

Bad Faith Bargaining
Revisiting a Classic: Charles Knapp's *Enforcing the Contract to Bargain*
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In the 1969 article *Enforcing the Contract to Bargain*, Charles Knapp advocates the recognition of “contracts to bargain,” legally enforceable agreements to negotiate. He explains that parties may “have reached agreement to such a degree that they regard themselves as bound to each other to the extent that neither can withdraw for an ‘unjustified’ reason, and yet still free enough that neither will be compelled to perform if – after good faith bargaining – actual agreement cannot be reached.” In other words, a party to a contract to bargain has a “present duty to ‘bargain’ – to engage, in good faith, in the process of attempting to reach agreement on the terms of the proposed exchange.” If a party fails to bargain in good faith, it will be liable for breach of its contract to bargain.

The concept of the contract to bargain has proved influential. In the years since publication of *Enforcing the Contract to Bargain*, several court opinions have cited the article, and many others have expressed a willingness to recognize precontractual liability of the sort contemplated by the article. Legal scholars, too, have embraced the study of precontractual liability. A significant portion of the academic work in this area has been devoted to demonstrating how precontractual liability can encourage efficient reliance by limiting opportunism in the bargaining process; for example, Kostriksy (1993), Craswell (1996), Katz (1996), Bebchuk & Ben-Shahar (2001), and Ben-Shahar (2004) all examine the interaction between liability and reliance during contractual negotiations. Johnston (1999) takes a different approach, analyzing how liability might affect precontractual interactions that facilitate efficient bargain formation by communicating information. This extensive literature offers substantial support for the idea that precontractual liability may sometimes be appropriate. It also affords an excellent opportunity to revisit some of the more nuanced aspects of Knapp’s work.

In particular, this literature may permit a more comprehensive assessment of the circumstances in which liability should be imposed. In *Enforcing the Contract to Bargain*, Knapp carefully distinguished a contract to bargain from a contract to reach an agreement. Under Knapp’s analysis, as long as a party to a contract to bargain has fulfilled its duty to bargain in good faith, it cannot be held liable for the failure of negotiations to reach a successful conclusion. Thus, before imposing any form of liability, a court must first determine whether a party’s actions during negotiations were characterized by “good faith” or “bad faith.” But what exactly do these terms mean? Citing the Summers (1968) “excluder” analysis of good faith, Knapp offers several examples of conduct that might constitute or indicate bad faith: withdrawal from negotiations in order to accept a better offer from a third party, withdrawal due to a “change of heart,” and “insistence on terms so clearly unreasonable that they could not have been advanced with any expectation of acceptance.” Farnsworth (1987) follows up on Knapp’s work with a detailed look at various types of preliminary agreements and an analysis of the content of the duty of fair dealing. He argues that a party to an agreement to negotiate must actually

negotiate and cannot insist on improper conditions (such as the other party's concession on an unrelated matter). Unlike Knapp, he argues that parties should be permitted to negotiate with third parties, absent a specific clause to the contrary. Other potential examples of bad faith conduct considered by various authors include insistence on retraction of terms specified in the contract to bargain, and insistence on agreement to terms not contemplated by the contract to bargain.

Missing from these categorizations of good faith and bad faith conduct is a systematic articulation of the theories or justifications that underlie them. Burton (1980) crafts a more general approach for assessing good and bad faith; he argues that bad faith performance occurs when a party attempts to recapture opportunities forgone in forming a contract. While Burton applies this definition of bad faith to post-contractual interactions, the same idea could be applied in precontractual settings. Identification of the opportunities that parties have chosen to forgo upon forming a preliminary contract, however, requires a thorough understanding of the purposes of contracts to bargain. More specifically, the desirability of imposing liability after negotiations have failed depends both on the parties' goals in entering the contract to bargain, and the reasons for which the negotiations have failed. Refining the analysis of potential breaches of contracts to bargain to include consideration of these factors, in addition to the parties' bargaining conduct, would help to assure that liability is imposed appropriately.

Take, for example, the conduct that Knapp considers in his good faith analysis. While Knapp argues that bargaining to impasse should not result in liability for either party to a contract to bargain, he also suggests that a change of mind or insistence on unreasonable terms may result in liability. These categories cannot be meaningfully distinguished, however, without more information. Often the reason that parties cannot reach agreement is that their bargaining ranges simply do not overlap; there is no combination of terms that will make both parties better off relative to their positions absent an agreement. But note that a change of mind or an insistence on "unreasonable" terms may result from precisely the same phenomenon. A party "changes its mind" about entering a transaction because it realizes that the parties' bargaining ranges do not overlap; in other words, it realizes that the other party will not be willing to agree to terms that would make the first party better off relative to its position absent an agreement. Similarly, a party's proposed terms are most likely to be characterized as unreasonable when they are clearly outside of the other party's bargaining range.

If parties anticipate a failure to reach agreement, they have little reason to enter a contract to bargain. The interesting question when parties do enter such a contract, then, is what might have caused a subsequent bargaining failure. It is possible that nothing at all changed after the preliminary agreement was formed. Perhaps the parties could actually reach a bargain – the parties' bargaining ranges do in fact overlap – but their hard bargaining tactics, their efforts to gain too large a portion of the "bargaining pie," have resulted in bargaining breakdown. It is also possible, however, that post-contract to bargain events have eliminated the overlap in the parties' bargaining ranges. One possibility is that general market events eliminated the overlap; a large increase in input prices, for example, might mean that the seller's cost of production exceeds the buyer's valuation of a product. If so, the parties will be unable to determine a mutually agreeable price. A second possibility is that information gathered or revealed after the formation of the contract to bargain demonstrates that the parties' expectations of eventual bargaining

success were overly optimistic, and that in fact, a bargaining range never existed. A related possibility is that a preferable third party offer arrives after the initial contract to bargain was formed; if the other party is unable to match the offer, no mutually desirable bargain can be reached. Any of these events could lead to a change of mind, insistence upon “unreasonable” terms, or a general bargaining impasse.

The elimination of overlap in the parties’ bargaining ranges does not imply that the parties should be able to abandon the deal without liability. After all, a sudden increase of input prices may lead a party to an ordinary contract to abandon production, but would not necessarily permit it to avoid contractual liability to the other party. The other party may want to proceed with the sale according to the contract’s original terms, and may insist on compensation if the deal does not proceed. Similarly, to the extent that the terms specified in the initial contract to bargain are binding, one of the parties may still gain from the deal and thus desire to either proceed with the deal or collect damages. Moreover, if a party abandons a deal in favor of a more lucrative alternative, the other party may be deprived of a portion of the surplus from the original positive-expected-value deal. Are the parties deprived of their expected gains in these scenarios entitled to a remedy? Or do the differences between a contract to bargain and an ordinary contract limit the availability of remedies?

The answers to these questions must ultimately depend on the nature of the initial contract to bargain. If the parties expressly address the relevant issues in the contract to bargain, for example by precluding negotiations with a third party or by requiring compensation for precontractual reliance, then the court’s obligations are relatively clear. More often, though, the parties will be vague about the nature of their obligations to each other. If so, it may be helpful to consider the circumstances surrounding the transaction, with particular attention to factors identified in the post-*Enforcing the Contract to Bargain* literature analyzing precontractual liability. Do the parties anticipate significant precontractual reliance? Do the parties set a price in the contract to bargain in anticipation of significant fluctuations of market conditions? Or do they simply provide broad contours of the agreement, to prevent misunderstanding and to provide focus for the remainder of the negotiations? These questions and others may help to determine whether a party has failed to contract in good faith, and if so, the nature of the appropriate remedy.

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