even argue that party might be ordered actually to conclude a final contract. *See* Beale H., Fauvarque Cosson B., Rutgers J., Tallon D., Vogenauer S. *Cases, Materials and Text on Contract Law*. Oxford: Hart, 2010, p. 415-418

## II. RELIANCE, EXPECTATION AND SHIFTING THE ECONOMIC RISK OF THE NEGOTIATIONS

*If I make a promise to you, I should do as I promise; and if I fail to keep my promise, it is fair that I should be made to hand over the equivalent of the promised performance.*[126]

Professor Valentinas Mikelėnas observes that with the development of international economic cooperation, and the increase of the number of complex contracts, which amount to tens and hundreds million USD, the pre-contractual relationships are becoming more and more significant.[127] It is assumed that a party, which makes some reliance investments during negotiations, believes that his investments will be covered by the surplus derived from a final agreement. However, as it is well observed by professor Valentinas Mikelėnas, negotiations are not always finished with conclusion of a contract, and consequences of termination of negotiations are usually painful.[128] It is argued by legal scholars[129] that if party breaks off negotiations and refuses to reach a final contract, he must compensate aggrieved party's reliance damages. Nonetheless, professor of law at Yale University Friedrich Kessler and an associate justice of the Appeals Court of the Commonwealth of Massachusetts Edith Fine argued that "case law and literature, on the whole, have had the good sense to reject this idea. If the utility of contract as an instrument of self-government is not to be seriously weakened, parties must be free to break off preliminary negotiations without being held to an accounting".[130] Nowadays, especially in the continental law countries, it would be hard – and even impossible – to agree with the before mentioned position. However, even Friedrich Kessler and Edith Fine observed that "the privilege of not being held accountant if the party breaks off preliminary negotiations presupposes that the parties have not come to a binding agreement. What may still seem to be a phase of preliminary negotiations to one of the parties, may be regarded by the law as a binding commitment in the interest of fair dealing. <…> Modern contract law has gone far in reconciling freedom of contract and the 'policy of certainty' of transactions with the dictates of good faith

[126] O'Gorman D. P. Expectation Damages, the Objective Theory of Contracts, and the "Hairy Hand" Case: A Proposed Modification to the Effect of Two Classical Contract Law Axioms in Cases Involving Contractual Misunderstandings. *Kentucky Law Journal*. 2011, 99(2): 327

[127] Mikelėnas V. *Sutarčių teisė. Bendrieji sutarčių teisės klausimai: lyginamoji studija*. Vilnius: Justitia, 1996, p. 122

[128] *Ibid.*

[129] For example, even famous R. Saleiles argued that occasionally, the thesis has been advanced that once parties have entered into negotiations for a contract neither party can break them off "arbitrarily" without compensating the other party for his reliance damages. *See* Saleilles R. De la responsabilité précontractuelle. *6 Revue Trimestrielle de Droit Civil*. 1907, p. 697

[130] Kessler F., Fine E. Culpa in Contrahendo, Bargaining in Good Faith and Freedom of Contract: A Comparative Study. *Harvard Law Review.* 1964, 77(3): 412

and business convenience"[131]. Nevertheless, professor at Yale University Alan Schwartz and professor at Columbia Law School Robert E. Scott argued that "after the parties agree upon what they can, and before uncertainty is resolved, one or both of them make a sunk-cost investment. This pattern of commercial behavior suggests that the parties have made a 'preliminary agreement' that will have one of two legally significant outcomes: if the transaction turns out to be profitable after uncertainty is resolved, the parties will make their agreement more concrete and then conduct the transaction. But if the transaction turns out to be unprofitable, the parties will abandon the project. Disputes sometimes arise under these preliminary agreements after one or both of the parties have invested. One party may then abandon the project even though the other party protests the first party's exit. In particular, the disappointed party believes that he is entitled to compensation either for his expectation or for his investment cost while the other party believes that she is entitled to exit without liability".[132]

Thus, in order to determine damages under pre-contractual liability, at first we will analyze parties' decisions in relation to reliance investments under different regimes and rules of pre-contractual liability from the economic point of view, and further, as the economic point of view of compensation of reliance expenditures will be already analyzed, we will determine compensatory and non-compensatory damages under pre-contractual liability.

## 2.1. Reliance investments

Before a contract is signed, there is generally a period – sometimes even a long one – in which parties negotiate the agreement's terms. During this period, the parties might make reliance expenditures – investments that will raise the value of performance if the contract is formed but will have a lesser value otherwise. For example, in negotiations of a financial loan, one party might invest in expanding its business, for instance, the party might buy some new property, and the other party might monitor the other party's business. Such investments increase the value of the completed transaction but are fully or partially wasted if the transaction does not go through. Thus, if negotiations broke off and the final agreement was not reached, the law should clearly determine, which party bears the cost of the reliance expenses, nevertheless it is utmost important to understand an economic perspective on reliance investments.

There are law and economics scholars[133] who analyzed pre-contractual liability from an

[131] Kessler F., Fine E. Culpa in Contrahendo, Bargaining in Good Faith and Freedom of Contract: A Comparative Study. *Harvard Law Review.* 1964, 77(3): 412-413

[132] Schwartz A., Scott R. E. Precontractual liability and preliminary agreements. *Harvard Law Review*. 2007, 120(3): 663

[133] *See* Bebchuk L. A., Ben-Shahar O. Precontractual reliance. *The University of Chicago Journal of Legal Studies*.

economic perspective and asked whether it would be efficient to award damages to the promisee. Professor Richard Craswell linked the analysis of pre-contractual liability to the theory of incomplete contracts and focused on the selection of an appropriate default rule to be applied when parties did not explicitly agree whether they intend to be bound by their preliminary relations.[134] Professor Richard Craswell suggested the 'optimal reliance investment rule' – it is implied that optimal investment increases the expected value of the transaction as it creates probable benefits to both relying parties, inasmuch as both – relying and non-relying – parties can benefit from the investment if they can capture even a minor fraction of the increased contractual surplus. Moreover, it is observed by legal scholars that "this is a reasonable assumption, as non-relying parties may appropriate some part of (but likely, not all) the increased contractual surplus by charging a higher price"[135]. However, legal academics criticize professor Richard Craswell's suggested model as to their mind "Craswell's hypothetical-contract rationale for precontractual liability requires some correction, ensuring that reliance investments be disclosed to, or otherwise observable by, the other party"[136]. Professor Avery W. Katz[137], on the other hand, analyzed the doctrine of promissory estoppel and investigated the possibilities under which the guilty party might be held liable and would have to reimburse the aggrieved party's damages. The before-mentioned legal scholar suggested that pre-contractual liability should be imposed to the party, which invested excessively, or on the so-called the 'least-cost-avoider'. It is observed by legal scholars that "the 'least-cost-avoider' is usually the party with the greater bargaining power *ex post* <…>. If the non-relying party has the greater bargaining power *ex post*, that party should be bound by preliminary promises, in order to prevent opportunistic behavior <…>. Conversely, if the relying party has the greater bargaining power, the traditional <…> rule of no liability should apply"[138]. Nevertheless, in our opinion, the most complete and worth analyzing is L. A. Bebchuk and O. Ben-Shahar's suggested model. In their economic and legal study[139], L. A. Bebchuk and O. Ben-Shahar observed that during negotiations each party relies on the other's promises and invests accordingly, thus the above-

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2001, 30(2); Johnston J. S. Communication and Courtship: Cheap Talk Economics and the Law of Contract Formation. *Virginia Law Review.* 1999, 85(3); Craswell R. Offer, Acceptance and Efficient Reliance. *Stanford Law Review.* 1996, 48(3); Katz A. W. When Should an Offer Stick? The Economics of Promissory Estoppel in Preliminary Negotiations. *Yale Law Journal.* 1996, 105(5); Schwartz A., Scott R. E. Precontractual liability and preliminary agreements. *Harvard Law Review*. 2007, 102(3)

[134] Craswell R. Offer, Acceptance and Efficient Reliance. *Stanford Law Review.* 1996, 48(3): 485

[135] Cartwright J., Hesselink M. *Precontractual liability. European Private Law*. London: Cambridge University Press, 2008, p. 435

[136] Cartwright J., Hesselink M., *op. cit.*, p. 436

[137] Katz A. W. When Should an Offer Stick? The Economics of Promissory Estoppel in Preliminary Negotiations. *Yale Law Journal*. 1996, 105(5)

[138] Cartwright J., Hesselink M., *op. cit.*, p. 436

[139] Bebchuk L. A., Ben-Shahar O. Precontractual reliance. *The University of Chicago Journal of Legal Studies*. 2001, 30(2)

mentioned legal scholars analyzed the impact of pre-contractual liability rules on the parties' incentives to participate in negotiations and explored how pre-contractual reliance decisions differ under three different pre-contractual regimes, i.e. under a regime of no liability for pre-contractual reliance[140], under a regime of strict liability for pre-contractual reliance[141] and under an intermediate regime of pre-contractual reliance[142]. It is observed by L. A. Bebchuk and O. Ben-Shahar that, firstly, under a regime of no liability for pre-contractual reliance, a party cannot recover any of its reliance expenses in the event if a final contract is not formed, thus in the absence of liability parties will underinvest in reliance.[143] As it could be concluded from the L. A. Bebchuk and O. Ben-Shahar's study, the result that the buyer and the seller probably would underinvest under a regime of no pre-contractual liability arises from the divergence between a party's private gain and the social benefit from reliance. Secondly, under the regime of strict pre-contractual liability, the party, which makes any pre-contractual reliance investments, is entitled to full recovery from the other party if the final agreement is not reached. Moreover, one party might be required to reimburse the other party's reliance expenditures even though the other party was liable for breaking off negotiations, i.e., for example, the buyer made some reliance investments and expanded its business, for instance, rented a new factory, until the final agreement was not reached; however, the buyer and the seller could not agree on the terms of the contract as, for example, the buyer changed his mind about the terms of the contract on the advanced stage of the negotiations, i.e. the buyer was liable for not reaching the legally binding agreement, the seller would be required to reimburse the buyer its reliance investments[144]. Therefore, according to L. A. Bebchuk and O. Ben Shahar, nor regime of no pre-contractual liability, nor regime of strict pre-contractual liability could lead parties to make proficient pre-contractual reliance investments, i.e. according to the fact that the regime of no pre-contractual

[140] It is argued by Bebchuk L. A., Ben-Shahar O. that most European jurisdictions share the basic no-liability approach, restricting it mainly by the duty to negotiate in good faith. *See* Bebchuk L. A., Ben-Shahar O. Precontractual reliance. *The University of Chicago Journal of Legal Studies*. 2001, 30(2): 424. It is usually implied that no liability approach is established in common law countries. Nevertheless, according to the before-mentioned legal scholars' statement, we can assume that in Lithuania exists basic no-liability approach, however, a party will be held liable and will have to reimburse damages to the other party if he breaches a duty to negotiate in good faith.

