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FROM FREEDOM OF CONTRACT TO FORCING PARTIES TO AGREEMENT

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1. Introduction

In the western world, freedom of contract is one of the axioms of contract law. This means that parties are free to enter or not to enter into agreements. In former days agreement was based on a very classic as simple model: an agreement is reached at the moment that an offer is accepted and that is all.

However, times are changing. The classic procedure for entering into agreements does not meet the requirements posed by the market today anymore. The modern contract making process is often a set of very complex agreements and usually involves big amounts of money. The negotiations may last for months or even years. As a result, the parties will reach an agreement by piecemeal. There is not a simple offer and an acceptance anymore, but there are offers, counter-offers, partial agreements etc. etc. and the ultimate agreement is reached only at the end of the discussion. But when exactly the discussion is ended? For this still developing contract formation procedure, in most legal systems there are no special and adequate rules established.

Since it is impossible to qualify in these cases offer and acceptance, a whole set of new problems arises:

1. has the agreement been concluded;
2. when was it concluded;
3. if the agreement is concluded, what are the terms of it.

In this paper I will examine and discuss a very controversial topic in the theory of the formation of contracts: the relationship between parties in a situation in which an agreement has not been reached and one of the parties breaks off the negotiations. This can be done in several ways: one

can just end the negotiations and walk away, the offerer can revoke his offer, an option clause is violated etc. Since there is still no contractual liability in these cases, the question arises if there is any liability at all and if so according to what theory a party is held liable.

I will analyse this problem from the point of view of two legal families: Common Law and Civil Law. In the context of this paper by Civil Law I mean the codified law systems in Western Europe and I will discuss French, German and Dutch law. We will see that there are important differences between the Common Law and the Civil Law approach to these problems. As a result of the still growing trade market between the United States and Western Europe it is of utmost importance that one is aware of these differences.

I want to discuss three topics:

1. cross-boundary pre-contractual negotiations will bring together law and culture and reality and perception and so many problematic situations; I will give you just some examples to show what I mean;
2. then I will discuss the different approaches as mentioned above and even more important the different results on what is understood as pre-contractual liability;
3. the last topic will be on recent European developments in contract law in this field as realized in a proposed European Code of Contract Law.

2. Law and culture

As I said before, pre-contractual negotiations will not only bring together law and culture but also reality and perception. So it is quite possible that one party – from his particular background and legal culture – is convinced that after some meetings an agreement is reached, as the opposite party thinks these were still preliminary conversations. When this is the case severe problems will rise and immediately two questions have to be answered:

1. according to which law the breaking off of the negotiations has to be judged;
2. and which court has standing.

In Common Law countries, as a rule lawyers will take part in the conversation in a very early stage of the negotiations.

Why? An explanation could be that according to German legal culture – and the same is true for The Netherlands - it is all a matter of trust. If you take your lawyers with you from the start of the

negotiations it means you don't trust the other party so they don't trust you. The result is that you start the negotiations one step behind the other party and that is exactly not what you want.

Probably this is also because English and American contracts are much longer than German, French or Dutch contracts.¹

Just one example; contrast these two standard forms of a forum selection clause:

- American clause: *The exclusive forum for the resolution of any dispute under or arising out of this agreement shall be the courts of general jurisdiction of xxx and both parties submit to the jurisdiction of such courts. The parties waive all objections based on forum non convenience;*
- German clause: *Ausschliesslicher Gerichtsstand ist xxx (the only competent court is xxx)* (p. 896)

So when you enter into international contracting your first lessons are:

1. be aware of the cultural differences and legal mentality between you and the other party ;
2. try to reach an agreement on two questions as early in the negotiations as possible:
 - a. which law has to be applied in case anything goes wrong (express choice of law);
 - b. which court has standing.

A way to realize an answer to these questions in the pre-contractual stage is the use of a so called Letter of Intend or a Memorandum of Agreement. In case anything goes wrong, such a Letter or Memorandum can save a lot of time and money for both parties. According to American case law the answer of the question if the Letter or Memorandum is legally binding depends on the following factors:

- The amount of details;
- The language used;
- Are there any escape-clauses;
- Are there 'subject to formal contract/definitive agreement' clauses;

¹ See for a comparison between American and German contracts: Claire A. Hill and Christopher King, *How do German contracts do as much with fewer words?* , 79 *Chicago-Kent Law Review* 2004, p. 889 – 926.

