American University of Armenia

Master of Law Program

2016

The institute of Pre-contractual liabilities

Mikael Vardgesyan

Table of contents:

Introduction

With the development and sophistication of economic relations the appropriate regulations designed to carry out the maintenance of such relations must also be developed. Civil institutions, which serve as the legal superstructure of the existing economic relations should first match them. Unfortunately, the development of social relations is often marked not only with positive achievements but also with emergence of new forms and types of offenses. Subjects of civil relations while seeking the maximum positive outcome often resort to new types of offences.

Traditionally, it was assumed that the subjects of legal relations are in no way tied with each other before concluding a contract. There was time, however, when agreements were being concluded quite rarely, considering that the latter is only a supplementary tool for achieving business result the parties are aiming to get. By the time, without formal articulation of the terms negotiated before the performance of a particular economic or other activity, and in cases when one of the parties acts in a way which has an adverse impact over the other party, they were encountering impediments, which they couldn't had foreseen previously. In such cases the fortune of these kinds of relations or sometimes even the life or health of one of the parties may be put under serious jeopardy. For example, let's assume a man wanted to grow tomato. In the region where he was going to operate his plantation the soil should be appropriately fertilized, due to specific climate conditions, which he didn't know (however let's also assume that this information is commonly known among people who are engaged in soil supplying). While agreeing with soil supplier to distribute a soil he specifically mentions that it is to be operated in that particular region. The supplier, however, conceives the information on specificity of the soil in that region and sold the soil without fertilization, making thereby more money. Eventually, due to the supplier's misconduct the man has lost all his harvest and lost a lot of money. He has brought experts to figure out the reasons of such failure. The experts explained him all the staff related to fertilization of the soil and were amazed that the supplier didn't warn him on that. That's why, for the sake of avoiding such unpleasant outcomes and for securing their interests, people gradually started to reflect their interests in the written form contracts. And currently

contracts have become the moving engines of nowadays economic relations, which are driven mainly by regulations of provisions of the respective contracts.

Despite all advantages, that contractual relationships have brought forward, they have progressively led to *contractual absolutism,* where agreements, which are not fixed in written form, become highly fragile in a sense, that such agreements do not receive an appropriate legal protection and in some cases even are not recognized by courts as legally binding. This is fraught with phenomenon, which may entail more global matters of concern, rather than just economic relations. Notwithstanding the deepness of penetration of the law into our lives, the simple human relations are built on a pure trust and belief. Society may not survive without mere trust to each other, because otherwise such society will be considered as *"invalid."* Hence, the issue of granting the pre-contractual relations with a certain legal status is more than relevant, as they will secure, to some extent, the human relations from purposeful infringements.

Nowadays, the history of development of contract law, as one of the constituent elements of civil law demonstrates the development from the maximum formalized process (when the contract or transaction was considered concluded only upon compliance with a specific process, the pronunciation of specific phrases and the stipulation of appropriate legal terms) to a flexible and informal process, by which legal entities as well as individuals can enter into contractual relations, for example, by using Internet. For instance, an immense quantity of people trades on eBay on daily basis, making the daily turnover of eBay to reach hundreds of millions of dollars.

It is undisputable that the Internet is playing a tremendous role in our lives. Moreover, in contemporary world a huge percentage of the world's population holds jobs working on-line. There are millions of contracts, which are concluded online each day, so it is of great importance to make this platform safe and protect the users' interests. Our traditional contractual practice, in terms of its formalization, would retard the rapidity of Internet users. Hence, the simplification of contract conclusions online and granting an appropriate legal protection to them is required for their proper operation.

Such development has led to the fact that at the present phase of development of civil relations the issue of regulation of pre-contractual stage in development of relations and the problems of regulation of pre-contractual liability it is becoming increasingly urgent.

A crucial role for imposition of liability for damages caused in pre-contractual stage plays the principle of *"good faith".* The lack of this principle makes the imposition of liability in pre-contractual stage extremely difficult. We are going to touch upon this issue more detailed furtherly.

In a democratic society, individuals and legal entities are free to enter into and quit negotiations, which is a demonstration of the freedom of contract. In the meantime, as we know, any freedom has its limitation and, in this case the limitation is the institute of pre-contractual liability. We shouldn't forget that any restriction is quite dangerous: if it is applied inappropriately, it may lead to a fundamentally opposite, negative effect. So what is the right line and where are the borders for correct imposition of pre-contractual liability? To find the true answers to these questions, inter alia, we consider it extremely important to study this issue, with the aim to understand the essence of this concept for its further application.

The lack of relevant judicial practice in Armenia makes the topic of this paper even more vital. We believe that the theoretical framework and the analysis thereof will allow courts in the future to properly apply these standards and effectively administer justice in pre-contractual disputes.

The purpose of the thesis is to examine different theoretical approaches to the definition of pre-contractual liability, the study, comparative analysis and identification of the advantages and disadvantages of legislation in different countries in the scope of this issue, the study of foreign theoretical and practical experience of solving the issues related to the definition of the nature of pre-contractual liability, as well as determining the form and amount of compensation in application of this Institute.

The objectives of the paper are the identification of the advantages and disadvantages in the definition and applying the Institute of pre-contractual liability, as well as proposing the mechanisms of improvement for solving these problems.

The paper is divided into three chapters. Such division is aimed at explaining all the aspects of pre-contractual liability and best practices.

The first chapter is devoted to examination of the concept, essence and legal nature of pre-contractual liability, whereby it will touch upon the important parts and the history of development of the institute of pre-contractual liability.

The second chapter will explain the relation between good faith principle and pre-contractual liability as well as the international practice on establishment of good faith principle in national legislations.

In the third chapter the estoppel principle will be introduced as type of pre-contractual and the mechanism of application of that institute. It will present also the types of estoppel, which particularly concern the pre-contractual stage of relationships.

The topic of the paper has been guided by works of honorable legal scholars such as N. Cohen, A. Schwartz, R. E. Scott, A. Kucher, T. Febbrajo, T. Amerit and others.