[141] It is argued that strict pre-contractual liability regime is applied in the Netherlands – if a party breaks off negotiations at a stage where such breach is not allowed, the party could be ordered either to reimburse an aggrieved party, either to continue negotiations or to conclude a final and legally binding agreement. *See* Cartwright J., Hesselink M. *Precontractual liability. European Private Law*. London: Cambridge University Press, 2008, p. 433-434. However, as to our mind, we assume that better example would be Italy – it is implied that the legal requirement which is not observed when negotiations are broken off abruptly is intended to prevent the other party suffering harm as a result of the fact that it is involved in negotiations and not because the negotiations did not ultimately result in a contract; fault is not required. *See* Opinion of Advocate General Geelhoed on European Court of Justice case (case No. C-334/00). Available at:
<http://www.unilex.info/case.cfm?pid=1&do=case&id=813&step=FullText> Accessed: 11 March 2012

[142] This regime is hypothetical and suggested by L. A. Bebchuk and O. Ben-Shahar.

[143] Bebchuk L. A., Ben-Shahar O. Precontractual reliance. *The University of Chicago Journal of Legal Studies*. 2001, 30(2): 431 (footnotes omitted)

[144] Damages are assumed to be equal to the reliance expenses.

liability would lead to underinvestment and the regime of strict pre-contractual liability would lead to overinvestment, L. A. Bebchuk and O. Ben-Shahar were first to introduce an intermediate regime of pre-contractual liability, or so called the 'sharing rule'. As L. A. Bebchuk and O. Ben-Shahar imply it, when both parties rely, each party bears part of the total reliance cost – pays for part of other party's reliance cost and recovers part of its own cost.[145] Sharing rule works because it equates the fraction of the cost that a party bears with the fraction of the surplus that it can capture via bargaining. However, it is implied by legal scholars that the before-mentioned authors' suggested model of the 'sharing rule' does not resemble any existing legal rules, furthermore, L. A. Bebchuk and O. Ben-Shakar's model is criticized because "the analysis is eminently 'normative', suggesting new legal solutions rather than analyzing the efficiency of existing rules"[146].

As the above-provided analysis of different rules and regimes of pre-contractual reliance, suggested by economic and legal scholars, indicates, both general, or so-called 'polar', regimes – no pre-contractual liability regime and strict pre-contractual liability regime – lead to inefficient levels of pre-contractual reliance investments. Under no pre-contractual liability regime parties are going to underinvest, however, under the strict pre-contractual liability regime parties are going to overinvest. Consequently, negotiating parties will not reach a best deal because under a regime of no pre-contractual liability, parties will be afraid to invest – if a deal breaks off, they will suffer damages which will not be reimbursed; under a regime of strict liability, parties will be able to invest as much as they want or can – and those investments might be unjustified. Furthermore, party might break off negotiations – he might even be guilty for not reaching a final agreement – and still be reimbursed. On the other hand, neither professor Richard Craswell's suggested optimal reliance investment rule, nor professor Avery W. Katz's suggested 'the least-cost-avoider' rule, nor L. A. Bebchuk and O. Ben-Shakar's proposed 'sharing rule', which, as to our mind, would be the best regime from the economic point of view, would work under existing legal rules. Therefore, even though the outcomes of the existing studies provide a valuable framework for the analyzing problems related to pre-contractual liability from an economic point of view, however, reimbursement of reliance investments are governed by law not by the rules of market economy. Thus, in the following parts of this master thesis we will analyze the possibility of compensation of damages under pre-contractual liability according to the legal point of view.

[145] Bebchuk L. A., Ben-Shahar O. Precontractual reliance. *The University of Chicago Journal of Legal Studies.* 2001, 30(2): 438

[146] Cartwright J., Hesselink M. *Precontractual liability. European Private Law*. London: Cambridge University Press, 2008, p. 439

## 2.2. Compensatory damages under pre-contractual liability

Compensation of damages is based on the principle of full compensation of damages (*restitutio in integrum*). *Restitutio in integrum* means that if party suffered any damages he must be fully reimbursed and this principle applies in case either contractual liability is implied, tortious liability is implied or *sui generis* type of liability is implied. Thus, it does not matter what kind of liability is implied if a general duty of pre-contractual good faith is breached and one of the parties suffered damages. In all cases, as it has been already mentioned, the aggrieved party must be fully reimbursed.

According to various legal sources[147], there are three types of interests, which might be infringed: expectation interest[148]; reliance interest; restitution interest.[149] We will concentrate only on expectation and reliance interests further on; as it is well observed by Jamie Cassels and Elizabeth Ammah Adjin-Tettey, restitution interest does not aim to cover the injured person's damages but to withdraw the profit that the wrongful party had acquired in the course of its unlawful actions.[150] Indeed, restitution could be understood as the return of something to the owner of it or to the person entitled to, or a body of substantive law in which liability is based not on tort or contract but on the defendant's unjust enrichment[151]; or remedy, intended to effect a fair and just balance between rights and interest of the parties concerned[152]. Furthermore, remedy is the means of enforcing a right or preventing or redressing a wrong[153]; or any of the methods available at law for the enforcement, protection, or recovery of rights or for obtaining redress for their infringement:[154] it might include damages, restitution, specific performance, or an injunction that might be given or ordered by a court or other tribunal for a wrong. Thus, firstly, as the object of this master thesis is to analyze compensatory and non-compensatory damages under pre-contractual liability, secondly, as damages are just part of remedies, i.e. compensation of an aggrieved party's damages under pre-contractual liability is one of the

[147] For example *see* O'Gorman D. P. Expectation Damages, the Objective Theory of Contracts, and the "Hairy Hand" Case: A Proposed Modification to the Effect of Two Classical Contract Law Axioms in Cases Involving Contractual Misunderstandings. *Kentucky Law Journal*. 2011, 99(2); Kiršienė J., Leonova N. Qualification of Pre-contractual Liability and the Value of Lost Opportunity as a Form of Losses. *Jurisprudencija.* 2009, 1(115); Selelionytė-Drukteinienė S. Deliktinės ir sutartinės atsakomybės konkurencija. *Justitia*. 2008, 1(67)

[148] Under pre-contractual liability the aggrieved party cannot recover expectations it had in profits of the sought contract (so called positive interest). Liquidated damages and forfeits, as part of expectation damages, should be understood as compensatory damages under pre-contractual liability.

[149] This division of interests (expectation, reliance, and restitution) was suggested by George Gardner, *see* Gardner G. K. An Inquiry into the Principles of the Law of Contracts. *Harvard Law Review.* 1932, 46(1): 15–19 and made famous by Lon Fuller, *see* Fuller L. L., Perdue W. L. Jr. The Reliance Interest in Contract Damages. *Yale Law Journal.* 1936, 46(52): 53–54

[150] Cassels J., Adjin-Tettey E. *Essentials of Canadian law. Remedies: the law of damages*. Toronto: Irwin Law, 2000, p. 7

[151] Black's Law Dictionary, Ninth Edition, West: Thomson Reuters business, 2009

[152] The Longman Dictionary of Law, Seventh Edition, Harlow: Pearson: Longman, 2007

[153] Black's Law Dictionary, *op. cit.*

[154] Oxford Dictionary of Law, Seventh Edition. Oxford: Oxford University Press, 2009

possible methods of reimbursement, and, thirdly, as restitution does not aim to cover the aggrieved party's damages, we will not analyze restitution under pre-contractual liability in this master thesis.

Moreover, it should be noted that in case if a preliminary agreement is signed, liquidated damages or forfeits might be compensated for the aggrieved party. This follows from the very nature of a preliminary agreement. It is observed by professor Valentinas Mikelėnas[155] that preliminary agreement[156] (in Latin *pactum de contrahendo*) is an agreement made in order to conclude the other – final – agreement[157]. Moreover, A. Schwartz and R. E. Scott imply that preliminary agreement is when the parties have agreed on certain terms but left other terms open, so that the best inference from their negotiations is that they made a binding preliminary commitment to pursue a profitable transaction.[158] Consequently, we can assume that the preliminary agreement is an agreement, containing some terms agreed by the parties, however, the aim of the preliminary agreement is for the parties to be bound to conclude the final and legally binding agreement in the future. Thus, according to the aim of a preliminary agreement, any cash payments cannot be done. However, the possibility of money transfer under preliminary agreement still exists. The Supreme Court of Lithuania supports the above-mentioned position[159]. The Supreme Court of Lithuania recognized that transfer of advanced payment under preliminary agreement does not conflict with imperative legal rules, however if one party made payment in advance, it should be determined what was the aim of such transaction.[160] Moreover, it is determined that if a party made advanced payment under a preliminary agreement, he might require returning it in all cases, except in a case when parties in the preliminary agreement settled that the advanced payment could not be returned if the terms of the preliminary agreement are breached; nonetheless, if the terms of the preliminary

[155] Mikelėnas V. *Lietuvos Respublikos civilinio kodekso komentaras. Šeštoji knyga. Prievolių teisė. T1*. Vilnius: Justitia, 2003, p. 210

[156] Preliminary agreement also could be called Memorandum of Understanding, Letter of Intent, Term Sheet, Heads of Agreement. For example, J. Kleinheisterkamp and S. Vogenauer implies that "in commercial practice, particularly when transactions of considerable complexity are involved, it is quite frequent that after prolonged negotiations the parties sign an informal document called "Preliminary Agreement", "Memorandum of Understanding", "Letter of Intent" or the like, containing the terms of the agreement so far reached, but at the same time state their intention to provide for the execution of a formal document at a later stage ("Subject to Contract", "Formal Agreement to follow")". *See* Kleinheisterkamp J., Vogenauer S. *Commentary of the UNIDROIT principles of international commercial contracts (PICC)*. Oxford: Oxford University Press, 2009, p. 46

[157] This follows from the aim of part 2 of article 6.165 of Lithuanian CC, which establishes that 'a preliminary contract is an agreement of parties by which they obligate themselves to conclude another – principal – contract in future under the conditions negotiated in the agreement'.

[158] Schwartz A., Scott R. E. Precontractual liability and preliminary agreements. *Harvard Law Review*. 2007, 102(3): 664

[159] For example, ruling as of 6 November 2006, the Plenary Session of the Civil Case Division of the Supreme Court of Lithuania (case No. 3K-P-328/2006); ruling as of 20 February 2012, the Civil Case Division of the Supreme Court of Lithuania (case No. 3K-3-61/2012)

[160] For example, ruling as of 22 December 2011, the Civil Case Division of the Supreme Court of Lithuania (case No. 3K-3-534/2011)

agreement are breached, the aggrieved party would be able to keep such advanced payment as liquidated damages or forfeits.[161]

Thus, even though most authors[162] analyze only possibilities of compensation of expectation or reliance damages, however, in our opinion, it is very important to provide an exhaustive analysis of compensatory and non-compensatory damages under pre-contractual liability. Therefore, as to our mind, under pre-contractual liability the aggrieved party might recover these kinds of damages:

1. Reliance damages:

1.1. Direct damages;

1.2. Lost opportunity damages;

2. Liquidated damages or forfeits.

However, expectation damages, as it is understood as a recovery of expectations in profits of the sought contract, usually are not awarded. Nevertheless, in the following parts of this master thesis, we will analyze compensatory damages under pre-contractual liability, i.e. reliance damages, liquidated damages and forfeits, and further on we will determine non-compensatory damages under pre-contractual liability.