- Contrariety;
- Complexity of the transaction;
- The way parties behave in the pre-contractual stage;
- Custom.

In Civil law similar factors are used.

For about seven years I was honorary judge in the Court of Rotterdam in a division on international contracts. In a surprisingly amount of cases – where contracts were actually formed – there was no provision on an express choice of law and on which court has standing. Making a choice on forehand will save time and money and the following factors can be taken into account. In the first place parties create certainty; both parties know what to expect in case anything goes wrong. Secondly parties can choose the law which is best applicable in this particular transaction. As to the choice which court has standing important factors are the costs and length of a trial and other economical factors.

This being said we will discuss the second topic.

3. PRE-ONTRACTUAL LIABILITY IN SEVERAL LEGAL SYSTEMS

For a long time the law remained completely silent as to the procedure for contract formation through negotiations. In former days the only requirements were offer and acceptance: when the offer is accepted the agreement has been reached, as simple as that. This approach was based on the so called aleatory theory of the pre-contractual process, which means that each party bears its own risks associated with the negotiation: both benefits and losses are treated as being at risk in negotiations.

This classical procedure theory is built on three assumptions:

1. any interference will result in the violation of the freedom of contract principle;
2. any interference will make the parties think twice before embarking on negotiations;
3. unless the parties are bound by an enforceable agreement, their behavior should be ignored as legally indifferent.

However, nowadays modern contract law recognizes negotiations as a separate contract formation procedure. A balance has to be found between freedom of contract and the protection of rights and interests of the parties entering in negotiations.

Because it is almost impossible to work out detailed provisions, only general principles of pre-contractual behavior can be established. First I will take a short look at the Common Law approach and then I will discuss several Civil Law systems.

3.1 COMMON LAW

In this paragraph both English and American law will be compared. I will take the English approach as a starting point, because this approach still resembles the classical theory on contract law.

3.1.1 ENGLISH LAW

(Giliker 2002, Cheshire and Fifoot 2001, Allen 1991)

In the case *William Lacey (Hounslow) Ltd. V. Davis* [1957] 1 W.L.R. 932, 934 (Q.B. 1957) the view is expressed that a party to negotiations ‘... undertakes this work as a gamble, and its cost is part of the overhead expense of his business which he hopes will be met out of the profits of such contracts as are made.’

More recently the leading case on this topic is *Walford v. Miles* [1992] 1 All ER 453. The question was if the parties can, by agreement, impose on themselves a duty to negotiate in good faith. Lord Ackner held:

‘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 negotiation or to withdraw in fact in the hope that the opposite party may seek to reopen 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 the negotiating party.’

In spite of this rather rigid and formalistic view English law has taken on this question, there are some grounds to pursue negotiations or to recover damages in case of breaking off the negotiations.

Although the main contract has not been concluded, the court may hold that there is a collateral contract which gives rise to some rights during the negotiating process.

And even though there is no contract, a party may be entitled to restitutionary relief on the grounds that the other party has derived a benefit from the transaction for which he should compensate the plaintiff even if no contract has arisen (unjust enrichment).

Finally a party can be held liable for loss which he inflicted on the other party in case of fraudulent misrepresentation (a claim in tort, e.g. when there was never an intention to form a contract) or negligent misrepresentation.

In England one can only claim negative interests.

Specific performance – that is to say forcing parties to re-open negotiations – is not possible.

3.1.2 AMERICAN LAW

(Tanner and Hamilton, paper 2004, Turack 1991)

Like in English contract theory, it is generally agreed that also in the United States the existence of a duty in good faith is denied in the absence of an enforceable contract. According to American law there are three other grounds for pre-contractual liability.

As in England, unjust enrichment as a basis for liability could be a ground for restitution. However, just a few courts have entertained such claims and the prevailing view is still the aleatory theory: both benefit and loss are at risk of the parties.

Also the misrepresentation theory is considered to be a ground for recovering losses in the pre-contractual stage in the United States, but situations in which this occurs are quite rare.