1. THE CONCEPT, ESSENCE AND LEGAL NATURE OF PRE-CONTRACTUAL LIABILITY.

Traditionally people (including lawyers) presumed that any intervention of law in the procedure of conclusion of the contract, when the parties have not yet bound themselves by contractual obligations and did not commit any offence, would violate one of the basic principles of civil law – the principle of freedom of contract. Law and the courts have been recognizing the parties' freedom of contract without any risk of pre-contractual liability, i.e. they start to decline any type of contract which is not fixed in written form. The party entering into the negotiations aiming to make profit as a result of conclusion of contract should bear the risk of all losses that may be caused by the fact that the second party will terminate the negotiations.

In confirmation of the stated above we would like briefly to refer to different approaches regarding the principle of freedom of contract that exists in civil law. We think it is necessary to consider the so-called *negative* and *positive* approaches to the understanding of the principle of freedom of contract, put forward in the works of N. Cohen, I. Berlin and I. A. Pokrovsky.

The meaning of this approach is that the freedom is divided into negative, "*freedom from"* (for example, external interference) and positive *"freedom for"*, which, on the contrary, is directed on achievement of any outcome. This division, according to the authors, is also embedded in contract law, which reflects both the positive freedom and negative one. Thus, positive freedom consists in the possibility of subjects of civil legal relations to conclude a binding contract, and, thereby, realize their autonomy of will. The negative manifestation of freedom is that the parties are free from any commitment until a contract is concluded.[1]

We believe that such a wide and exclusively negative understanding and interpretation of the principle of freedom of contract is very dangerous. Any principle or right has its limits, and it is unacceptable to absolutize them. Such limits to the principle of freedom of contract are, on the one hand, the positive component of the principle of freedom of contract, on the other hand establishing the concept of pre-contractual liability in the legislation. As Nili Cohen mentions in his work *"the desire to achieve positive freedom of contract encourages each legal system to the*

[1] Pokrovsky I. A. - Main problems of civil law. 3-rd edition / / The Statute, 2001. – 249-250.

establishment of rules imposing liability on those who violate the minimum conditions that guarantee this freedom."[2]

However, it should be noted, that circumstances which invoke liability for misconduct during pre-contractual stage must be scrutinized in detail in order not to be mistaken. The line between those circumstances is very thin and we should be very cautious in determination thereof.

Alan Schwartz, a scholar, has made a division of those circumstances, according to which if the parties have not yet reached a fully binding contract, their negotiations will fall into one of three categories. First, the parties have engaged in "preliminary negotiations" when they have discussed a deal but have not agreed to one. In this event, the disappointed party can recover nothing.[3] Second, the parties have agreed on all material terms and intend to memorialize this agreement in a formal document. In the interval between agreement and memorialization, the promisor has had a change of heart. Courts treat this type of agreement as a fully binding contract when the evidence supports a finding that the parties did not intend the formalization of their agreement to be essential.[4] As is usual with binding contracts, courts protect the promisee's expectation interest. Third, the parties have made a preliminary agreement as defined above when they have agreed on certain terms but left other terms open, so that the best inference from their negotiations is that they have made a binding preliminary commitment to pursue a profitable transaction.[5] Here, the emerging legal rule requires parties to such preliminary agreements to bargain in good faith over open terms. Should the promisor – the party who prefers to exit - fail to bargain in good faith, she will be liable for the promisee's reliance expenditures. [6]

Although Mr. Schwartz preserves the opinion that after conclusion of written contract it is assumed that all the material terms are expressed and there could be no dispute regarding those, we will furtherly present the opinions and cases where even in formal existence of contract it was reversed due to misconduct by one of the parties.

As the idea brand new for the law, pre-contractual liability (*culpa in contrahendo*), i.e. the liability imposed for undue behavior at the pre-contractual stage, started its development *extra*

---

[2] Nili Cohen Pre-Contractual Duties: Two Freedoms and the Contract to Negotiate //Good Faith and Fault in Contract Law. – Oxford, 2002. – P. 26

[3] For example - PFT Roberson, Inc. v. Volvo Trucks North America,Inc.

[4] Gorodensky v. Mitsubishi Pulp Sales (MC) Inc. Disputes in which the parties agreed on all material terms but also agreed later to memorialize their agreement in a more formal document arise primarily because parties failed to express clearly their intention regarding when their arrangement would become legally enforceable.

[5] Teachers Ins. & Annuity Ass'n of Am. v. Tribune.

[6] Schwartz, Alan and Scott, Robert E., "Pre - contractual Liability and Preliminary Agreements" (2007).

legem, at the level of court practice and business usages, and only relatively recently, in the fall of the twentieth century, found its way into the legislative acts and regulations.

The German legal system was the most receptive to the idea of pre-contractual liability. The first one to point out the need to introduce the concept of pre-contractual liability for failure to observe the fair conduct (*good faith*) rule, was the German lawyer Rudolf von Iering. In 1861 he evolved the *culpa in contrahendo* theory that existed in a very limited scope in Roman law, worked out the grounds for pre-contractual liability and divided them into the following groups:

- one of the parties appears to be incapable of entering into the agreement; *(i.e. the party embarking into negotiation should know beforehand whether or not he is capable of entering into agreement)*

- the agreement cannot be performed; *(i.e. pre-contractual liability is imposed on the party that knew or should have known and failed to inform about the impossibility of performance of the agreement at the time of conclusion of the contract)*

- the will of one or both parties when entering into the agreement is defective.[7] *(the purpose of one of the parties in entering into agreement is malicious)*

From the stated above we may conclude that the key point for applying the pre-contractual liability is determination of good faith conduct by the parties. In all three cases defined by Rudolf von Iering the party in breach may be imposed liability only when that party has acted in bad faith during the pre-contractual stage.

Italian law went even further in developing of pre-contractual liability concept. It shows that the scope of liability is not limited by three occasions stated above.