### *2.2.1. Reliance damages*

J. Kleinheisterkamp and S. Vogenauer observe that the more advanced the negotiations, the more reasonable is the other party's reliance based on affirmative behavior by the first party.[163] Indeed, as it is implied by J. Cartwright and M. Hesselink "one might say that entering into negotiations, or, alternatively, one party's conduct during the negotiations might create in the other party the expectation that the contract is to be formed"[164]. Of course, the expectation in this case does not mean the same as the expectation in contract law because reliance damages will never put an aggrieved party in such a good position as if the final agreement was concluded

[161] For example, ruling as of 22 June 2010, the Civil Case Division of the Supreme Court of Lithuania (case No. 3K-3-279/2010)

[162] For example *see* O'Gorman D. P. Expectation Damages, the Objective Theory of Contracts, and the "Hairy Hand" Case: A Proposed Modification to the Effect of Two Classical Contract Law Axioms in Cases Involving Contractual Misunderstandings. *Kentucky Law Journal.* 2011, 99(2); Smith B. Loss of a chance. *Victoria University of Wellington Law Review*. 1999, 29(2); Kiršienė J., Leonova N. Qualification of Pre-contractual Liability and the Value of Lost Opportunity as a Form of Losses. *Jurisprudencija*. 2009, 1(115); Ivanauskas A. Prarastos galimybės piniginė vertė. *Justitia*. 2007, 1(63)

[163] Kleinheisterkamp J., Vogenauer S. *Commentary of the UNIDROIT principles of international commercial contracts (PICC).* Oxford: Oxford University Press, 2009, p. 305

[164] Cartwright J., Hesselink M. *Precontractual liability. European Private Law*. London: Cambridge University Press, 2008, p. 453

or expectation damages were awarded. J. Cartwright and M. Hesselink agree with the before-mentioned argument and observe that pre-contractual liability might be based on the reliance of one of the parties – if one party reasonably believes that the final contract will be concluded and makes some reliance investments, i.e. there is a direct causal link between the reliance that the final agreement will be concluded and the reliance investments, the aggrieved party should be compensated.[165] It should be noted that in order to analyze compensation of the reliance damages, we should separate two concepts – reliance investments and reliance damages. On the one hand, reliance expenditures are relation-specific investments that will raise the value of performance if the contract is formed. On the other hand, reliance damages (also could be called *reliance interest, reliance losses* or *negative interest*) – damages awarded for losses incurred by the plaintiff in reliance on the contract[166]; reliance damages restore the plaintiff to the economic condition the plaintiff enjoyed before the contract was formed[167]. Thus, one might say that reliance investments should be understood as a sum of money[168] invested during negotiations in order to make the future agreement more valuable; howbeit reliance damages, one might say, are the sum of money awarded to the aggrieved party and should cover not only reasonable reliance investments but additionally a value of loss of a chance. However, A. N. Kucher argues that reliance damages caused at the pre-contractual stage might be divided into real losses[169] and lost profits.[170] Nevertheless, J. Kleinheisterkamp and S. Vogenauer observes that damages under pre-contractual liability cover all reasonable expenses incurred in reliance on the negotiations and include compensation for realistic loss of a chance to conclude a contract with a third party (so called negative interest); however, an aggrieved party cannot recover the expectations it had in profits of the sought contract (so called positive interest).[171] Moreover, it is implied by Y. Ben-Dror that "negative interest includes both expenses and losses that were incurred as a

[165] Cartwright J., Hesselink M. states that "the imposition of precontractual liability might be based on the reliance of the claimant, i.e. for example, the defendant makes a false statement during the course of negotiations, which the claimant believes and acts on, one can speak of the claimant's reliance on the defendant's statement; and one can identify the causal consequences of the false statement by reference to the acts undertaken by the claimant on reliance on it". *See* Cartwright J., Hesselink M. *Precontractual liability. European Private Law*. London: Cambridge University Press, 2008, p. 453

[166] Black's Law Dictionary, Ninth Edition, West: Thomson Reuters business, 2009

[167] *Ibid.*

[168] A party might rent a new property, buy new equipment, hire more employees and do other kind of investments, which cost money.

[169] A. N. Kucher implies that real losses usually include (1) expenditures reasonably incurred in anticipation of the agreement (or in reliance on the validity of the agreement that has been concluded) and (2) the difference between the terms on which the agreement could have been concluded (or has been concluded but thereafter invalidated) and the terms on which a substitutive agreement can be entered into. *See* Kucher A. N. Pre-contractual liability: Protecting the Rights of the Parties Engaged Into Negotiations. Available at: <http://www.nyulawglobal.org/fellowsscholars/forums/papers/Kucher-paper.pdf> Accessed: 19 February 2012

[170] Kucher A. N., *op. cit.*

[171] Kleinheisterkamp J., Vogenauer S. *Commentary of the UNIDROIT principles of international commercial contracts (PICC).* Oxford: Oxford University Press, 2009, p. 306

consequence of the creditor's breached reliance"[172]. Furthermore, the Supreme Court of Lithuania as well supports the above-mentioned position.[173] Hence, we should agree with those legal scholars who argue that an aggrieved party might recover direct damages and loss of an opportunity, both as part of reliance damages, and we could not support the position of A. N. Kucher as to our mind positive interest, i.e. lost profits, should not be generally recoverable under pre-contractual stage.

#### *2.2.1.1. Direct damages*

Direct damages – damages that the law presumes follow from the type of wrong complained of[174]; or damages for a loss that is an immediate, natural, and foreseeable result of the wrongful act[175].

In order to understand the concept of direct damages we should analyze a hypothetical case: A, a buyer, wants to buy a new factory, which is sold by a seller, B. The buyer wants to expand its business and a new factory is needed for that purpose. A and B starts negotiations. A, who lives in a city, X, which is the other city than the factory is situated, comes to a city, Z, where the factory is actually situated. Thus, the buyer has travel expenses. As A and B has already started negotiations, A, who is not a professional lawyer, hires an attorney-at-law to draft a preliminary agreement and a final contract. Thus, the buyer has legal expenses. After A saw the factory and got drafts of a preliminary agreement and final contract from his lawyers, the buyer one more time travels to city Z to meet the seller. A wants to sign a preliminary agreement with the seller and in the near future to sign the final legally binding contract. However, even though A and B talked on the phone and agreed to meet at the precise time, as A comes to the city Z, the seller informs the buyer that he cannot meet him today and reschedules the meeting for tomorrow. A books a room in a hotel and spends a night there. Next day the seller and the buyer meet. However, the seller informs the buyer that he changed his mind and decided to expand his own business and to keep the factory.

J. Kleinheisterkamp and S. Vogenauer observe that aggrieved party's damages should cover all reasonable expenses incurred in reliance on the negotiations.[176] Thus, in our presented

[172] Ben-Dror Y. The Perennial Ambiguity of Culpa in Contrahendo. *American Journal of Legal History.* 1983, 27(2)
[173] The Supreme Court of Lithuania stated that party who acted in bad faith during negotiations should compensate the aggrieved party's reliance damages, which consist of direct damages and loss of an opportunity. *See* ruling as of 19 January 2005, the Civil Case Division of the Supreme Court of Lithuania (case No. 3K-3-38/2005)
[174] Black's Law Dictionary, Ninth Edition, West: Thomson Reuters business, 2009
[175] Merriam-Webster Dictionary of Law. Available at: <http://dictionary.findlaw.com> Accessed: 26 February 2012
[176] Kleinheisterkamp J., Vogenauer S. *Commentary of the UNIDROIT principles of international commercial contracts (PICC).* Oxford: Oxford University Press, 2009, p. 306

hypothetical case the seller must fully compensate all buyer's reasonable expenses (*restitutio in integrum*): the seller should compensate buyer's travel expenses, as the buyer came to meet the seller twice; costs, which were spend for the lawyers; and hotel expenses. The Supreme Court of Lithuania supports the above-mentioned position.[177] Of course, to our mind, A's expenditures should be reasonable – the seller should not have to reimburse the unreasonable costs, for example, if the buyer traveled only on the first/business class or booked a room in a five start hotel. Nevertheless, if the buyer's expenditures were reasonable, it should be compensated.

#### *2.2.1.2. Loss of opportunity*

Lost opportunity or loss of a chance theory of damages was first conceived at the beginning of last century. It is observed by Ben Smith that "damages were first awarded for loss of a chance in contract and were initially confined to solicitors' negligence actions. In this context, loss of a chance damages reinforce the fundamental goals of contract law. <…> However in the late twentieth century, the loss of a chance theory has slipped its theoretical moorings and drifted into previously uncharted areas of liability"[178]. Moreover, Ben Smith declares that "it appears that loss of a chance damages should be available in both tort and contract. This is consistent with the modern development of concurrent liability. <…> However the general principle is the same; the plaintiff should receive the monetary sum which, so far as money can, represents fair and adequate compensation for the loss of injury sustained by reason of the defendant's wrongful conduct"[179]. Conversely, Lithuanian scholars Julija Kiršienė and Natalja Leonova claim that "the lost opportunity damages are a part of the institute of reliance damages, because the party acting in good faith relies on the negotiating partner and therefore looses an opportunity to conclude a similar contract with another partner. Therefore, the compensation of the value of the lost opportunity puts the aggrieved party in the position, in which it would have been, if the delict had not been committed by the negotiation partner acting in bad faith. Therefore, the award of such damages should be considered in cases where there were no preliminary contract concluded between the parties to negotiations"[180]. However, we cannot agree with Julija Kiršienė and Natalja Leonova's position as to our mind Ben Smith's arguments are more reasonable. In our opinion, the lost opportunity damages, which are part of

[177] The Supreme Court of Lithuania stated that direct damages could consist of travel expenses; payments for lawyers; expenses, which occurred because of the preparation of documents; etc. *See* ruling as of 6 November 2006, the Plenary Session of the Civil Case Division of the Supreme Court of Lithuania (case No. 3K-P-328/2006).
[178] Smith B. Loss of a chance. *Victoria University of Wellington Law Review.* 1999, 29(2)
[179] *Ibid.*
[180] Kiršienė J., Leonova N. Qualification of Pre-contractual Liability and the Value of Lost Opportunity as a Form of Losses. *Jurisprudencija.* 2009, 1(115): 237

reliance damages, should be awarded not only if a preliminary agreement was not signed but also if a preliminary agreement was signed. This follows from the very nature of the theory of lost opportunity – as it conceived from contract law, it is obvious that reliance damages should be awarded if a preliminary agreement was signed. Moreover, image a situation: parties have signed a preliminary agreement and agreed to conclude a final agreement after several weeks, however parties did not indicate the amount of liquidated damages or forfeits. According to the statement of Julija Kiršienė and Natalja Leonova, as parties did conclude a preliminary agreement, lost opportunity damages could not be compensated; and as parties did not agree on liquidated damages or forfeits, it follows that parties can recover only direct damages. It is evident that particular situation cannot exist under conditions of market economy, principles of good faith, fair dealing and *restitutio in integrum*. Moreover, it should be noted that the Supreme Court of Lithuania supports the before-mentioned position and declares that if parties have signed a preliminary agreement, the aggrieved party might recover reliance interest, i.e. direct damages and loss of opportunity.[181]

Possibility of recovery of lost opportunity damages is also established under various legal acts. Under UNIDROIT PICC[182] an aggrieved party might recover reliance damages, i.e. direct damages and loss of an opportunity. According to commentary of the UNIDROIT PICC[183] and official comment of UNIDROIT PICC[184], the aggrieved party might recover the expenses incurred in the negotiations and might also be compensated for the lost opportunity to conclude another contract with a third person; these damages cover all reasonable expenses incurred in reliance on the negotiations, including compensation for realistic lost opportunities to conclude a contract with another third party. Furthermore, in order to understand compensatory damages under pre-contractual liability, official comment of UNIDROIT PICC provides a hypothetical case: "A learns of B's intention to sell its restaurant. A, who has no intention whatsoever of buying the restaurant, nevertheless enters into lengthy negotiations with B for the sole purpose of preventing B from selling the restaurant to C, a competitor of A's. A, who breaks off negotiations when C has bought another restaurant, is liable to B, who ultimately succeeds in selling the restaurant at a lower price than that offered by C, for the difference in price"[185]. In

[181] For example, ruling as of 3 April 2009, the Civil Case Division of the Supreme Court of Lithuania (case No. 3-3K-126/2009); ruling as of 21 December 2011, the Civil Case Division of the Supreme Court of Lithuania (case No. 3-3K-530/2011)

[182] UNIDROIT PICC article 2.15 part 1 declares that 'a party is free to negotiate and is not liable for failure to reach an agreement'. Part 2 of the same article declares that 'however, a party who negotiates or breaks off negotiations in bad faith is liable for the losses caused to the other party'.