The most fruitful basis for recovering pre-contractual damages in American courts is the doctrine of promissory estoppel: one negotiating party cannot without liability breach a promise made during negotiations, if the other party relied on that promise. Leading case is *Hofmann v. Red Owl Store* (133 N.W. 2d 267 (Wis. 1965)):

'[A] supermarket chain promised to sell the claimant a franchise, first advising the claimant to sell his bakery, move to another town and open a smaller grocery store as a means of gaining experience, and buy a lot the chain had selected for the potential franchise location. The supermarket chain then told the claimant to sell his small grocery store, which was operating at a profit, only to break off negotiations for the franchise shortly thereafter.' (Tanner 2004, p. 16)

The court formulates three requirements of promissory estoppel:

1. Was the promise one which the promisor should reasonably expect to induce action or forbearance of a definite and substantial character on the part of the promisee?
2. Did the promise induce such action or forbearance?
3. Can injustice be avoided only by enforcement of the promisee?

Then the court held:

'We deem it would be a mistake to regard an action grounded on promissory estoppel as the equivalent of a breach-of-contract action. As Dean Boyer points out, it is desirable that fluidity in the application of the concept be maintained. ... While the first two of the above listed three requirements of promissory estoppel present issues of fact which ordinarily will be resolved by a jury, the third requirement, that the remedy can only be invoked where necessary to avoid injustice, is one that involves a policy decision by the court. Such a policy decision necessarily embraces an element of discretion.

We conclude that injustice would result here if plaintiffs were not granted some relief because of the failure of the defendants to keep their promises which induced plaintiffs to act to their detriment.'

Under the doctrine of promissory estoppel only negative interests can be recovered, damages based on loss of profits is considered inappropriate because estoppel is not the equivalent of breach of contract.

In respect of promissory estoppel American law differs from English law; in English law this doctrine in the context of pre-contractual liability is seldom used.

Another difference is that when there is a binding agreement to agree, there is a general obligation of fair dealing attaches to deal. The same result can be reached by a Letter of Intend: a duty

to negotiate in good faith is imposed on the parties when the language of the Letter makes this duty clear or when it may be implied by the court if the agreement is silent.

In absence of any of the above mentioned conditions, the core premise of the aleatory view of contract adopted by American courts is that a party to pre-contractual negotiations, may break off the negotiations at any time and for any reason, including no reason at all, and face no liability.

Recovery based on restitution is measured by the benefit of the party which improperly received the idea of services. The measure of damages for misrepresentation is reliance interest, expectation interest and lost opportunities. The same is true for pre-contractual liability grounded upon the doctrine of promissory estoppel.

No case law is available as to the question if an American court would order specific performance of either continued negotiations or of entering the envisaged contract. The overall view is, that specific performance might not be a realistic sanction in case of a breach of the obligation to negotiate, because the possibility of success in a forced negotiation will be quite slim. It is most likely that in a pre-contractual situation reliance damages are granted.

3.1.3 CONCLUSION ON THE COMMON LAW APPROACH

Up until now English courts have refused to regulate the pre-contractual period, save in exceptional circumstances. The most important tool seems to be the theory of unjust enrichment. In American law emphasis is on the theory of promissory estoppel as an explanation of pre-contractual liability. In my opinion the American approach is far more fruitful and satisfying than the English, because estoppel can be applied in far more cases than unjust enrichment and is – as an equitable remedy – more flexible.

3.2 CIVIL LAW

In this paragraph I will concentrate on the German, French, and Dutch legal system as an illustration of the way the problem of pre-contractual liability is approached and developed by civil law-

yers. I will start with the German legal system, because German law can be assumed as the cradle of the doctrine of pre-contractual good faith.

3.2.1 GERMAN LAW

(Lorenz 1991)

In 1861 Rudolph von Jhering introduced the concept of *culpa in contrahendo* in German law, which means fault in pre-contractual negotiations. He divided the grounds for liability into three groups:

1. one of the parties appears to be incapable of entering into agreements and should have notified the other party thereof;
2. the agreement cannot be performed;
3. the will of one or both parties in entering into the agreement is defective.

So a distinction is made here for the first time between pre-contractual liability when the agreement is not concluded (1.) and already has been concluded (2. and 3.).

