The Texaco-Pennzoil Affair and the Economic Analysis of Remedies for Mistakes in Contract Formation

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Mark P. Gergen*

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I. Introduction

In *Texaco, Inc. v. Pennzoil Co.*,¹ Texaco based much of its defense on the claim that an agreement in principle was not considered binding on Wall Street. Pennzoil challenged whether this was the trade practice and argued that any such practice was immoral. According to one witness at the trial, these issues were "probably what the case is all about."² Recent work by economists suggests that granting reliance damages may be the optimal remedy for certain mistakes in contract formation. This work offers some interesting insights into the question of the effect of an agreement in principle.³ If an award of reliance damages rather than expectation damages is the optimal remedy for breach of contract when there is a mistake in contract formation, then we would expect trade practice to treat an agreement in principle as nonbinding. If an agreement in principle is dishonored, it is likely to be because it was a mistake to enter into the agreement and because the parties usually place little reliance on such an agreement.

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¹ 729 S.W.2d 768 (Tex. App.—Houston [1st Dist.] 1987, writ ref’d n.r.e.), cert. denied, 485 U.S. 994 (1988). In the remainder of this Article, I refer to the case as "Pennzoil v. Texaco," the popular name.

² Record at 4677, Pennzoil Co. v. Texaco, Inc., No. 84-05905 (Dist. Ct. of Harris County, 151st Judicial Dist. of Texas, Dec. 10, 1985).

³ I might just as well have analyzed the issue in light of the rich literature on the economics of tender offers. Analysis of tender offers falls into several camps. The members of one camp favor unregulated tender offers because they think tender offers tend to enrich shareholders and move corporate resources to the highest valued use. See, e.g., Easterbrook & Fischel, *The Proper Role of a Target’s Management in Responding to a Tender Offer*, 94 Harv. L. Rev. 1161 (1981); Schwartz, *The Fairness of Tender Offer Prices in Utilitarian Theory*, 17 J. Legal Stud. 165 (1988). Proponents of a free market in tender offers presumably would disagree with the analysis here and would favor protecting the acquirer’s expectation if a contract of corporate acquisition is breached. The rule of free breach proposed here results in a system much like the system of auctions for corporate control in tender offers, which the free market camp opposes.

Another camp favors regulated tender offers to ensure that target shareholders receive the same price as a single owner would. This is to avoid problems with collective action. See, e.g., Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 Harv. L. Rev. 1693 (1985). This is no longer much of an issue because most takeovers are highly leveraged and all the target shareholders are bought out. The trend toward leveraged buyouts raises a new issue: whether the premiums paid are merely a result of taxes saved by substituting debt for equity. Another camp questions basic assumptions about rational behavior in tender offers. See, e.g., Roll, *The Hubris Hypothesis of Corporate Takeovers*, 59 J. Bus. 197 (1986). Similar questions about people’s behavior in Pennzoil v. Texaco are raised below. See infra text accompanying notes 94-105.
Thus, an economic model lends some credence to Texaco’s claim as to what the trade practice was. This model also provides a reason to respect that trade practice.

Mistake is probably not the first issue that comes to mind when one thinks of *Pennzoil v. Texaco*. Rather, one would think the central issue was whether there was a contract between Pennzoil and Getty. But the two issues are related. In cases such as *Pennzoil v. Texaco* in which no party acted in reliance on a contract, the argument for awarding reliance damages for mistakes in contract formation is an argument for finding that no contract existed at all. And the theory helps us understand the alleged trade practice of treating agreements in principle as nonbinding, a practice that was a central element of Texaco’s argument that there was no contract.

The analysis is relevant to other issues raised by the case. For those who think the damage award excessive, the claim that, at most, reliance damages should be allowed for breach of a preliminary agreement suggests a radically different perspective on the case. If expectation damages were appropriate, Pennzoil probably was entitled to at least $500 million—the difference between the price Pennzoil paid for three-sevenths of Getty Oil and the price Texaco paid. And even the $7 billion awarded by the jury was supportable under Pennzoil’s theory that that was the cost of replacing three-sevenths of Getty Oil’s oil and gas reserves, particularly given Texaco’s failure to present any evidence on damages. If reliance is the appropriate measure of damages, Pennzoil was entitled to little or nothing.

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4. In this Article, the J. Paul Getty Museum, the board of directors of Getty Oil Co., and Gordon Getty, who was acting as trustee for the Sarah C. Getty Trust, will be referred to collectively as Getty. These are the parties to the agreement in principle with Pennzoil. References to one or more of these entities individually are indicated by specific names.