[183] Kleinheisterkamp J., Vogenauer S. *Commentary of the UNIDROIT principles of international commercial contracts (PICC)*. Oxford: Oxford University Press, 2009, p. 306

[184] UNIDROIT Principles of International Commercial Contracts 2010. Rome: Unidroit, 2011

[185] *Ibid.*

this case, A should compensate B's reliance damages: A should compensate B's direct damages, which he had because of the negotiations with A, and B's loss of a chance to conclude a contract with C, i.e. A should compensate the difference of the price between the price, which was offered by C, and the price, which was paid by the third person.

Under CISG an aggrieved party might recover reliance damages, i.e. direct damages and loss of a chance, if parties, engaged into negotiations, managed to conclude a preliminary agreement. Article 74 of CISG declares that 'damages for breach of contract by one party consist of a sum equal to the loss, including loss of profit, suffered by the other party as a consequence of the breach. Such damages may not exceed the loss which the party in breach foresaw or ought to have foreseen at the time of the conclusion of the contract, in the light of the facts and matters of which he then knew or ought to have known, as a possible consequence of the breach of contract'. The commentary of CISG states that "the compensable disadvantages are established by comparing the situation the promisee actually finds himself in as a result of the breach of contract, with the situation the promisee would be in had the contract been properly performed. The compensation must satisfy not only the promisee's expectation interest, i.e. the interest in the advantages arising out of performance, but also the indemnity interest, i.e. the interest in avoiding damages to goods and rights as a result of non-performance, which the promisee has independently of the contract. Furthermore, Article 74 protects the reliance interest, i.e. expenses incurred as a result of reliance on the contract".[186] Moreover, commentary of CISG explains that "obligations regarding the parties' conduct during negotiations are not contractual obligations insofar as they are not based on an express or implied preliminary contract. Liability for breach of obligations arising out of negotiations thus largely remains outside the scope of the CISG. <…> Claims for damages either for infringement of the negotiating partner's legal interests, or for culpable termination of negotiations are therefore governed solely by the relevant contract or tort statute, depending on the claim's qualification according to the applicable international private law";[187] furthermore, Schlechtriem and Schwenzer state[188] that only the contracting party affected by the breach of contract is entitled to claim damages. Therefore, we could conclude that if parties did not conclude a preliminary agreement, damages for the aggrieved party would be compensated according to the national laws. However, if parties managed to conclude an express or implied preliminary contract, in case of breach of such a contract, as article 74 protects the reliance interest, we could assume that the aggrieved party should be reimbursed

[186] Schlechtriem P., Schwenzer I. *Commentary on the UN Convention on the international sale of goods (CISG).* Oxford: Oxford University Press, 2005, p. 746
[187] *Ibid.* p. 751-752
[188] Excerpt from Schlechtriem P., Schwenzer I. *Commentary on the UN Convention on the International Sale of Goods (CISG), Third Edition*. Available at: <http://www.globalsaleslaw.org/db/1/182.pdf> Accessed: 7 March 2012

because of his reliance, i.e. party should be able to recover loss of a chance damages. Thus, if parties did not conclude a final agreement, we assume that an aggrieved party might recover the difference between the contract price and the price of the replacement transaction. This position is supported by legal scholars as in CISG-AC Opinion No. 6 it is stated that "if there has been a breach of contract and then the aggrieved party enters into a reasonable substitute transaction without first having avoided the contract, the aggrieved party may recover damages under Article 74, that is, the difference between the contract price and the substitute transaction"[189].

In most legal systems a party, who breaks off negotiations without reasonable cause is liable for the negative contractual interest, i.e. such interest includes not only the direct expenses but also the loss of a chance to conclude another contract with a third party. In this respect we will briefly analyze various legal systems. According to Lithuanian CC[190] if one party breaks off negotiations, he should compensate the aggrieved party's reliance interest, i.e. direct expenses and loss of opportunity. It should be noted that the Supreme Court of Lithuania admits that an aggrieved party might recover its lost opportunity damages and in order to calculate those damages the Supreme Court of Lithuania applies the principle that the aggrieved party might recover the difference between the contract price and the price of the replacement transaction. The Supreme Court of Lithuania stated that one way to determine value of the lost opportunity is according to the part 5 of article 6.258 of Lithuanian CC (the difference of the prices). Difference of the prices (value of the existing lost opportunity) is determined by comparison of the price at which a contract would have been concluded with a third person if there were no negotiations with a party of a preliminary agreement, which have been unfair, and price of a concluded final agreement. The Supreme Court of Lithuania explained that rules declared in part 5 of article 6.258 of Lithuanian CC could be applicable only if an agreement, which was not concluded with a guilty party, but was concluded with the third person, substitute each other, are analogical, i.e. the aim, purpose, object, other terms, which impacts the price of the agreement, coincide. If contracts do not substitute each other – as it was discussed above – the difference of contracts prices do not confirm the damages of the aggrieved party and cannot be implied in order to determine incurred damages. In the case law of the Supreme Court of Lithuania it is declared that comparison of prices principle is one, however not the only one method to determine value of lost opportunity. When a party who acts in accordance with principle of good

[189] CISG AC Opinion No. 6, Calculation of Damages under CISG Article 74. Available at: <http://www.cisg.law.pace.edu/cisg/CISG-AC-op6.html#*> Accessed: 29 February 2012

[190] Part 3 of article 6.163 of Lithuanian CC declares that 'a party who begins negotiations or negotiates in bad faith shall be liable for the damages caused to the other party'. Part 5 of article 6.258 of Lithuanian CC declares that 'where the aggrieved party dissolves the contract on the grounds that the other party has violated it and makes a replacement transaction within a reasonable time, it may claim from the guilty party the difference between the contract price and the price of the replacement transaction as well as damages for any further loss'.

faith does not conclude a contract with a third person, the prices comparison principle cannot be applicable. Value of lost opportunity in such case could be determined in other methods, for example by lost of interest, etc.[191] Thus, an aggrieved party might recover it's loss of a chance damages. Moreover, in our opinion, the Supreme Court of Lithuania in the newest case law correctly determined that the value of lost opportunity could be determined in different methods and from now on, to our mind, parties, which acted in accordance with good faith during negotiations, could be more ensured that their reliance damages would be reimbursed.

On the contrary, under Italian law, parties must act in good faith during negotiations and the formation of a contract. As it is observed by Advocate General Geelhoed[192] party who breaks off negotiations without just cause, having created an expectation that a contract will be entered into, is liable for the negative contractual interest[193], thus an aggrieved party might recover its reliance damages, i.e. direct damages and lost opportunity. However the Supreme Court of Cassation of Italy, differently from the explanation of the Supreme Court of Lithuania, in so called *the Giuliana* case held that reliance losses include not only expenses but also the loss of opportunities to conclude a contract with a third party, which may be of a different kind.[194] Thus, in Italy value of loss of opportunity might be determined by comparing contracts of different kind, it is a position, which is not recognized in Lithuania. Moreover, it is argued by legal scholars that under Italian law a party is liable if he breaks off negotiations without a good reason after having induced in the other party the justified reliance that a contract would be concluded; in such case fault of a party is not required.[195] Furthermore, legal scholars observe that under Italian law only the reliance interest can be recovered, reliance losses include expenses as well as the loss of opportunities to conclude a contract with third parties.[196] In Austria an aggrieved party might recover its reliance damages. Under the Austrian law, as it is observed by legal scholars[197], pre-contractual liability might arise in the case of reasonable and legitimate reliance of the one party that the other party will not break off the negotiations[198].

[191] Ruling as of 21 December 2011, the Civil Case Division of the Supreme Court of Lithuania (case No. 3-3K-530/2011)

[192] Opinion of Advocate General Geelhoed on European Court of Justice case (case No. C-334/00). Available at: <http://www.unilex.info/case.cfm?pid=1&do=case&id=813&step=FullText> Accessed: 11 March 2012

[193] Such negative interest specifically includes lost opportunities in addition to expenses.

[194] Ruling as of 12 March 1993, the Supreme Court of Cassation of Italy. *Translated by* Beale H., Fauvarque Cosson B., Rutgers J., Tallon D., Vogenauer S. *Cases, Materials and Text on Contract Law*. Oxford: Hart, 2010, p. 402-403

[195] Beale H., Fauvarque-Cosson B., Rutgers J., Tallon D., Vogenauer S., *op. cit.*, p. 403; Opinion of Advocate General Geelhoed on European Court of Justice case (case No. C-334/00)., *op. cit.*

[196] Beale H., Fauvarque-Cosson B., Rutgers J., Tallon D., Vogenauer S., *op. cit.*, p. 404

[197] Cartwright J., Hesselink M. *Precontractual liability. European Private Law*. London: Cambridge University Press, 2008, p. 455

[198] It is observed by legal scholars that "from the moment when the parties start negotiations or, even earlier, when they prepare the ground for the contract, a relationship of reliance (*Vertrauensverhältnis*) exists between the parties that leads to a legal relationship (*Rechtsverhältnis*) with duties of protection and loyalty (*Schutz- und Loyalitäts-*

Thus, legal scholars claim that an aggrieved party might recover expenses incurred because of the reliance of the contract.[199] In Germany an aggrieved party might recover its reliance damages and it is established in the case law of German courts. For example, *Bundesgerichtshof* in so called *The Letter* case held that once a party has induced or encouraged in another a confident expectation that a contract will be concluded, the breaking off of negotiations without good reason will give rise to liability to compensate the other for damage suffered as a result of his reliance on the expectation[200]; in so called *Two sellers* case, the court held that a party who negligently expresses himself in such a way as to bring about misunderstanding in the mind of the other party and which prevents a contract from coming into existence may bear the burden of liability for the loss and damage suffered as a result[201]; in so called *The Housing Association* case the court held that a failure on the part of a commercial company to ensure that a contract concluded with private individuals complies with the necessary formalities represents a breach of the company's duty to conduct pre-contractual negotiations with care and can give rise to a claim to compensation for the loss suffered as a result.[202] It is argued by legal scholars that in practice in most cases reliance damages consist in expenses, however lost of a chance might be recovered as well.[203] In common law countries an aggrieved party might recover loss of a chance damages even if the aggrieved party cannot prove the exact amount of losses. Professor at University of Toronto Stephen Michael Waddams observes that "it is well established, in English and Commonwealth law that a loss may be compensated even though its value cannot be established with any degree of certainty. If the plaintiff proves that the defendant has caused a loss, the impossibility of proving the precise value of the loss 'cannot relieve the wrongdoer of the necessity of paying damages'"[204]. Moreover, Stephen Michael Waddams implies that if a plaintiff is deprived of a chance of considerable value that many people would give money for then that the lost chance should be compensable.[205] Conversely, Ben Smith argues that " <…> there are chances of considerable value that many people give money for, whether it be a person paying premiums on an insurance policy, a stockbroker speculating on the stock exchange, or a