Because of the shortcomings of early German tort law, the *Reichsgericht* based an opinion on the *culpa in contrahendo* doctrine as early as 1911. The facts are as follows:

‘A woman had entered a department store in order to buy a linoleum floor cover. After having discussed the matter with an employee she pointed to a pattern in which she was primarily interested. When the employee tried to pull out this roll two others which he had put aside fell due to his negligence. The customer and her child were badly hit and struck to the floor. In view of the ensuing excitement no contract of sale was made.’ (Lorenz 1991, p. 163-164)

The court construed a pre-contractual relationship between the prospective buyer and the store, the content of which is the preparation of the intended contract of sale. On this construction § 278 BGB – on vicarious liability in contractual relations – had to be applied. As a result the employer was held liable for the negligent act committed by the employee in the course of negotiations.

The court had to reason this way, because under German law the employer can avoid liability by showing and proving that his employee was well selected, trained and properly supervised (§ 813).

The later *Bundesgerichtshof* (1944) expended this line of reasoning. It is possible to recover damages on the basis of *culpa in contrahendo* even though one had not entered into contractual negotiations when the accident happened (a visitor slipping on a banana skin in a store, BGH 26 Sept. 1961, NJW 1962, 31). In a following case not the customer but her child slipped on a vegetable leaf lying on the floor in a department store. The court made a combination of *culpa in contrahendo* with a contract with protective effects towards a third party (Vertrag mit Schutzwirkung für Dritte, BGR 28 Jan. 1976, BGHZ 66, 51).

For two reasons, the problem of breaking off negotiations appears less significant in German law compared to other legal systems. In the first place according to German law an offer is irrevocable unless this binding effect is excluded (§ 145 BGB):

‘Once negotiations have been ripened into an offer, it solely depends upon the offeree to bring about a contract. But if the offeror expressly declares that he does not consider himself bound, the other party has little or no reason to rely on the proposed contract and to spend money in expectation of it. This is why in German law such revocable offers are mostly regarded as mere invitations to deal.’ (Lorenz 1991, p. 166)

And the second reason is the possibility of a contract to make a contract (*Vorvertrag*). If a contract is considered as an instrument of self-determination, parties must be free to break off negotiations without any fear of liability.

Nevertheless it is possible to recover damages for breaking off negotiations. According to BGH 10 July 1970, NJW 1970, 1840 and BGH 12 June 1975, NJW 1975, 1774, ‘[r]eliance damages must be paid by a party who in the course of negotiations has made the other party believe that a contract will certainly be concluded, but then without good reason or from ulterior motives refuse to go ahead.’ (Lorenz 1991, 166)

Recently (2002) this case law is codified in the German Civil Code. § 241 II reads, that when there is an obligation between two parties – an obligation is a legal relationship between two or more persons, giving on the one hand a right and creating on the other hand a corresponding duty – they have to take into account each others rights and interests. And § 311 II add to this, that this legal relationship also come into existence when starting pre-contractual negotiations. In other words, also in this stage parties have to take into account each others rights and interests.

In this way the doctrine of *culpa in contrahendo* is now part of the Civil Code. According to German law as it is now, the basis for pre-contractual liability is to be found in the above mentioned code provisions.

One can recover for negative interests only and specific performance is not possible.

3.2.2 FRENCH LAW

(Giliker 2002, Schmidt-Szalewski 1991)

Although France has also a codified law system and so has its own Civil Code, this Code does not provide any rules as to the mechanism of negotiations and conclusions of contracts. Point of departure is that as long as there is no contract compensation of damages in the pre-contractual stage may only be treated in torts. The theory of *culpa in contrahendo* is rejected in French case law.

The French author Saleilles suggested as early as in 1907 to apply the 'fair conduct' or good faith principle to the entire pre-contractual process (6 RTDC 1907, p. 697). Nevertheless it will take to 1972 before the Cour de cassation (the French Supreme Court) allows a claim on recovering damages for breaking off negotiations.