The traditional strict interpretation of pre-contractual liability was definitively abandoned in 2007, with two «twin judgements» of the Sezioni Unite (Combined Chambers) of the Court of Cassazione, concerning the infringement of information duties made by a bank in its dealings with customers. In its findings the Supreme Court of Italy has clarified the following essential matters: 1) the scope of pre-contractual liability is not limited, as traditionally claimed, to cases of unjustified withdrawal from the negotiations or conclusion of a voidable contract the extent of pre-contractual liability (art. 1337 of Civil Code of Italy) cannot be precisely predetermined. It certainly imposes a requirement to deal fairly and disclose to the other party all information relevant to the conclusion of the contract; 2) there is pre-contractual liability when the contract is valid but "*disadvantageous*" (which itself may be expressed in two ways – *objective* and

[7] Kucher A.N.: Pre-contractual liability: Protecting the rights of the parties engaged in the negotiations - NYU Hauser Global Law School, 2004 – p. 10 - 11

subjective) for a party as a result of behavior contrary to good faith by the other party during negotiations.[8]

A good example of such *"valid but disadvantageous"* contract was, as we have mentioned, the case concerning the infringement made by bank in relation to one of its customers. The facts were as follows: an investor bought shares of a well - known Italian bank, paying a higher price than the market value because of misleading information contained in the brochure. The Cassazione stated that the customer was entitled, under article 1337 Civil code of Italy, to compensation equal to the difference between the price paid and the real value. In this case the disadvantage is *objective* - one of the parties, due to the misconduct of the other, purchases at a price that is different from the market value as a result of misleading by the bank. [9]

In other occasions, misleading statements during negotiations may lead to commercial transactions that are less advantageous than one of the parties could reasonably have expected (and not at the market value of the transaction) In this case, the disadvantage is *subjective*. Consider the following case: during the negotiations for the purchase of an industrial machine, a seller informed his client that the sale would be subject to a tax benefit of 33% of the asset value, without knowing that, actually, the benefit had been suspended by the Italian Government a few months earlier. The customer trusted the seller and bought the machinery. As soon as he discovered that he was not entitled to the tax benefit, he sought compensation for damages assessed at 33% of the asset's value, for not being properly informed. The seller claimed the impossibility of any pre-contractual liability as the parties had entered into a valid contract. The Court of Cassazione considered this to be a case of pre-contractual liability by "valid, but disadvantageous contract", so that the "decrease of profitability or the increase of economic burden", due to the breach of good faith, had to be compensated. In this case, the contract terms sustained a "decrease of profitability" equal to the tax benefit not enjoyed, and thus 33% of the value of the asset.[10]

On this basis, we believe that by introduction of the institute of pre-contractual liability, the legislator will also perform other, more global issues such as deepening the social role and consolidation of principles of civil liability. In particular, it will not only help to compensate losses and recover damages incurred on the stage of conclusion of the contract, but also to implement a fair punishment for counterparty's misconduct. Thus there is an equitable

[8] Tommaso Febbrajo – Pre - contractual liability in Italy to toward the European pattern, p. 6

[9] Cass., 11 June 2010, n. 14056, Guida al diritto, 2010, 29, p. 35. ; T. Febbrajo – Pre - contractual liability in Italy to toward the European pattern, p. 8

[10] Cass., 8 Oct. 2008, n. 24795, Foro it., 2009, p. 440, annotated by E. SCODITTI, Responsabilità precontrattuale e conclusione di contratto valido: l'area degli obblighi di informazione.

redistribution of losses, which earlier in the framework of the traditional theory of contracting fell solely on the aggrieved party.

We also should take into account, that at the present stage of development of relations, civil law moved away from liberal tenets and became more social in its nature. The emergence of the institute of pre-contractual liability is a demonstration of this tendency.

However, it should not be inferred that the introduction of the institute of pre-contractual liability and the duty to act in good faith at the stage of negotiations mean that the participants of legal relations shall conclude an agreement on a mandatory basis. The introduction of this institute does not entail any liability for the failure to conclude the contract. Right the opposite, the institute acts as a fair guarantee of observance of the rights of all participants of civil legal relations and the issue of responsibility arises only for wrongful behavior. As Martin Kaerdi rightly points out "the negotiations themselves do not give rise to the obligation to conclude a contract. The mere fact that negotiations have been completed and not resulted in the conclusion of a contract does not create legal consequences for the parties to the negotiations. This means that the parties have no pre-contractual obligations based on the right to enter into a contract. Such an obligation may be created only by the conclusion of "preliminary agreement". However, the prohibition of unfair termination of negotiations proves that even in the absence of the obligation to conclude a contract the termination of negotiations or refusal to conclude a contract may result in the violation of pre-contractual obligations and may bring corresponding liability."[11]

Aforementioned brings us to the following question - what conduct on pre-contractual stage can be considered as action in bad faith, and give rise to pre-contractual liability?

So, Cohen suggested that the definition of bad faith should be based on the division of freedom of contract to positive and negative, as mentioned above. In particular, according to the author, in the presence of the two abovementioned cases of freedom two types of unlawful conducts in the framework of pre-contractual relations are possible. So, in the first case, the illegality consists in the defect of the will of one of the parties, which shall enter into negotiations, initially without aim to conclude the contract, or as a result of errors, misrepresentations or misconceptions. The second case of bad faith conduct is the breach of promise to contract, or unjustified withdrawal from the stage of negotiations.[12] This occurs when one of the parties during negotiation stage realized that the contract will not be beneficial to him

[11] M. Kaerdi - The development of the concept of pre-contractual obligations in Estonian law // Journal of the Supreme arbitration court of the Russian Federation. – 2009. – 10. – P. 35

[12] Nili Cohen Pre - Contractual Duties: Two Freedoms and the Contract to Negotiate // Good Faith and Fault in Contract Law. – Oxford, 2002. – P. 33

and suddenly withdraws from the negotiations, provided that other party has already made some material contributions based on their negotiations and suffered losses.

In order to be able to enforce the liability inappropriate representation during pre-contractual stage, which resulted in suffering damages for the party aggrieved, the national legislation should provide grounds for determination of such conduct. Therefore summarizing all the stated above we come to a conclusion that the pre-contractual liability is strictly connected with adherence of the principle of good faith, without proving which it is almost impossible to impose liability for the pre-contractual stage of relationships. Hence, this leaves us with no other choice than to discuss what the good faith principle implies, how it works, the necessity of inclusion of that principle in our legislation, the international practice on this issue and, finally, what the mechanism of proof of good faith conduct is.