5. The award of punitive damages is harder to justify. The jury may have assessed punitive damages because of the conduct of three individuals unrelated to Texaco: Martin Lipton, Bart Winokur, and Geoffrey Boisi. See infra text accompanying notes 115-18. The jury arrived at the figure of $3 billion in punitive damages for the peculiar reason that Texaco indemnified three entities: the Museum, the Trust, and Getty Oil. See infra text accompanying note 119. The award of punitive damages was later reduced to $1 billion by a Texas Court of Appeals. Texaco, Inc. v. Pennzoil Co., 729 S.W.2d 768, 866 (Tex. App.—Houston [1st Dist.] 1987, writ ref’d n.r.e.), cert. denied, 485 U.S. 994 (1988).
The analysis is also relevant to the issue of whether Texaco should be liable in tort for interference with contract. Under economic theory, whether the interferor or the seller compensates the original buyer for her loss (whether defined as expectation or reliance) is a matter of indifference. Nothing is inherently wrong with the tort of interference with contract so long as the interferor knows it will pay the original buyer from the outset. The price of the contract should reflect this allocation of risk. The present system is objectionable because it creates uncertainty by permitting the buyer to sue either the seller or the interferor. However, the parties can eliminate this uncertainty contractually—as Getty and Texaco did through an indemnity provision—by allocating the liability for paying the buyer to either the interferor or the seller. 

Economic analysis is relevant because it may be that interference with contract can be justified as a tort only if one believes that keeping a promise is a moral imperative and that enticing someone to break a promise should be condemned morally. Certainly Pennzoil claimed that keeping a promise is a matter of honor and that Texaco should be punished for not respecting another’s contract. Joe Jamail, counsel for Pennzoil, argued to the jury that “this is a case about promises and what you think of the business

6. The jury’s finding that Texaco knew a contract existed between Pennzoil and Getty is questionable. Knowledge that a contract exists is a necessary element of interference with contract. Representatives of Texaco made numerous inquiries about whether Getty Oil was still available and were told that it was by John Weinberg (a partner at Goldman, Sachs & Co., Getty’s investment adviser), T. PETZINGER, OIL AND HONOR: THE TEXACO-PENNZOIL WARS 209 (1987); Sidney Petersen (chairman of the board of Getty Oil), id. at 215; Martin Lipton (attorney for the Museum), id. at 214-15; and Lawrence Tisch, id. at 215. Bruce Wasserstein, the investment banker at First Boston who brokered the Texaco deal, received similar assurances from Bart Winokur (counsel to Getty Oil’s board), id. at 205; Lawrence Tisch (board member of Getty Oil), id. at 202; and Martin Lipton, id. These assurances also were conveyed to Texaco by representatives of First Boston. Id. at 211-12. Several Texaco witnesses, including Bill Weitzel (Texaco general counsel), testified that they thought Getty was “free to deal.” Id. at 385. The strongest evidence against Texaco were the indemnity provisions and Getty’s disclaimer of any promise that it was not bound under the Pennzoil agreement. But Lipton assured Texaco that these provisions were included merely because his client was overcautious. Id. at 232-33.

7. The converse is not true. Just because we believe there is a moral obligation to keep a promise, we need not also hold it wrong to entice others to break their promises. The duty to keep a promise may extend to the promisor alone. Did the serpent sin with Eve?

8. See T. PETZINGER, supra note 6, at 398-99.
community and whether [promises] should be kept when made." Under an economic (or utilitarian) model of contract, keeping a promise is not in itself morally significant. Thus, a utilitarian model of contract may cut the moral underpinnings from beneath the tort of interference with contract and from beneath Pennzoil's case against Texaco.

II. Background

Pennzoil claimed that when Getty Oil's board of directors voted on January 3, 1984, to approve a proposed price for the sale of Getty Oil's stock, it acceded to a Memorandum of Agreement, already signed by the Trust and the Museum, that provided that the Museum and the public shareholders of Getty Oil would be cashed out, leaving the Trust and Pennzoil with four-sevenths and three-sevenths of Getty Oil, respectively. According to Pennzoil, this was the agreement in principle announced the next morning in the press release. Pennzoil argued that this agreement bound Getty to negotiate a final agreement in good faith.