So a party suffering loss must turn to art. 1382 CC and following. Art. 1382 CC reads:

'Any act which causes harm to another obliges the person whose fault caused the harm to make reparation.' (Giliker 2002, p. 120)

French Courts accept that negotiations in the pre-contractual stage involve a period of risk and they adhere to the aleatory theory. They want not to exceedingly hamper the freedom of contract, especially in business relations. So one Court dismissed an action for damages on the grounds that

'... it would amount to a serious injury towards individual freedom and business security if one could be easily liable for breach of negotiations and dealing with a competitor; the pre-contractual fault must, in other words, be obvious and undisputable.'

(Pau, 14 jan. 1969, D. 1969, p. 716) (1991, p. 150)

But at that point intervention by the law is necessary to impose certain duties of good conduct (fairness and good faith) on the parties. Leading case is a decision of de Cour de cassation in

1972 (Cass com 20.3.1972 JCP 1973 II 17543). Between the claimant and the executive distributor in France of American-made machines for the manufacture of cement pipes intensive negotiations had taken place. In this period the claimant had visited the United States to observe the operation of those machines at considerable expense. Also he had attempted to ascertain further information, which the distributor was later found to have withheld. Then followed a sudden termination of all discussion: just a short phone-call. A contract was made with the claimant's competitor. According to a clause in that contract the distributor would not supply a similar machine in that region for the following 42 months.

The Cour de cassation found such conduct to invoke delictual liability.

Since this case a lot of other cases followed in the years after. Just one more citation of the Court of Appeal of Riom (10.6.1992 RJDA 1992, No 893, p. 732) on freedom of contract:

'If freedom [of contract] is the main principle in the pre-contractual period and includes the freedom to break off the negotiations at any time, it is still true that when the latter have reached a length and a level of intensity such that one party may legitimately believe that the other is about to conclude the contract and in readiness encourages him to incur certain expenses, breaking off such negotiations is wrong, causes loss and gives rise to reparation.'

(Giliker 2002, p. 124)

In a recent case the Cour de cassation (Com 7.4.1998 D 1999.514) highlights the factors influencing the decision of the courts:

- the advanced stage of negotiations;
- the work already undertaken;
- the suddenness of withdrawal from the negotiating process. (Giliker 2002, p. 125)

A last remark on French law. According to French law it is not possible to recover for loss of profit for the same reason as used in the American *Red Owl*-case mentioned before: that would treat negotiations as equivalent to contract.

It is hard to say what exactly is the basis for pre-contractual liability in French law. A number of cases suggest a basis of good faith dealing but certainly not all. According to Schmidt-Szalewsky liability will be imposed where the defendant has undermined a relationship of trust between the parties. A last theory is that liability is based on the concept of abus de droit (abuse of right).

In any case, all these theories are based on liability in tort.

Whatever the basis is, French case law shows that the concept of freedom of contract is more and more caved in by other concepts to impose certain duties of good conduct on the parties.

3.2.3 DUTCH LAW

(Van Beukering-Rosmuller 2004, Wessels 2003, Van Dunné 1991)

The new Dutch Civil Code of 1992 has no provision on pre-contractual liability. Although a provision was formulated, the legislator refused to incorporate it into the Code. The development of this doctrine was left over to the courts.

The Dutch Supreme Court (Hoge Raad = HR) held in a case in 1957 (*Baris – Riezenkamp*, HR 15 nov. 1957, NJ 1958, 67) that parties in negotiations take part in a 'legal relation ruled by the principle of good faith'. The consequence of this view is that parties have to take into account the 'justified interests of the other party.' As a result the court came to the formulation of a 'duty of care'; in this case the duty for the buyer to investigate the facts of the subject of contract. Just a few years later the court formulated a similar duty for the seller to disclose material facts to the buyer in the course of negotiations (*Booy – Wisman*, HR 21 jan. 1966, NJ 1966, 183). In these cases the contracts were actually formed already and this principle of good faith in the pre-contractual stage was formulated in the context of the doctrine of misrepresentation.