2. THE PRINCIPLE OF *"GOOD FAITH"* FOR PRE-CONTRACTUAL LIABILITY

In the legal dictionary the good faith is defined as *"Honesty; a sincere intention to deal fairly with others."* Good faith is an abstract and comprehensive term that encompasses a sincere belief or motive without any malice or desire to defraud others. It derives from the translation of the Latin term *bona fide*, and courts use the both terms interchangeably.[13]

The concept of good faith played a huge role in the history of law. The Greek society viewed good faith as a *"universal social force that governed their social interrelationships - that is, each citizen had an obligation to act in good faith toward all citizens."*[14] Under Canon Law, the duty of good faith was a universal moral norm, individually determined by each person's honesty and his or her duty to God[15]. According to Roman Law, the obligation to act in accordance with good faith bound contracting parties "not only by the terms they had actually agreed to, but by all the terms that were naturally implied in their agreement."[16]

Since antiquity, in civil law the principle of good faith is considered as one of the limits of implementation of civil rights.

---

[13] http://legal-dictionary.thefreedictionary.com/good+faith

[14] Eric M. Holmes, A Contextual Study of Commercial Good Faith: Good - Faith Disclosure in Contract Formation, 39 U. Pitt. L. Rev. (1978) (citing F. Pringsheim, The Greek Law of Sale 87 (1950)

[15] Monique C. Lillard, Fifty Jurisdictions in Search of a Standard-L The Covenant of Good Faith and Fair Dealing in the Employment Context, 57 Mo. L. Rev. (1992)

[16] E. Allan Farnsworth, Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code, 30 U. Chi. L. Rev. (1963)

The principle of good faith requires parties to the transaction to deal honestly and fairly with each other, to represent their motives and purposes truthfully, and to refrain from taking unfair advantage that might result from a literal and unintended interpretation of the agreement between them.[17] The covenant of good faith and fair dealing acts as an implied promise that neither party to a contract will act so as to deprive the other party of the expected benefits of the contractual bargain.[18]

For the development of the concept of good faith in the United States a remarkable step was made by New York court of appeal in 1933 in the case of *Kirke La Shelle Company v. The Paul Armstrong Company,* whereby it states the following:

"In every contract there is an implied covenant that neither party shall do anything, which will have the effect of destroying or injuring the right of the other party, to receive the fruits of the contract, which means that in every contract there exists an implied covenant of good faith and fair dealing."[19]

Most of the courts (even though were rarely applying the good faith principle) did not recognize the principle of good faith in the US till the adoption of *Uniform Commercial Code*[20] in 1952. The Code was signed by all the states whereby bringing a fresh air in the commercial relationships and broadening the applicability of good faith principle.

By establishing the concept of the good faith as a legal obligation, the legislators focused on the legislation of most countries with developed legal system, whereas as an example of such best practice was US, which established the doctrine of good faith in its UCC.

The courts had previously applied the principle of good faith while examining such cases, however, normative fixation of this principle a one of the fundamental principles of civil legislation allowed the participants of the civil law relationships in the cases of bad faith conduct by the counterparty to apply measures of civil law protection on this basis in considerably greater quantity.

So, why is the principle of good faith especially that important for imposition of pre-contractual liability?

Under the Italian Civil code, for instance, "the parties involved in negotiations are required to act according to the good faith principles"[21].

---

[17] D' Amato, Anthony, "Good faith" in Encyclopedia of Public International law, p. 599 – 601 (1992)

[18] J. R. Erb, "The Implied Covenant of Good Faith and Fair Dealing in Alaska: One Court's License to Override Contractual Expectations", p. 36

[19] Kirke La Shelle Company v. The Paul Armstrong Company et al. 263 N.Y. 79; 188 N.E. 163; 1933 N.Y. .

[20] The UCC set requirements for several types of contracts, e.g. sale of goods, lease agreements, but not sale of real estate. It sets also requirements depending on the value of the contract.

[21] Art. 1337 Civil Code of Italy - Negotiations and pre contractual liability - the parties, in the conduct of negotiations, and the formation of the contract, shall conduct themselves according to good faith.

Acting in good faith does not entail a duty to enter into an agreement (as the parties are always free to decide whether or not to conclude a deal) but obligates the parties to act in a clear way, avoiding any unnecessary loss of time or money. Any conduct in breach of such principle, may involve a responsibility for the damages caused to the other party involved in such negotiations.[22]

For example, a conduct will not be in compliance with the good faith principle:

a) if, without cause, a party breaks off negotiations that are in such an advanced state that they might give rise to a reasonable expectation by the other party that the deal will be concluded

b) if a party during the negotiations fails to disclose the existence of matters which would legally constitute reasons for invalidity of the contract, once it is executed, and

c) **if a party, which intends to break off negotiations, does not communicate immediately such intention to the other party and drags on negotiations while looking for other business opportunities.** [23]

Therefore, taking this into account we shall infer that imposing pre-contractual liability on the party acting in bad faith is possible only in case the national legislation stipulates the general obligation of good faith conduct of the parties in pre-contractual stage. However, in the Armenian civil law there is no duty of good faith conduct of the parties during the negotiation phase as there is no general duty to behave in good faith in the exercise of civil rights and duties. The Civil Code of RA stipulates the good faith behavior in a very few clauses (e.g. the clauses 275, 276, etc.), but even in implementation of that clauses the courts encounter a deadlock situation as there is no legislative levers, mechanisms for determination of good or bad faith conduct.

2.1. International practice on establishment of "*good faith*" principle in the national legislations.

In this regard, the Russian legislation was even more progressive than the Armenian one: by the respective decree of the President of Russian Federation the amendments have been made to Civil Code stipulating, inter alia, the principle of the good faith as one of the fundamental principles of civil law, in particular "by the establishment, implementation and protection of civil rights and performance of civil duties, the parties

[22] Simmons & Simmons – Italy , Pre – contractual negotiations, p. 1
[23] Simmons & Simmons – Italy , Pre – contractual negotiations, p. 1

to civil law relations should act in good faith"[24]. The respective amendments have entered into force on 1st March 2013.