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*pfichten*) for both parties". *See* Cartwright J., Hesselink M. *Precontractual liability. European Private Law*. London: Cambridge University Press, 2008, p. 455

[199] The Commission on European Contract Law. *Principles of European Contract Law*. The Hague: Kluwer Law International, 2000, p. 193

[200] Ruling as of 10 July 1970, the Bundesgerichtshof. *Translated by* Beale H., Fauvarque Cosson B., Rutgers J., Tallon D., Vogenauer S. *Cases, Materials and Text on Contract Law*. Oxford: Hart, 2010, p. 383-384

[201] Ruling as of 5 April 1922, the Bundesgerichtshof. *Translated by* Beale H., Fauvarque-Cosson B., Rutgers J., Tallon D., Vogenauer S., *op. cit.*, p. 419-420

[202] Ruling as of 29 January 1965, the Bundesgerichtshof. *Translated by* Beale H., Fauvarque Cosson B., Rutgers J., Tallon D., Vogenauer S., *op.cit.*, p. 420-422

[203] Cartwright J., Hesselink M., *op. cit.*, p. 455; Beale H., Fauvarque-Cosson B., Rutgers J., Tallon D., Vogenauer S., *op. cit*, p. 420

[204] Waddams S. M. The Valuation of Chances. *Canadian Business Law Journal*. 1998, 30(88)

[205] *Ibid.*

sporting enthusiast gambling at the TAB. It is not disputed that all these chances although speculative, are of value. However if any of the above people were negligently denied the above chances and compensated in accordance with a value paradigm, then the proverbial spectre of indeterminate liability of an indeterminate amount to an indeterminate class would well be nigh"[206]. Furthermore, on the one hand Advocate General Geelhoed observes that in common law countries the risk that a party will break off negotiations before a contract has been entered into is regarded as a 'business loss', however, on the other hand Advocate General Geelhoed states that pre-contractual liability in common law countries might be implied on the other notions than breach of the duty of good faith, and those notions are comparable with notions in continental law such as the protection of good faith and legitimate expectations.[207] Although, in our opinion, Ben Smith's argumentation is correct and well grounded, however we should agree with those legal scholars, who imply that in common law jurisdictions loss might be compensated even though its value cannot be proven with any degree of certainty, because such a loss would be compensated on the grounds of misrepresentation or promissory estoppel. Consequently, we can state that in most of legal jurisdictions and according to various legal acts an aggrieved party might recover loss of an opportunity, which, as to our mind, should be compensated either contractual, tortious or *sui* generis type of liability is implied; however, there are different grounds for implying it, as well as, different damages calculation systems.

### *2.2.2. Liquidated damages and forfeits*

Liquidated damages – an amount contractually stipulated as a reasonable estimation of actual damages to be recovered by one party if the other party breaches;[208] or if the parties of the contract have properly agreed on liquidated damages, the sum fixed is the measure of damages for a breach, whether it exceeds or falls short of the actual damages[209]; or a sum fixed in advance by the parties to a contract as the amount to be paid in the event of a breach[210]. Forfeits, on the other hand, is a sum of money determined by laws or a contract which the debtor shall be bound to pay to the creditor in the case of failure to perform an obligation, or defective performance thereof.[211] Thus, it could be assumed that liquidated damages and forfeits are the sum of money

[206] Smith B. Loss of a chance. *Victoria University of Wellington Law Review.* 1999, 29(2)
[207] Opinion of Advocate General Geelhoed on European Court of Justice case (case No. C-334/00). Available at: <http://www.unilex.info/case.cfm?pid=1&do=case&id=813&step=FullText> Accessed: 11 March 2012
[208] Black's Law Dictionary, Ninth Edition, West: Thomson Reuters business, 2009
[209] *Ibid.*
[210] Oxford Dictionary of Law, Seventh Edition, Oxford: Oxford University Press, 2009
[211] Even though in the translation of Lithuanian CC the word 'penalty' instead of the word 'forfeits' is used, in order to avoid confusion we will use word 'forfeits'. Furthermore, in our opinion, word 'penalty' is not a correct term, as a

that the parties to a contract specify and which will have to be paid if the contract is breached. Moreover, it should be stressed that compensation of either liquidated damages or forfeits under pre-contractual liability should be compensated only and only if: (1) negotiating parties have signed a preliminary agreement; (2) the parties have incorporated a clause of liquidated damages or forfeits into the preliminary agreement. Furthermore, it should be noted that parties might included a clause of liquidated damages or forfeits – i.e. one or another; they cannot include both of those clauses into a preliminary agreement.

In Lithuania, liquidated damages[212] are not determined in Lithuanian CC, however, although this kind of cases are relatively rare, the Supreme Court of Lithuania recognizes the existence of liquidated damages under pre-contractual liability and acknowledges the difference between liquidated damages and forfeits.[213] Forfeits, on the other hand, are determined in Lithuanian CC and recognized by the case law of Lithuanian courts. For example, in one case it was stated that a plaintiff and a defendant concluded a preliminary agreement. The plaintiff transferred 150 000 LTL for the defendant as an advanced payment. Moreover, under the terms of the preliminary agreement the parties agreed that if the plaintiff unilaterally terminates the preliminary agreement, the advanced payment is considered as forfeits and is not returned to the plaintiff; if the defendant breaches the preliminary agreement, he must return the advanced payment to the plaintiff and pay forfeits as of the amount of 150 000 LTL. Further, the Supreme Court of Lithuania held that the parties incorporated the clause of forfeits into the preliminary agreement. Moreover, the Supreme Court of Lithuania stated that the parties may incorporate the clause of forfeits into a preliminary agreement and if the preliminary agreement is breached, i.e. the final contract is not concluded, the aggrieved party should be awarded the specified amount of forfeits. In our presented case the Supreme Court of Lithuania held that the defendant was liable for not reaching the final agreement. However, even though the parties agreed that in case the defendant breaches the preliminary agreement, he must return the advanced payment to the plaintiff and pay 150 000 LTL as forfeits, as the plaintiff in a statement of claim requested only for the return of advanced payment, the Supreme Court of Lithuania awarded the plaintiff the sum of 150 000 LTL.[214] However, in our opinion, the plaintiff should have requested and the Supreme Court of Lithuania should have awarded the plaintiff with the sum equal to 300 000 LTL: 150 000 LTL as a return of the advanced payment and 150 000 LTL as the forfeits.

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purpose of 'penalty' is to punish the guilty party, however, the aim of contractual remedies is to compensate an aggrieved party.

[212] Either stipulated in the contract or in pre-contractual document.

[213] Ruling as of 6 November 2006, the Plenary Session of the Civil Case Division of the Supreme Court of Lithuania (case No. 3K-P-328/2006)

[214] Ruling as of 22 June 2010, the Civil Case Division of the Supreme Court of Lithuania (case No. 3K-3-279/2010)

Even though the Supreme Court of Lithuania distinguished that liquidated damages cannot be equated to forfeits, the court did not determined the difference between the two before-mentioned concepts. To our mind, as concept of liquidated damages is not incorporated into Lithuanian CC, as there are no Lithuanian legal scholars who analyzed possibility of compensation of liquidated damages in Lithuania, as liquidated damages might be confused with forfeits, we are deemed to analyze compensation of forfeits and liquidated damages under pre-contractual liability in this master thesis. First of all, short analyzes of forfeits will be provided. Secondly, we will provide more exhaustive analyzes of liquidated damages as this concept is not well known in Lithuania.

Concept of forfeits, as it was mentioned above, is well know in Lithuanian legal system and it is determined in Lithuanian CC.[215] Thus, according to *pacta sunt servanda* principle parties of the preliminary agreement might specify the amount of forfeits[216], which would be suffered if the preliminary agreement would be breached and final agreement would not be signed. Thus, parties determine the amount of forfeits *ex ante* and, as it is stated in the case law of the Supreme Court of Lithuania, in case of the breach of the preliminary agreement, an aggrieved party would not have to prove the exact amount of losses, as specified amount of forfeits would be determined as an aggrieved party's loss, which might be as well acknowledged as minimal damages.[217] Thus, forfeits, indicated in the preliminary agreement, define limits of the guilty parties' liability in case the preliminary agreement is breached. Furthermore, the amount of forfeits, indicated in the preliminary agreement, generally should not be mitigated. The Supreme Court of Lithuania supports the before-mentioned position.[218]

Even though parties of the preliminary agreement, while implementing *pacta sunt servanda* principle, determine the amount of forfeits *ex ante*, in our opinion, the *ex post* valuation of the judge is what ultimately counts. The judge might mitigate the amount of forfeits if it is, to the view of the judge, excessive[219]; or the judge might increase the sum, which would be awarded to the aggrieved party, if the agreed amount of forfeits were lesser than the actual

[215] Article 6.71 of Lithuanian CC (*Concept of forfeits*) establishes that:
**'(**1) Forfeits are a sum of money determined by laws or a contract, which the debtor shall be bound to pay to the creditor in the case of failure to perform an obligation, or defective performance thereof (fine, interest). **(**2) The forfeits may be established in the form of a concrete sum of money or expressed in percentage terms on the amount of the secured obligation. (3) The forfeits stipulated for a delay in performance of an obligation may be established for every day, week, month, etc. that exceeds the time-limit of the performance'.
[216] Parties to a contract should specify the sum of forfeits, which should be of the amount of factual loss.
[217] Ruling as of 12 October 2007, the Extended Chamber of Judges of the Civil Case Division of the Supreme Court of Lithuania (case No. 3K-7-304/2007)
[218] Ruling as of 2 November 2010, the Extended Chamber of Judges of the Civil Case Division of the Supreme Court of Lithuania (case No. 3K-7-409/2010)
[219] While implementing court's right of discretion, the judge might reduce clearly over-compensatory forfeits.

damages.[220] The before-mentioned position is supported by the case law of the Supreme Court of Lithuania. It is declared that if the amount of damages is greater than contractual forfeits, according to the part 1 of article 6.73 of Lithuanian CC, an aggrieved party should get reimbursed the amount of the incurred damages[221]. Furthermore, it is declared by the case law of the Supreme Court of Lithuania that if the amount of forfeits is higher than the actual damages, the court should determine the compensable amount in this way: firstly, the part of specified forfeits[222] should be included into the amount of awardable damages; secondly, the court should decide whether the remaining amount of contractual forfeits should be mitigated and to what extent; and finally, the court should determine the final amount, which would be awarded to the aggrieved party.[223]

Therefore, according to the before provided analyzes, we could assume that forfeits are contractually specified amount of money, which should be paid in case of the breach of the preliminary agreement. Moreover, nevertheless the parties agreed on the amount of payable forfeits *ex ante*, the court might mitigate the payable forfeits if it exceeds the actual damages; or might award an aggrieved party a greater amount of money, if actual damages are higher than agreed forfeits. Thus, in our opinion in cases when there is a need to award an aggrieved party the amount of agreed forfeits, judge's *ex post* valuation of such an amount is utmost important.