These developments in case law were the beginning of reconsidering the law in a second situation where no contract was concluded at all between the parties, especially in cases of breaking off the negotiations. The first and still leading case in this field is *Plas – Valburg*². Construction firm Plas tendered for the building of a municipal swimming pool in the town of Valburg. The mayor and his aldermen agreed to the plans, but their decision still had to get approval from the City Council. A member of the Council took the initiative for an alternative tender and this resulted in a lower price. As a result Plas was set aside and he claimed for damages. In this landmark decision the court makes a distinction between three stages in the negotiating process:

1. the *initial stage*: parties are free to break off negotiations without any obligation to compensate the other party;
2. the *continuing stage*: a party may be free to break off negotiations, but at this stage he is under the obligation to compensate the other party for expenses incurred;

² (HR 18 June 1982, NJ 1983, 723)

3. the *final stage*: a party is not allowed to break off the negotiations because this would be against good faith; violation of this obligation not only gives rise to compensate the negative interests of the other party, but also – if deemed appropriate – the positive interests, in other words the profits that would have

A following step was made by the Supreme Court in 1983: when a party is unwilling to continue negotiations, there may be nevertheless a legal obligation to do so and the unwilling party may be forced by the court to negotiate.³

The result of this development of the case law is that the freedom to break off negotiations may be barred on the ground of the justified reliance on the side of the other party that a contract will be concluded or in consideration of other circumstances of the case. Specific performance of such obligations may be granted by the court with the use of a recognition.

As far as I know only in Dutch law it is possible to force parties to re-open negotiations; this development in law is unique in the world.

In Dutch law it is hard to explain on what theory pre-contractual liability is based. There are two doctrines: tortious liability or the doctrine of good faith. Last mentioned doctrine is neither based on contract or tort. The pre-contractual stage seems to have a status of its own.

4. PRE-CONTRACTUAL LIABILITY IN THE PRINCIPLES OF EUROPEAN CONTRACT LAW

In the *Introduction to the Principles of European Contract Law* one can read:

'In some respects the Principles may be compared with the American Restatement of the Law of Contract, which was published in its second edition in 1981. Like the Restatements the articles drafted are supplied with comments and notes. The Restatements consist of non-binding rules, "soft law". They purport to restate the Common Law of the United States. The Principles are also "soft law", but their main purpose is to serve as a first draft of a part of a European Civil Code. Furthermore a common law does not exist in the European Union. The Principles has therefore been established by a more radical

³ HR 11 March 1983, NJ 1983, 585. See also *Du Mee – Vestdijk and others*, Court of Appeal of Amsterdam, 7 May 1987, NJ 1988, 635).

process. No single legal system has been their basis. The Commission has paid attention to all the systems of the Member States, but not every of them has had influence on every issue dealt with. The rules of the legal systems outside of the Communities have also been considered. So have the American Restatement on the Law of Contracts and the existing conventions, such as The United Nations Convention on Contracts for the International Sales of Goods (CISG). Some of the Principles reflect ideas which have not yet materialised in the law of any state. In short, the Commission has tried to establish those principles which it believed to be best under the existing economic and social conditions in Europe.'

Section 3 of the Principles is on liability for negotiations. Article 2:301 reads:

Negotiations Contrary to Good Faith

- (1) A party is free to negotiate and is not liable for failure to reach an agreement.
- (2) However, a party who has negotiated or broken off negotiations contrary to good faith and fair dealing is liable for the losses caused to the other party.
- (3) It is contrary to good faith and fair dealing, in particular, for a party to enter into or continue negotiations with no real intention of reaching an agreement with the other party.

This article may be assumed as a summary of Civil Law on the liability of breaking off negotiations.

5. CONCLUSION ON THE CIVIL LAW APPROACH IN COMPARISON WITH THE COMMON LAW

In the Common Law pre-contractual liability is imposed and based upon specific contract theories as restitution, misrepresentation and promissory estoppel. In Civil Law there are many ways to incorporate a duty of acting in good faith in the pre-contractual stage. In France it is based on tort law, in Germany on the doctrine of *culpa in contrahendo* - which seems to be an extension of contract law - and now codified in the Civil Code and in The Netherlands on tort law or on pre-contractual good faith as a standard on its own.

Except for the Netherlands, in all other legal systems in this research one cannot recover but for negative interests. The Dutch legal system goes two steps further:

- one can recover positive damages as well;
- the court can force a party to re-open the negotiations.

The overall conclusion is, that there are substantial more possibilities to recover damages in cases of pre-contractual liability in the codified law systems discussed above, than in Common Law countries.