In this new version of the Russian Civil Code, however, there is no clear criteria for definition of good faith. What this can lead to? First, this may result in various interpretations in judicial practice, second, it can lead to limitation of freedom of contract, and third, the incompleteness of the new rules will provide the judges with grounds to freely abuse the law. Therefore, despite the fact that the good faith is an evaluative concept, the legislator must prescribe the criteria of good faith, which would greatly help to orient participants of civil relations, as well as guide the courts during the dispute resolution process.

In comparison with other European countries the English law lacks the doctrine of good faith. Most scholars will say that there is no good faith in English law, and that any similar outcome would be based on equity instead. The system promotes *pacta sunt servanda* (Latin for – "agreements must be kept") as an absolute doctrine. This way, the adversarial process honors parties' arrangements and avoids leaving room for interpretation, thereby excluding an implied doctrine of good faith. One of the most cited opinions, when opposing the application of good faith, is Interfoto Picture Ltd v. Stiletto Visual Programmes Ltd. Here Lord Bingham states:[25]

"In many civil law systems, and perhaps in most legal systems outside the common law world, the law of obligations recognizes and enforces an overriding principle that in making and carrying out contracts parties should act in good faith. This does not simply mean that they should not deceive each other, a principle which any legal system must recognize; its effect is perhaps most aptly conveyed by such metaphorical colloquialisms as 'playing fair', 'coming clean' or 'putting one's cards face upwards on the table.' It is in essence a principle of fair open dealing… English law has, characteristically, committed itself to no such overriding principle but has developed piecemeal solutions in response to demonstrated problems of unfairness."[26]

In fact English law exercised some sort of resistance towards the concept of good faith, according to some scholars is due to following reasons: 1) the English method of seeking particular solutions instead of general overarching principles; 2) the belief that contracts

[24] Clause 1 of Civil Code of Russian Federation

[25] Mayra C. Artiles Fonseca – Negotiating in good faith: Only a civil law obligation? http://pangeaupr.org/2013/12/10/negotiating-in-good-faith/#_ednref52

[26] Interfoto Picture Ltd v. Stiletto Visual Programmes Ltd. - by Mayra C. Artiles Fonseca

under English law are to be pursued under the parties' own self-interest; and 3) the belief that a general vague and subjective doctrine of good faith may create uncertainty.[27]

Despite the fact that English law does not stipulate the good faith principle as it is, recently, however, the courts cover up such lack of legislation by its case law (even without mentioning the concept "good faith") and findings which bear normative character. So, basically we may assume that England also has principle and/or obligation to act in good faith in civil relationships.

Based on the statements and examples of international practices on the issue of good faith principle and given the fact that the principle of good faith is common to all civil law relations, we believe that the duty to act in good faith also extends to pre-contractual stage. Thus, we may dare to conclude that in the issue of contradiction of principle of freedom of contract (which is abided by proponents of the conservative approach) and pre-contractual liability, most of legislations took the side of the second approach. And therefore, the opinions, that only the parties themselves, because of the principle of freedom of contract, bear the risk of non-conclusion of contract in the stage of negotiations - are not absolute, even more – they are outdated.

In understanding of principle of good faith and its link with the pre-contractual liability we also need to see and understand the mechanisms and examples of its operation. Of such mechanisms an immense role plays a doctrine of *"estoppel",* which is unfamiliar to our national legislation, unfortunately, and yet, is a crucial part in international practice. Estoppel doctrine itself might become a topic for thorough examination due to its varieties and role in maintaining of human relations in honesty, however, for the purposes of this paper, we will concentrate mainly on key points, which particularly concern the pre-contractual liability.

3. *"ESTOPPEL"* DOCTRINE AS A TYPE OF PRE-CONTRACTUAL LIABILITY

We have already talked about the pre-contractual liability to be the restrictive measure to the principle of freedom of contract. Certain manifestations of the estoppel principle are designed as such preventive measures towards the contractual absolutism, particularly in securing the implementation of pre-contractual obligations estoppel principle plays a huge role, which, as we considered, is worth scrutinizing.

[27] Mckendrick, Contract law 221 - 2 (9th ed. 2011)

The legal concept of estoppel does not arise very often, but where applicable it can potentially be crucial to the outcome.[28]

In recent period this doctrine has been continuously developed in many countries with progressive (mainly in common law) legal systems. Estoppel in English law, for example, is a doctrine that may be used in certain situations to prevent a person from relying upon certain rights, or upon a set of facts (e.g. words said or actions performed) which is different from an earlier set of facts[29]. The general idea of estoppel is to serve as a shield in the stage of dispute resolution by the court to be protected from the counterparty's "legal" arguments, or as Wikipedia defines: *"Estoppel is a collective name given to a group of legal doctrines in common law legal systems whereby a person is prevented from asserting certain matters before the court to prevent injustice - the person is said to be "estopped"*. It basically operates in a way of ***preventing*** someone from asserting a particular fact in court, or ***exercising*** a certain right, or from ***bringing*** a particular claim (even if such right/claim is legal).[30]

Estoppel principle has many variations and due to which it may be applied in various legal relations. Due to its diversity and universality this tool is being effectively used dispute resolution both in civil and criminal proceedings.

To be more precise lets concentrate on the types and examples of estoppel doctrine and understand the nuances of its implementation in international practice.

Although in different legislations the types of estoppel are established differently, the general approach in terms of its applicability, however, is the same (or almost the same). The main variations of estoppel doctrine are the following: *promissory estoppel, equitable estoppel, estoppel by convention, estoppel by laches, proprietary estoppel, collateral estoppel, estoppel by record, etc.* Undoubtedly all of mentioned categories deserve to be presented, and yet, in order not to deviate from our topic lets focus on few of them related to the discussion.