On the other hand, Lithuanian CC does not regulate the possibility of compensation of liquidated damages. However, as it was mentioned above, even though there is no legal act, which would regulate the compensation of liquidated damages, the Supreme Court of Lithuania declared that parties might be entitled to the compensation of such damages, however it did not distinguish the difference between liquidated damages and forfeits. Therefore, we are reasoned to determine the meaning and application of liquidated damages and to compare it to the meaning and application of forfeits.

Thus, parties might agree on the amount of the liquidated damages, which would be

[220] Article 6.258 of Lithuanian CC (*Forfeits and damages*) establishes that:
'**(**1) It may be provided for by laws or a contract that the party guilty for non-performance of an obligation or defective performance thereof shall be bound to pay a forfeits (fine, interest). **(**2) In the instances where forfeits are established, the creditor may not concurrently demand from the debtor the performance of the principal obligation and the payment of the sum stipulated in the penal clause (the forfeits) except in the cases where the time-limit of performance of the obligation is delayed by the debtor. An agreement providing for any other stipulation shall be null and void. In the event of a claim for compensation of damages being made, the forfeits shall be included in the damages. (3) The sum stipulated as forfeits (fine, interest) may be reduced by the court when it is unreasonably excessive, or if the creditor has benefited from the partial performance of the obligation. However, this sum may not be reduced below the damages payable for the non-performance of the obligation or defective performance thereof. Forfeits may not be reduced after its payment'.
[221] The amount of the agreed forfeits is included in the awarded sum.
[222] This part should be equal to the amount of the incurred damages.
[223] Ruling as of 12 October 2007, the Extended Chamber of Judges of the Civil Case Division of the Supreme Court of Lithuania (case No. 3K-7-304/2007)

paid in the event of the breach of the preliminary agreement, however, it is argued that there is at least two constrains. The first is that the actual damages must be difficult to prove; the second is that the damages must be reasonable at the time of drafting the contract.[224]

Parties of a preliminary agreement might agree on liquidated damages, which are of the amount of the factual loss, which will be suffered if the preliminary agreement is breached and a final contract is not signed. However, parties as well might agree on over-compensatory liquidated damages, which might be as well called penalty damages, and under-compensatory damages. Paul G. Mahoney observes that "as liquidated damages origin from contractual remedies, it is noted that the economic function of contract remedies, then, is to alter the incentives facing the party who regrets entering into the contract, which will directly affect the probability of performance and indirectly affect the number and type of contracts people make, the level of detail with which they identify their mutual obligations, the allocation of risks between the parties, the amount they invest in anticipation of performance once a contract is made, the precautions they take against the possibility of breach, and the precautions they take against the possibility of a regret contingency"[225]. Furthermore, Gerrit De Geest and Filip Wuyts imply that liquidated damages may create incentives to over-performing as well as to over-breaching.[226] To our mind, this position is worth to be analyzed. As Tess Wilkinson-Ryan observes it, under an economic analysis, breach of contract is efficient if it leaves no one worse off and at least one party better off.[227] A party who is required to pay liquidated damages in the event of breach will not breach unless it is profitable to do so even after compensating the aggrieved party the liquidated damages. Thus, if breaching of a contract will earn money for a party, the party will breach the contract[228]. Consequently, if parties agree on over-compensatory liquidated damages, it follows that more contracts – than if parties have agreed on factual amount of losses as liquidated damages – will be performed. And on the contrary, if parties agree on under-compensatory liquidated damages, it follows that less contracts – than if parties have agreed on factual amount of losses as liquidated damages – will be performed.

Thus, consequently we can assume that parties of a preliminary agreement will not make excessive reliance investments if they agreed on a fixed sum of liquidated damages in the

[224] Wilkinson-Ryan T. Do Liquidated Damages Encourage Breach? A Psychological Experiment. *Michigan Law Review*. 2010, 108(5): 642

[225] Mahoney P. G. Contract remedies: general. Available at: <http://encyclo.findlaw.com/4600book.pdf> Accessed: 24 February 2012

[226] De Geest G., Wuyts F. Penalty clauses and liquidated damages. Available at: <http://encyclo.findlaw.com/4610book.pdf>, p. 141. Accessed: 24 February 2012

[227] Wilkinson-Ryan T. Do Liquidated Damages Encourage Breach?, *op. cit.*, p. 638

[228] It was shown by the experiment that a party is usually more willing to breach a contract if by breaching the contract, the party will earn extra money. Moreover, it was proven that parties are more willing to breach a contract with liquidated damages clause than a contract with an otherwise identical damages award specified by the law of contracts. *See* Wilkinson-Ryan T., *op. cit.*

preliminary agreement. It seems reasonable from the economic point of view – parties will not want to lose their reliance investments as it will be definitely lost if parties agreed on a fixed amount of the liquidated damages and as this amount is lesser than reliance investments. As it is well observed by Gerrit De Geest and Filip Wuyts, this is not the case with normal expectation or reliance damages awarded by a judge, because judges generally do not examine whether the reliance costs made by the promisee were excessive or not.[229] However, parties who make reliance investments understand if their made reliance investments are excessive or not and can compare the amount of reliance investments and the sum of liquidated damages.

If characterized as a liquidated damages clause, an agreed damages provision is valid and enforceable.[230] But the clause of liquidated damages will not be enforced and will be invalid if it is determined as a penalty clause. Penalty clause – a contractual provision that assesses against a defaulting party an excessive monetary charge unrelated to actual harm.[231] Moreover, it is argued that an agreed sum is a penalty if the amount stipulated is, in the circumstances 'out of all proportion' to, or 'significantly greater' than, the damage likely to be suffered as a result of breach.[232]

On the one hand, in most countries contractual penalty clauses are forbidden. In common law penalty clauses are forbidden according to the 'penalty doctrine'.[233] As in Lithuania, penalty clauses are also prohibited. Thus, if parties agreed on over-compensatory liquidated damages, it would be considered as penalty clause and should not be enforced. Furthermore, the Supreme Court of Lithuania supports the before-mentioned position and declares that the aim of contractual liability is to compensate an aggrieved party, i.e. not to punish the guilty party[234].

On the other hand, it is argued that the penalty doctrine was directly derived from the rationality assumption in economics: we may assume that people are rational, so if they sign a penalty clause they must have good reasons to do so, thus the contract must be efficient, otherwise they would not have signed it.[235] Moreover it is argued that all liquidated damages clauses should be enforced without distinction, at least when the provision was knowledgeably

[229] De Geest G., Wuyts F. Penalty clauses and liquidated damages. Available at: <http://encyclo.findlaw.com/4610book.pdf>, p. 145. Accessed: 24 February 2012
[230] Peden E., Carter J. Agreed Damages Clauses - Back to the Future? S*ydney Law School Research Paper*. 2007, 07(52): 189
[231] Black's Law Dictionary, Ninth Edition, West: Thomson Reuters business, 2009
[232] Peden E., Carter J., *op. cit.* p. 190
[233] De Geest G., Wuyts F., *op. cit.*, p. 141
[234] Ruling as of 2 November 2010, the Civil Case Division of the Supreme Court of Lithuania (case No. 3K-7-409/2010)
[235] De Geest G., Wuyts F., *op. cit.*

and fairly bargained-for.[236]

In our opinion the above-mentioned position is worth to be analyzed. According to *pacta sunt servanda* principle, parties are free to determine the terms of the contract, however, of course, those terms cannot breach the imperative legal acts, principles of good morals and public order. Thus, as parties agree on the amount of liquidated damages *ex ante*, at the time of the conclusion of a preliminary agreement, parties determine the amount, which compensates their damages in case a final agreement is not reached. Moreover, the value of damage done if the final agreement is not reached might not be declared in an exact sum of money, as party's reliance on the contract might have non-monetary value, thus this is the reason why parties agree on the value before. For example, parties make a preliminary agreement – one party, A, wants to rent a bus with a driver on the specific day. A and the bus company, B, concludes a preliminary agreement – B commits to provide a bus and a driver on the specified day and to take A to the specified place, therefore, because of the B's policy, parties agree to conclude a final agreement on the specified day. A needs the bus on the specified day to get to the one-in-a-lifetime concert. Thus, A and B conclude the preliminary agreement and indicate that the amount of the liquidated damages is 3000 euros. It may seem that such amount is over-compensatory, however, this is an amount of liquidated damages on which parties agreed. Indeed, as it is argued by Paul G. Mahoney, this would give promisees a high degree of confidence that the promised performance will occur and induce a high level of investment in anticipation of performance.[237] Moreover, parties agreed on the terms of the preliminary agreement via bargaining, both of the parties understood the consequences of not signing the final agreement on that specified day, and agreed with those terms, thus, why such terms should not be applicable? In our opinion, if parties concluded the contract via bargaining, understood the terms of the contract and consequences of non-performance, the amount of agreed liquidated damages should be awarded to the aggrieved party. Otherwise, the aggrieved party's substantiated interests would be breached; as the aggrieved party relied that in the case of non-performance at least liquidated damages would be awarded.

Liquidated damages can be a rational option, especially if parties have more information about the possible losses than judges.[238] Therefore, it is argued by legal scholars that if parties agreed on liquidated damages, the probability that a judge will err in estimating the damage is

[236] De Geest G., Wuyts F. Penalty clauses and liquidated damages. Available at: <http://encyclo.findlaw.com/4610book.pdf>, p. 141. Accessed: 24 February 2012
[237] Mahoney P. G. Contract remedies: general. Available at: <http://encyclo.findlaw.com/4600book.pdf>, p. 118. Accessed: 24 February 2012
[238] De Geest G., Wuyts F., *op. cit*, p. 141

largely eliminated.[239] However, there is always a possibility that a court will determine the liquidated damages clause as a penalty clause. It is observed by Gerrit De Geest and Filip Wuyts that courts have adopted a skeptical attitude toward these so-called liquidated damages clauses – in general, courts will enforce a liquidated damages clause only if (1) at the time of contracting, the damage that the promisee will suffer in the event of breach (that is, the promisee's expectation) is uncertain, and (2) the amount of liquidated damages is both a reasonable estimate of (the mean of) those damages and not disproportionate to the actual *ex post* damages.[240]

However, in our opinion, a court should not correct the liquidated damages[241], which were agreed on by the parties of a preliminary agreement[242]. If judges always corrected liquidated damages that turn out to differ from the real losses, this would mean that the *ex post* valuation of the judge is the only thing that ultimately counts, except for those cases where judges are uncertain as to what are the true losses and put the burden of proof with the party that argues that the true losses differ from what is stipulated *ex ante*[243] or in cases if contract was not reached via bargaining, i.e. party signed so called 'standard contract' or in case if one of the party is a consumer and there is a need to protect consumer's rights. Consequently, to our mind, first, if both parties of a preliminary agreement are professionals, i.e. they are not consumers, second, if the parties agreed on the amount of the liquidated damages via negotiations, third, they signed a preliminary agreement and, forth, parties understood the consequences of breach of the preliminary agreement, courts should not mitigate the amount of the liquidated damages.

Therefore, as we could conclude from the above provided analyzes, there is a difference between liquidated damages and forfeits:

1. In order to award liquidated damages, an aggrieved party must ascertain that, firstly, it is difficult to prove the actual damages and, secondly, that the amount of the agreed damages were reasonable at the time of drafting the contract; however, in order to award the specified amount of forfeits, first of all, there is no obligation to attest that it is difficult to prove the actual damages; secondly, the amount of specified forfeits must be reasonable not at the time of drafting the contract but at the time of the breach of the contract.