3.1. Promissory Estoppel

Promissory estoppel is a contract law doctrine. It occurs when a party reasonably

[28] Stuart Thwaites – Estopped by convention, what does it mean? (posted on 12 November 2015)
[29] https://en.wikipedia.org/wiki/Estoppel_in_English_law
[30] Duhaime's Law Dictionary – the definition of Estoppel

relies on the promise of another party, and because of the reliance is injured or damaged. For example, suppose a restaurant agrees to pay a bakery to make 50 pies. The bakery has only two employees. It takes them two days to make the pies, and they are unable to bake or sell anything else during that time. Then, the restaurant decides not to buy the pies, leaving the bakery with many more pies than it can sell and a loss of profit from the time spent baking them. A court will likely apply the Promissory Estoppel doctrine and require the restaurant to fulfill its promise and pay for the pies.[31] The doctrine of promissory estoppel allows a party to recover the benefit of a promise made even if a legal contract does not exist. Use of this doctrine relies on how significant the promisee's loss is in the absence of the fulfilled promise.[32] In understanding this principle let's examine a case McIntosh v. Murphy (1970) (US), by which the court defined the essential elements for implementation of promissory estoppel:

In March of 1964, George Murphy, owner of Murphy's Motors, located in Hawaii, flew to southern California to recruit for his car dealership. At the time, Dick McIntosh was searching for work. The two met on two occasions to interview. In April of the same year, Murphy contacted McIntosh via telephone to inquire about his interest in a position. McIntosh expressed continued interest in the position, and the parties agreed that employment would begin within 30 days of the conversation. In the oral agreement, Murphy offered McIntosh a one-year employment contract. He brought along personal items, sold other items and rented an apartment. In the afternoon of Saturday, April 25, Murphy called McIntosh to let him know he could begin employment as assistant sales manager on the coming Monday. Things seemed like they were going smoothly when out of nowhere, everything changed. McIntosh was terminated from employment on July 16, 1964. Murphy claimed that McIntosh was unable to close deals on cars and could not train salespeople. McIntosh sued Murphy for promissory estoppel, arguing that his decision to relocate some 2,200 miles from home was solely based on the promise of a yearlong contract for employment. Further, even though no written contract had ever been drafted, the promise made by Murphy in the oral contract was significant enough that McIntosh believed that employment would last for a period of one year. Murphy claimed that the contract violated the Statute of Frauds (a doctrine whereby the certain types of contracts should be reduced to writing in order to be enforceable) and was therefore void.

The court holding states: an oral promise which the promissor should reasonably expect to induce either action or forbearance on the part of the promisee is enforceable <u>when injustice can be avoided only by enforcing the contract.</u> See Restatement (Second) of Contracts § 217A (now §139). The court held that if a party has relied on an oral promise and rendered part performance the other party should be estopped from asserting the Statute of Frauds.[33][34]

[31] http://legal-dictionary.thefreedictionary.com/estoppel
[32] Kat Kadian-Baumeyer – Doctrine of Promissory Estoppel
[33] McIntosh v. Murphy, (Haw. 1970).
[34] The Statute of Frauds stipulates a mandatory requirement for certain types of contracts to be in written form. Otherwise they won't be enforceable.

As we saw, the doctrine of promissory estoppel has served as a tool for keeping the oral agreement in force, notwithstanding the fact that it would otherwise fall under the doctrine Statute of Frauds and therefore voided, because it did not fulfill the requirement under that statute (stipulating that this type of contracts must be created in written form). The court based its decision on the § 217A (now §139) of the Restatement (Second) of Contracts which says "*A promise, which the promisor should reasonably expect to induce action or forbearance on the part of the promisee or a third person and which does induce the action or forbearance is enforceable notwithstanding the Statute of Frauds if injustice can be avoided only by enforcement of the promise. The remedy granted for breach is to be limited as justice requires,"*[35] which has become precedential for resolution of further similar cases, as hereby were determined the essential elements of implementation promissory estoppel institute.

For a promissory estoppel, it must be shown that a party to an existing legal relationship made a clear and *unequivocal* representation that it would not rely on its strict legal rights, the promisee acted to its detriment in reliance on that representation, and it would therefore be inequitable to permit those legal rights to be enforced,[36] and when injustice can be avoided only by enforcing the promise[37].

This case is a classic example where the liability was imposed for the actions/promises made during pre-contractual negotiations, even though no written contract was in place.

Under English law there is also a separate concept of *proprietary estoppel*, which arose in relation to rights to use the land of the owner, and possibly in connection with disputed transfers of ownership.[38] However, due to its similarities with elements of promissory estoppel this concept does not exist in American law.

3.2. Equitable Estoppel

The Duhaime's law dictionary defines equitable estoppel as *"a bar to a party from asserting a legal claim or defense that is contrary or inconsistent with his or her prior action of conduct."*[39] Equitable estoppel is a defensive doctrine preventing one party from

[35] Restatement (Second) of Contracts § 217A (now §139)
[36] Lubbock, M. - Estoppel analysed (Commercial contracts newsletter, March 2012)/ https://www.ashurst.com/publication-item.aspx?id_Content=7522
[37] McIntosh v. Murphy, (Haw. 1970) – holding of the court
[38] Cobbe v Yeoman's Row [2008] UKHL 55
[39] Duhaime's Law Dictionary – the definition of Equitable Estoppel

taking unfair advantage of another when, through false language or conduct, the person to be estopped has induced another person to act in a certain way, which resulted in the other person being injured in some way.[40]

In the case Combe v. Combe (1951) the position of Lord Alfred Denning states: *"The principle, as I understand it, is that where one party has, by his words or conduct, made to the other a promise or assurance which was intended to affect the legal relations between them and to be acted on accordingly, then once the other party has taken him at his word and acted on it, the one who gave the promise or assurance cannot afterwards be allowed to revert to the previous legal relations as if no such promise or assurance had been made by him, but he must accept their legal relations subject to the qualification which he himself has had introduced, even though it is not supported in point of law by any consideration, but only by his word."*[41]