2. If determined as a liquidated damages clause, an agreed damages provision is

[239] De Geest G., Wuyts F. Penalty clauses and liquidated damages. Available at: <http://encyclo.findlaw.com/4610book.pdf>, p. 145. Accessed: 24 February 2012

[240] Mahoney P. G. Contract remedies: general. Available at: <http://encyclo.findlaw.com/4600book.pdf>, p. 127-128. Accessed: 24 February 2012

[241] As to our mind, the court cannot correct liquidated damages. There is a main difference between liquidated damages and forfeits as the amount of compensable forfeits might be mitigated or increased.

[242] To our mind, the Supreme Court of Lithuania began to follow a good path, and in one of the newest case stated that liquidated damages should not be mitigated as negotiating parties have agreed on such amount of the liquidated damages. *See* ruling as of 2 May 2011, the Civil Case Division of the Supreme Court of Lithuania (case No. 3K-3-223/2011).

[243] De Geest G., Wuyts F. Penalty clauses and liquidated damages., *op. cit.*, p. 153

lawful and enforceable. Conversely, if determined as a penalty clause, an agreed damages provision should be prohibited and not enforceable. However, if determined as forfeits clause, the agreed amount of forfeits should be awarded to an aggrieved party, nonetheless, it might be reduced or increased by the court.

3. In case of liquidated damages, the amount, which is stipulated *ex ante*, is likely to be suffered in case of the breach of the preliminary agreement. Besides, the amount of indicated liquidated damages must be reasonable at the time of the drafting of the contract. Conversely, in case the parties agree on the amount of forfeits, which is stipulated *ex ante*, such an amount must be reasonable at the time of the breach of the preliminary agreement.

In our opinion, as liquidated damages clause is a reasonable option because parties have more information about possible losses than judges, we assume that it would be rational to determine the possibility of compensation of liquidated damages in Lithuanian CC and to ensure that parties, while implementing *pacta sunt servanda* principle, would be able to agree on liquidated damages clause, which would be acknowledged by the courts.[244] Therefore, we recommend specifying the Lithuanian CC.[245] For example, part 1 of article 6.258 of Lithuanian CC[246] should declare that: 'It may be provided for by laws or a contract that the party guilty for non-performance of an obligation or defective performance thereof shall be bound to pay forfeits (fine, interest) or liquidated damages'.

## 2.3. Non-compensatory damages under pre-contractual liability

Contract law seeks to protect an aggrieved party's expectation interest[247], which is party's interest in being put in the position he would have been in had the promise been kept.[248] Moreover, it is observed by Richard Craswell that "the expectation measure restores to the nonbreacher not only everything he gave up in reliance on the contract, but also any net profits he would have made if the contract had been performed"[249]. Even though it is argued by some legal scholars that "damages based on protecting the expectation interest is a 'queer kind of

[244] In case the concept of liquidated damages would be incorporated into the Lithuanian CC, there is a greater possibility that Lithuanian courts would not err liquidated damages clause with forfeits clause.
[245] It should be noted that in order to incorporate concept of liquidated damages into Lithuanian CC, the systematic adjustments of Lithuanian CC (especially in Book 6) should be done. Therefore, the author does not provide the exhaustive list of all articles of Lithuanian CC, which should be changed.
[246] Part 1 of article 6.258 of Lithuanian CC declares that 'It may be provided for by laws or a contract that the party guilty for non-performance of an obligation or defective performance thereof shall be bound to pay forfeits (fine, interest)'.
[247] Expectation interest as non-compensatory damages under pre-contractual liability should be understood as lost profits.
[248] O'Gorman D. P. Expectation Damages, the Objective Theory of Contracts, and the "Hairy Hand" Case: A Proposed Modification to the Effect of Two Classical Contract Law Axioms in Cases Involving Contractual Misunderstandings. *Kentucky Law Journal.* 2011, 99(2): 330
[249] Craswell R. Against Fuller and Purdue. *University of Chicago Law Review.* 2000, 67(1): 102

compensation' because it gives the injured party something he or she never had"[250], nevertheless, compensation of lost profits is possible under contractual liability.[251]

Under pre-contractual liability, on the other hand, an aggrieved party usually cannot recover expectation damages; nevertheless there are some exceptions. Thus, we should analyze possibility of recovery of expectation damages under different legal sources.

The basic rule under UNIDROIT PICC is that an aggrieved party cannot recover its expectation damages. It is provided in the official comment of UNIDROIT PICC that "an aggrieved party <…> may generally not recover the profit which would have resulted had the original contract been concluded (so-called expectation or positive interest)"[252]. Furthermore, J. Kleinheisterkamp and S. Vogenaur support the before-mentioned position and declare that the aggrieved party cannot recover the expectations it had in profits of the sought contract (positive interest).[253] Nevertheless, even under UNIDROIT PICC there is a possibility for an aggrieved party to recover expectation damages under pre-contractual liability. Official comment of UNIDROIT PICC implies that "only if the parties have expressly agreed on a duty to negotiate in good faith, will all the remedies for breach of contract be available to them, including the remedy of the right to performance"[254]. Thus, if parties have expressly agreed on a duty to negotiate in good faith[255], and one of the parties broke off negotiations without a just reason, it could be assumed that an aggrieved party might recover expectation damages. However, we cannot agree with the before-mentioned statement. Obligation to negotiate in accordance with good faith principle is already implied by the law, thus parties are obliged not to infringe this duty. Therefore, if a party breaks off negotiations contrary to good faith principle, it will be held accountant even if parties did not expressly agree to negotiate in accordance with good faith principle. Hence, as to our mind, an aggrieved party might recover its expectation interest only if parties have expressly agreed on not only to negotiate in accordance with good

[250] O'Gorman D. P. Expectation Damages, the Objective Theory of Contracts, and the "Hairy Hand" Case: A Proposed Modification to the Effect of Two Classical Contract Law Axioms in Cases Involving Contractual Misunderstandings. *Kentucky Law Journal.* 2011, 99(2): 335

[251] For example, part 1 of article 6.249 of Lithuanian CC establishes that 'damage shall include the amount of the loss or damage of property sustained by a person and the expenses incurred (direct damages) as well as the incomes of which he has been deprived, i.e. the incomes he would have received if unlawful actions had not been committed'.

[252] UNIDROIT Principles of International Commercial Contracts 2010. Rome: Unidroit, 2011

[253] Kleinheisterkamp J., Vogenauer S. *Commentary of the UNIDROIT principles of international commercial contracts (PICC).* Oxford: Oxford University Press, 2009, p. 306

[254] UNIDROIT Principles of International Commercial Contracts 2010. *op. cit.*

[255] For example, included an obligation to act in accordance with good faith in the preliminary documents.

faith principle but as well declared that if one of the parties breaches this duty, an aggrieved party might recover all remedies, including expectation interest[256].

As under CISG, to our mind, an aggrieved party cannot generally recover expectation damages. As it was mentioned in the first chapter of this master thesis, concluded preliminary agreements fall within the scope of CISG, nonetheless, CISG does not directly set framework for pre-contractual liability. However, under CISG, in our opinion, if a preliminary agreement is breached, courts should follow article 7 (2) of CISG[257] and award damages to the aggrieved party according to the rules established in UNIDROIT PICC.

As under Lithuanian law, an aggrieved party cannot recover expectation damages under pre-contractual liability. Legal scholars support the before-mentioned position and claim that compensatory damages under pre-contractual liability do not consist of lost profits, which an aggrieved party would have gained if a final agreement had been concluded.[258] The Supreme Court of Lithuania also withstands this position.[259] Nonetheless, it is not clear if an aggrieved party could be awarded expectation damages if parties, engaged into negotiations, would have expressly agreed to negotiate in good faith and declared that if such a duty is breached an aggrieved party might recover expectation interest. Nor case law, nor legal scholars did provide a solution to the before-mentioned issue. To our mind, as UNIDROIT PICC were used as an example to Lithuanian CC, moreover, in order to ensure parties' right to agree on the contract terms, we assume that if negotiating parties would expressly agree to negotiate in good faith and declare that in case of a breach an aggrieved party might recover all remedies, an aggrieved party should be awarded expectation damages. Furthermore, in such case, as it was mentioned above, parties would implement *pacta sunt servanda* principle. Nonetheless, in our opinion, the Supreme Court of Lithuania should provide an explanation to the before-mentioned matter.

Legal scholars observe that under German law, as well as under Italian law, an aggrieved part cannot recover expectation interest. The same general rule applies in common law countries. However, it should be mentioned that under Dutch law, if negotiations have reached a

[256] As to our mind, it would be rational to allow for the parties to agree that in case of the breach of the preliminary agreement, an aggrieved party might recover all remedies, including expectation interest or even specific performance. According to this approach, parties would implement *pacta sunt servanda* principle.

[257] Article 7 (2) establishes that 'questions concerning matters governed by this Convention which are not expressly settled in it are to be settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the law applicable by virtue of the rules of private international law'.

[258] *See* Ambrasienė D., Baranauskas E., Bublienė D., Cirtautienė S., Galvėnas R., Laurinavičius K., Norkūnas A., Papirtis L. V., Rudzinskas A., Skibarkienė Ž., Stripeikienė J., Švirinas D., Toločko V., Usonienė J. *Civilinė teisė. Prievolių teisė.* Vilnius: Mykolo Romerio Universiteto Leidybos centras, 2006, p. 141; Mikelėnas V. *Lietuvos Respublikos civilinio kodekso komentaras. Šeštoji knyga. Prievolių teisė. T1*. Vilnius: Justitia, 2003, p. 208

[259] The Supreme Court of Lithuania declared that damages under pre-contractual liability should be real and not expected (hypothetical) profit. *See* ruling as of 6 November 2006, the Plenary Session of the Civil Case Division of the Supreme Court of Lithuania (case No. 3K-P-382/2006)

stage at which negotiations cannot be broken off, an aggrieved party might recover expectation interest. Netherlands is the only European jurisdiction, which award expectation damages under pre-contractual stage to an aggrieved party.[260]

Therefore, the general rule, according to various legal acts and jurisdictions, is that an aggrieved party cannot recover expectation damages under pre-contractual liability. Nevertheless, it should be noted that if courts would concede that negotiating parties agreed on all terms of the contract and concluded a final and legally binding agreement even though it is called a preliminary agreement, they could award an aggrieved party expectation damages. The Supreme Court of Lithuania declared that in assessing whether a contract was concluded or not, the essential matter is consensus and will of the parties rather than formalities[261]; furthermore, the court established that it is utmost important to ascertain how was the agreement reached, i.e. via negotiations; via implementation of imperative legal rules; or in other way[262]. Therefore, as it is well observed by legal scholars, when the parties have agreed upon everything important – when they have made what courts call a fully binding agreement – the courts will enforce the disappointed promisee's expectation.[263]

Consequently, an aggrieved party, which is engaged into negotiations, usually cannot recover expectation damages; nonetheless, some exceptions might be noted. First of all, if courts would determine that parties concluded the final and legally binding agreement, an aggrieved party might recover expectation damages. Secondly, if parties expressly agreed to negotiate in good faith and declared that in case of a breach an aggrieved party might recover all the remedies for the breach of the contract, an aggrieved party should recover remedies for the breach of the contract, including, as to our mind, expectation damages. The first rule is well acknowledged by case law and by various legal scholars, however, it is not quite clear, as nor case law, nor legal academics established any rules, if the second rule would work in practice. As to our mind, if negotiating parties have expressly agreed to negotiate in good faith and declared that in case of the breach an aggrieved party might recover all the remedies for the breach of the contract, according to *pacta sunt servanda* principle courts should acknowledge the right of the parties to agree on the terms of the contract, therefore in case of the breach the courts

[260] *See* Opinion of Advocate General Geelhoed on European Court of Justice Case (case No. C-334/00). Available at: <http://www.unilex.info/case.cfm?pid=1&do=case&id=813&step=FullText> Accessed: 11 March 2012; Beale H., Fauvarque-Cosson B., Rutgers J., Tallon D., Vogenauer S. *Cases, Materials and Text on Contract Law*. Oxford: Hart, 2010, p. 402-424

[261] Ruling as of 31 January 2011, the Civil Case Division of the Supreme Court of Lithuania (case No. 3K-3-81/2011); ruling as of 30 November 2010, the Civil Case Division of the Supreme Court of Lithuania (case No. 3K-3-488/2010)

[262] Ruling as of 7 April 2010, the Civil Case Division of the Supreme Court of Lithuania (case No. 3K-3-127/2010); ruling as of 5 May 2009, the Civil Case Division of the Supreme Court of Lithuania (case No. 3K-3-168/2009)

[263] Schwartz A., Scott R. E. Precontractual liability and preliminary agreements. *Harvard Law Review.* 2007, 120(3): 675

should award an aggrieved remedies for the breach of the contract, including expectation interest.

# CONCLUSIONS AND RECOMMENDATIONS

In conclusion, we might state that after the analysis of existing the case law of various courts and tribunals, as well as legal acts and doctrine, the goal and tasks of this master thesis have been successfully implemented: the author revealed the applicability of principle of good faith under different national and international legal acts as well as rulings of various European judicial institutions, determined the nature of pre-contractual liability; moreover, while using economic and law theories, the author revealed negotiating parties' conduct during pre-contractual stage and determined compensatory and non-compensatory damages under pre-contractual liability. Furthermore, the defending statements have been sustained. Following conclusions and recommendations have been made:

1. Parties of the negotiations must act in accordance with the principle of good faith. Even though according to *pacta sunt servanda* principle, before entering into a binding contract, parties retain some freedom to change their mind, to negotiate with other potential parties, to obtain information, to make reliance investments, which might increase the surplus of the future contract, and to hold out if changes in the circumstances or some other aspect of the transaction make it unprofitable, however, they cannot break off negotiations contrary to good faith, otherwise they will be held liable and will have to reimburse an aggrieved party's damages.

2. Various legal acts define parties' conduct during negotiations through different legal terms – in UNIDROIT PICC and Lithuanian CC terms 'good faith' and 'in bad faith' are used, in DCFR terms 'good faith' and 'contrary to good faith' are employed, in the text of CISG only the term 'good faith' is exploited. In order to avoid confusion, furthermore, as notion 'in bad faith' is not used in DCFR, which might become a part of *acquis communautaire*, the author recommends specifying article 6.613 of Lithuanian CC and declaring that 'A party who begins negotiations contrary to good faith shall be liable for the damages caused to the other party'.

3. Pre-contractual liability might be determined either as contractual, tortious or *sui generis* type of liability. However, in some legal systems determination of pre-contractual liability depends on pre-contractual stage: in case a preliminary agreement is concluded, contractual liability is implied; in case pre-contractual agreement is not concluded, tortious liability is implied. The author assumes that application of different rules in the pre-contractual stage is irrational; thus the author recommends for the Supreme Court of Lithuania to acknowledge that pre-contractual liability is *sui generis* type of liability with its own rules and to determine the burden of proof, limitation periods, the rules for determination of jurisdiction and applicable law in cross-border cases if *sui generis* type of liability is implied.

4. Before final and legally binding contract is concluded the parties might make some reliance expenditures – investments that will raise the value of performance if the contract is formed but will have a lesser value otherwise. Under two polar regimes of no pre-contractual liability and strict pre-contractual liability, parties would not make efficient reliance investments as they would underinvest or overinvest, respectively. According to various economic and legal theories, the most efficient investments would be done under intermediate regimes; nonetheless those regimes could not work under existing legal rules.

5. During negotiations one party's conduct might create the other party the reasonable expectation that the final and legally binding contract would be formed. Therefore, in case aggrieved party's reliance is breached, compensatory damages under pre-contractual liability should cover all reasonable expenses incurred in reliance on the negotiations and include compensation for realistic loss of an opportunity to conclude a contract with a third party; however, if parties agreed on the amount of liquidated damages or forfeits, the agreed amount should be paid to the aggrieved party. The aggrieved party cannot recover both – reliance damages and liquidated damages or forfeits.

6. Expectation interest, i.e. lost profits, generally cannot be recovered under pre-contractual liability, except in cases when court declares that parties agreed on all terms and such an agreement could be determined as a final agreement, or whether in the preliminary agreement it is declared that in case one party acts contrary to good faith an aggrieved party might recover all possible remedies, including expectation damages.

7. Loss of a chance damages should be awarded in case contractual, tortious or *sui* generis type of liability is implied. Loss of opportunity damages should be determined by the comparison of the price, at which a contract would have been concluded with a third person if there were no negotiations, and the price of a concluded final agreement; and in other methods, for example, by loss of interest.

8. Liquidated damages cannot be coincident with forfeits. On the one hand, liquidated damages clause should be valid and enforceable if the amount, which was stipulated *ex ante*, was reasonable at the time of drafting the contract and it is difficult to prove the actual damages. On the other hand, forfeits clause should be enforceable if the amount, stipulated in the pre-contractual agreement, is reasonable at the time of the breach. The court should not mitigate liquidated damages; however, the amount of forfeits might be reduced or increased by the judge.

9. The author recommends determining the possibility of compensation of liquidated damages in Lithuanian CC. Consequently, systematic adjustments of Lithuanian CC should be done.

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# SUMMARY

## Determination of Damages Under Pre-Contractual Liability

**Keywords:** damages, expectation damages, forfeits, good faith, liquidated damages, loss of opportunity, negotiations, pre-contractual investments, pre-contractual liability, reliance.

**Summary content.** This master thesis analyzes genesis of pre-contractual liability and compensatory and non-compensatory damages under pre-contractual liability. The purpose of highlighting these problems is to contribute to the discussion concerning parties' reliance in pre-contractual stage and consequences, which arises if an aggrieved party's reliance is breached and final and legally binding contract is not concluded.

**Summary**

This master thesis deals with matters concerning determination of damages under pre-contractual liability. The main emphasis of this master thesis is on determination of the genesis of pre-contractual liability and establishment of an exhaustive analyzes of compensatory and non-compensatory damages under pre-contractual stage. Therefore, the author of this master thesis analyzes the application of pre-contractual good faith principle under various national and international legal acts, hence the Civil Code of the Republic of Lithuania, UNIDROIT Principles of International Commercial Contracts, United Nations Convention on Contracts for the International Sale of Goods and other legal documents are analyzed. Furthermore, the author examines different legal systems as well as case law of various courts and tribunals in order to define the nature of pre-contractual liability, thus it is analyzed whether pre-contractual liability should be determined as contractual, tortious or *sui generis* type of liability. Besides, the author employs economic and legal theories in order to analyze parties' decisions in relation to reliance investments under different regimes and rules of pre-contractual liability. Additionally, compensatory and non-compensatory damages under pre-contractual liability in this master thesis are discussed. The author assumes that an aggrieved party might recover reliance damages, which consists of direct damages and loss of an opportunity, as well as liquidated damages or forfeits. It should be noted that the author determines and distinguishes two different concepts – liquidated damages and forfeits. Finally, it is provided that expectation damages, i.e. lost profits, cannot be generally recovered under pre-contractual liability, nonetheless, some exceptions are considered.

# SANTRAUKA

## Nuostolių atlyginimas esant ikisutartinei atsakomybei

**Pagrindinės sąvokos:** nuostoliai, tikėtini nuostoliai, netesybos, sąžiningumo principas, iš anksto sutarti nuostoliai, prarastos galimybės piniginė vertė, derybos, ikisutartinės investicijos, ikisutartinė atsakomybė, pasitikėjimas.

**Santraukos turinys.** Šiame magistro baigiamajame darbe analizuojama ikisutartinės atsakomybės turinys ir kilmė bei yra aptariami atlygintini ir neatlygintini nuostoliai. Šių teisinių problemų tyrimas skirtas tam, kad teisinėje bendruomenėje kiltų diskusijos, susijusios su derybas vedančių šalių pasitikėjimu, ikisutartinėmis investicijomis bei pasekmėmis, kurios kyla, jeigu nukentėjusiosios šalies pasitikėjimas yra pažeistas ir pagrindinė sutartis nėra sudaryta.

**Santrauka**

Šiame magistro baigiamajame darbe nagrinėjami probleminiai klausimai, susiję su ikisutartinių nuostolių atlyginimu. Didžiausias dėmesys yra skiriamas ikisutartinės atsakomybės turinio ir kilmės nustatymui bei išsamiai atlygintinų ir neatlygintų nuostolių analizei. Pirmoje magistro baigiamojo darbo dalyje autorė analizuoja įvairius nacionalinius ir tarptautinius teisės aktus (Lietuvos Respublikos civilinį kodeksą, UNIDROIT Tarptautinių komercinių sutarčių principus, Jungtinių Tautų Vienos Konvenciją dėl tarptautinių prekių pirkimo-pardavimo sutarčių bei kitus teisės aktus), siekdama atskleisti sąžiningumo principo taikymo aspektus ikisutartinėje stadijoje. Be to, autorė, norėdama nustatyti ikisutartinės atsakomybės kilmę, nagrinėja įvairias teisines sistemas bei teismų sprendimus. Autorė analizuoja, ar ikisutartinė atsakomybė turėtų būti kvalifikuojama kaip sutartinė, deliktinė ar *sui generis* atsakomybė. Antroje magistro baigiamojo darbo dalyje, naudodama ekonomines ir teisines teorijas, autorė nagrinėja, kaip skirtingi ikisutartinės atsakomybės režimai ir taisyklės įtakoja derybose dalyvaujančių šalių sprendimus, susijusius su ikisutartinėmis investicijomis. Šioje magistro baigiamojo darbo dalyje taip pat yra analizuojami atlygintini ir neatlyginti ikisutartiniai nuostoliai. Autorė darbe nurodo, jog nukentėjusiajai šaliai gali būti atlyginami pasitikėjimo nuostoliai, kuriuos sudaro tiesiogiai nuostoliai ir prarastos galimybės piniginė vertė, bei iš anksto sutarti nuostoliai (angl. *liquidated damages*) ar netesybos. Taip pat autorė apibrėžia ir atskiria du skirtingus nuostolių atlyginimo institutus – iš anksto sutartus nuostolius (angl. *liquidated damages*) ir netesybas. Galiausiai, šiame magistro baigiamajame darbe yra nurodoma, kad tikėtini nuostoliai, t.y. negauta nauda, ikisutartinėje stadijoje nėra atlyginami, tačiau yra nagrinėjamos galimos išimtys.