In its holding of the case Parker v Sager (1949), Chief Justice Stevens of the United States Court of Appeals, District of Columbia Circuit defines the essential elements (both from plaintiff's and defendant's side) necessary for implementation of equitable estoppel as follows: *"The essential elements of equitable estoppel as related to the party estopped are: (1) Conduct, which amounts to a false representation or concealment of material facts, or, at least, which is calculated to convey the impression that the facts are otherwise than, and inconsistent with, those which the party subsequently attempts to assert; (2) intention, or at least expectation, that such conduct shall be acted upon by the other party; (3) knowledge, actual or constructive, of the real facts. As related to the party claiming the estoppel, they are: (1) Lack of knowledge and of the means of knowledge of the truth as to the facts in question; (2) reliance upon the conduct of the party estopped; and (3) action based thereon of such a character as to change his position prejudicially."*[42]

From the above stated holdings we may summarize the essential elements as follows: 1) Facts misrepresented or concealed, 2) Knowledge of true facts, 3) Fraudulent intent, 4) Inducement and reliance, 5) Injury to complainant, 6) Clear, concise, unequivocal proof of actus (not by implication)[43]

For a moment it seems like equitable estoppel and promissory estoppel are the same, moreover, under English law the promissory and proprietary estoppels are considered as parts of equitable estoppel. And nonetheless we are more inclined to the

[40] Equitable Estoppel Law & Legal Definition - http://definitions.uslegal.com/e/equitable-estoppel/
[41] The case Combe v. Combe (1951)
[42] The case Parker v. Sager (1949)
[43] Cox, Lucian B. (1951). Equity: Principles and procedures in Virginia and West Virginia. § 288

American approach towards this issue, and we believe that there is a difference between those doctrines, which makes them survive a separate concept. That element, in our opinion, is that in case of promissory estoppel a clear promise should have taken place, whereas in equitable estoppel it is a misrepresentation of facts, which invokes reliance by the other party.

Let's bring another example, which we think will be a manifestation of breach of equitable estoppel doctrine in Armenia if of course this doctrine operated in our country. Article 306 of the Civil Code of RA states that "the fictitious deal, i.e. the deal made in order to disguise the other deal is considered void,"[44] by another provision of the Civil Code, article 303, "the claim for application consequences of invalidity of such void deal may be presented by any interested person"[45]: from the first glance it seems clear and fair that the legislator hereby wants to secure that neither party will enter into fictitious transaction, as such transaction will not be secured by the law and even the second party to such deal may file a claim and recognize such deal as void. However, if we look at this from the other point, it is apparent that at the time the parties entered into deal, that deal mutually satisfied the interests of the parties. Therefore if the party presenting the invalidity claim does do after receiving the fruits of that deal, then by recognizing such fictitious transaction void puts the claiming party in unjustly favorable position. We believe that this kind of loopholes in the legislation may be filled in only by implementation of principle of pre-contractual liability, particularly in this case, the doctrine of equitable estoppel which will serve as a tool estop the other party from making claims in fulfillment of which he receives the fruits and gives nothing instead.

By this we didn't want you to think that estoppel doctrine allows people to make their illegal deals legal. The reason why we shared this point is to demonstrate that even in the relations, which are based on illegal grounds and which are created by mutual consent, one of the parties will be banned from abusing his rights whenever the circumstances are favorable for him.

3.3. **Estoppel by Convention**

[44] Civil Code RA – art. 306
[45] Civil Code RA – art. 303

"...Where two parties arrive at a common understanding of their relationship, they may be precluded from departing from the terms of that understanding, where it would be unconscionable to do so."[46]

For an estoppel by convention, the parties must act on an assumed state of facts or law, which they either both share (or one makes and the other acquiesces in). They will be precluded from denying that assumption if it would be unjust or unconscionable to allow them - or one of them - to go back on it.[47] In 2009, the House of Lords in Chartbrook Ltd v Persimmon Homes Ltd (Chartbrook) held that an understanding or common assumption reached by contracting parties in the course of their pre-contractual negotiations, including "an assumption that certain words will bear a certain meaning" could provide the basis for an estoppel by convention claim.[48]

T. Amerit states that the estoppel by convention as understood in English law (also known as estoppel by agreement) occurs where two parties negotiate or operate a contract based on a shared assumption or mutual understanding of a legal effect (or interpretation) of that contract, they are bound by that belief, assumption or understanding if, firstly, they both knew the other operated under the same, and secondly, they both regulated their subsequent dealings on the same.[49]

The essential part of this concept is that the parties to negotiation prior to conclusion of the contract are setting a common ground, soil, for their agreement. They are making sure that the letter and the spirit of their upcoming agreement is mutually understood by both of them. The sense of the contract is clear and that each party is aware of the expectation of the other party from their agreement. None of them should be in doubt that the other acts in bad faith, and each may require from the other the strict compliance to principle of good faith throughout the whole process of negotiation , conclusion and afterwards during the implementation of the agreement.

The issue concerning this doctrine was raised on the grounds that allows consideration of pre-contractual negotiations to prove an estoppel by convention is undermining the rule that pre-contractual negotiations are inadmissible as an aid to interpretation of a contract (the exclusionary rule).[50] From the first impression it seems persuasive. We are sure that every practicing lawyer has at least encountered with the

---

[46] Gerard McMeel The Construction of Contracts: Interpretation, Implication and Rectification (Oxford University Press, Oxford, 2007) at 367

[47] Lubbock, M. - Estoppel analysed (Commercial contracts newsletter, March 2012)/ https://www.ashurst.com/publication-item.aspx?id_Content=7522

[48] Chartbrook Ltd v Persimmon Homes Ltd [2009]

[49] T. Amerit – The Law of Contract, Estoppel by convention

[50] Investors Compensation Scheme Ltd v West Bromwich Building Society [1997]

covenant in a contract, which states that the provisions of the contract are exhaustive notwithstanding the stage of negotiations (*parol evidence rule*). So what is the problem if both parties agree on this provision? The thing is that even in presence of this kind of covenant the party considering that he has become a victim of breach by the other party of his pre-contractual liabilities, may, under doctrine of estoppel by convention, put under question the overall agreement, by proving the existence of misconduct by the other party and the bad faith conduct and showing that in other, fair circumstances the contract would not have been concluded at all.

The *parol evidence rule* operates when the parties have acted in good faith during the pre-contractual stage, whereas the estoppel by convention may be enforced in case if a clear misconduct (misrepresentation, concealment of essential terms/facts) has taken place by either of the parties and may reverse the agreement. And this is, in our opinion, quite just. The philosophy of agreement is designed in a way to match the parties' initial intents and should come from their legitimate interests. If due to an unfair conduct of either of the parties this formula is frustrated, disregarding the period during which such breach has occurred (in contractual or pre-contractual stage), this should invoke pre-contractual liability for that party, resulting the agreement automatically to become void.

Conclusion

Summarizing the results of the paper, we can conclude that the institute of pre-contractual liability is a much more complex phenomenon than it might seem at a first glance. We believe that for the proper and effective implementation of this institution must first determine its nature – that is, to clearly define the place of pre-contractual liability in the civil law system.

It was shown that for imposition of liability for the improper conduct during pre-contractual stage of the agreement the court should confirm primarily that the party has acted in bad faith. For the purpose whereof, we consider it absolutely necessary to include the definition of good faith principle in the Civil Code of Armenia, at first place.

In some of the common law countries this issue has been resolved otherwise: in absence of concept of good faith and its element in the law, the appropriate courts, during dispute resolution process, have themselves given the definition of good faith by fixing them in their decision which afterwards become precedential.

In case of the Republic of Armenia it is completely different. Our courts cannot perform the powers of legislator, in comparison with countries of Anglo Saxon legal system, and adopt decisions in the spirit of law. The Court of Cassation of Armenia is only authorized to make legal interpretations if the law may be interpreted ambiguously in a particular case. This is the reason why the institute of pre-contractual liability has not been developed in Armenia. There is no judge in Armenia who, in resolving the issue of imposition of pre-contractual liability, will base his decision on the principle of good faith without clear existence of that principle and its elements in the legislation. Why we have underlined the word *element*? The thing is again related to the difference of legal systems. A judge in Armenia (maybe due to the lack of sufficient knowledge) cannot afford himself, in absence of even one element determining the good faith behavior, establish that element on his own, whereas US judges, for instance, are free to make addition to law if they consider it may help to complete the essence of judgement, and which will guide the courts in resolution of similar cases in future. Moreover, taking into account

nowadays level of professionalism of judges in RA, then even granting them legislative authorities may result in arbitrary behavior by the latter thereby frustrating the principle of predictability of court decisions.

That is why we believe this to be a prerogative of the legislator to establish the concept of good faith in the legislation of Armenia.

List of sources:

1. Civil Code of the Republic of Armenia dated 05.05.1998// http://www.arlis.am.
2. Civil Code of Russian Federation Part 1 dated 30.11.1994 and Part 2 dated 26.01.1996.
3. RA Law "On protection of consumer rights" dated 20.07.2001// http://www.arlis.am.
4. German Civil Code dated 18.08.1896// http://www.pnu.edu.ru
5. General Civil Code of Austria dated 01.06.1801.
6. Restatement (Second) of Contracts of US.
7. Statute of Frauds of US.
8. Uniform Commercial Code of US.
9. Ewan McKendrick. Contract Law. Text, Cases and Materials. Second Edition. – Oxford University Press, 2005.
10. J.H.M. van Erp. The Pre-Contractual Stage // Towards a European Civil Code / A. S. Hartkamp, M.W. Hesselink, Ewoud H. Hondius, C. Mak, C.E. du Perron (editors). Fourth revised and expanded edition. – Kluwer Law International, 2011.
11. Kucher A.N.: Pre-contractual liability: Protecting the rights of the parties engaged in the negotiations.
12. Kaerdi M. The Development of the Concept of Pre-contractual Duties in Estonian Law // Juridica international. Law Review University of Tartu. Vol. XIV. Tartu, 2008.
13. Febbrajo T.: Pre-Contractual liability in Italy toward the European pattern.
14. Podshivalov T. P. Comparative legal characteristics of the pre-contractual liability // International public and private law.
15. Nili Cohen Pre-Contractual Duties: Two Freedoms and the Contract to Negotiate //Good Faith and Fault in Contract Law. – Oxford: Clarendon Press, 2002
16. Fingerprints of Equitable Estoppel and Promissory Estoppel on the Statute of Frauds in Contact Law - Stephen J. Leacock.
17. Pokrovsky I. A. - Main problems of civil law. 3-rd edition / / The Statute, 2001.
18. Schwartz, Alan and Scott, Robert E., "Pre - contractual Liability and Preliminary Agreements" (2007).
19. Eric M. Holmes, A Contextual Study of Commercial Good Faith: Good - Faith Disclosure in Contract Formation, U. Pitt. L. Rev. (1978).
20. Monique C. Lillard, Fifty Jurisdictions in Search of a Standard-L The Covenant of Good Faith and Fair Dealing in the Employment Context, Mo. L. Rev. (1992).
21. E. Allan Farnsworth, Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code, U. Chi. L. Rev. (1963).
22. D' Amato, Anthony, "Good faith" in Encyclopedia of Public International law (1992).
23. J. R. Erb: "The Implied Covenant of Good Faith and Fair Dealing in Alaska: One Court's License to Override Contractual Expectations".

24. Mayra C. Artiles Fonseca – Negotiating in good faith: Only a civil law obligation? http://pangeaupr.org/2013/12/10/negotiating-in-good-faith/#_ednref52
25. Mckendrick, Contract law (9th ed. 2011).
26. Stuart Thwaites – Estopped by convention, what does it mean? (posted on 12 November 2015).
27. Duhaime's Law Dictionary.
28. Kat Kadian-Baumeyer – Doctrine of Promissory Estoppel.
29. Lubbock, M. - Estoppel analysed (Commercial contracts newsletter, March 2012)/ https://www.ashurst.com/publication-item.aspx?id_Content=7522
30. Cox, Lucian B. (1951). Equity: Principles and procedures in Virginia and West Virginia.
31. T. Amerit – The Law of Contract, Estoppel by convention