Texaco responded in two ways. First, it argued that Getty Oil's board had voted to approve only the price and that the board had not assented to the Memorandum of Agreement. However, this argument is implausible. If Getty Oil's board members had agreed only on price, then why would their attorneys agree to a press release announcing an agreement in principle that incorporated the terms of the Memorandum of Agreement? Texaco's

9. Record at 1328.
11. Record at 2841-42 (Jeffers opening statement).
12. Record at 2960-61 (Keeton opening statement).
13. The terms included an option on the part of Pennzoil to buy a block of Getty Oil's stock, a provision for the liquidation of Getty Oil if the Trust and Pennzoil could not agree on its management, and other important terms. Record at 3519-22 (Kerr).

Several other facts support Pennzoil on this issue. In opposing an effort by a Getty family member to stop the deal with Pennzoil, Charles Cohler, an attorney for Gordon Getty who was at Getty Oil's board meeting when the agreement with Pennzoil was approved, told a court that an agreement had been completed between Pennzoil and Getty on January 3. Pennzoil Co. v. Getty Oil Co., No. 7425, slip op. at 11 (Del. Ch. Feb. 6, 1984) (1984 WL 15,664).

Pennzoil's investment banker, Goldman, Sachs & Co., submitted its bill on January 4. T. Petzinger, supra note 6, at 203. Pennzoil argued that this billing traditionally occurs when a deal is complete. Record at 24,568 (Jamail closing argument). And Getty
other argument was that Getty understood that an agreement in principle was nonbinding.\(^\text{14}\)

III. Getty’s “Mistake”

Getty made one of two mistakes in voting to approve the agreement and in announcing an agreement in principle. Perhaps Getty honestly thought that an agreement in principle would be considered nonbinding. The attorneys for Getty and for the Museum testified that they insisted that the press release announcing the proposed merger agreement use the phrase “agreement in principle” to indicate that the agreement was not binding.\(^\text{15}\) If this is true, then the attorneys chose their words unwisely.

Or perhaps Getty intended to be bound at least to conclude negotiations in good faith,\(^\text{16}\) but undervalued Getty Oil. Selling the Getty Oil stock for about $112.50\(^\text{17}\) may have been a mistake when the stock eventually commanded a price of $128 per share.\(^\text{18}\) Most probably would agree that Getty made a mistake by selling the Getty Oil stock for a lower price if it acted negligently in ignoring the warnings of its investment banker that the Pennzoil offer was too low\(^\text{19}\) or if Getty otherwise had reason to believe that another buyer would have paid a higher price. I define “mistake” more broadly to include any decision that turns out to be wrong, even if the decision seemed reasonable at the time it was made.

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14. Record at 2340, 2378-84 (Miller voir dire); Record at 2970, 2976, 2989-90 (Keeton opening statement).
15. Record at 14,461, 14,506-08 (Winokur); Record at 14,838-41, 14,855-56 (Vlahakis). For a copy of the press release of January 4, 1984, see T. Petzinger, supra note 6, at 198.
16. If this was Getty’s intention, then Texaco’s claim that it believed agreements in principle were nonbinding, which composed much of Texaco’s defense, was a lie.
17. Pennzoil agreed to pay $110 plus a “stub” with a value based on Getty Oil’s insurance subsidiary with a minimum value of $5.00 payable in five years.
18. If Gordon Getty made a mistake about the value of Getty Oil, it was to his advantage. He increased the Trust’s interest in Getty under the agreement.
19. T. Petzinger, supra note 6, at 188-89.
Thus, I would consider the board’s decision a mistake even if it was reasonable in light of the facts known to the board at the time.

Doctrinally, it is unlikely that Getty could have obtained relief from the agreement by pleading mistake. Courts rarely grant relief for mistakes as to the value of a contract, especially if the mistake is unilateral. Courts usually analyze mistakes about whether a contract exists under the rules of contract formation, which enforce apparent but unintended promises unless the other party knew that a promise was not intended.

IV. The Economic Argument for Awarding Reliance Damages for Mistakes in Formation

Some commentators believe that mistakes in contract formation raise the sorts of issues that are best dealt with through tort rather than through contract, because a person who is mistaken about the existence, effect, or extent of an obligation does not assent to that obligation. These scholars conclude that the measure of damages in cases involving mistakes should be reliance rather than expectation. A recent article by Professor Richard Craswell may alter significantly the debate over the proper remedy for mistakes in contract formation. He shows that a reliance measure of damages may be the most efficient remedy in many cases. If

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20. How we define "mistake" may be of substantive significance, for our definition ultimately goes to whether the standard of liability for mistake should be negligence or strict liability. I do not discuss the standard of liability in this Article, nor do I consider whether a seller who breaches should be wholly excused from paying damages to the first buyer if the first sale was not negligent.

21. See, e.g., Wood v. Boynton, 64 Wis. 265, 25 N.W. 42 (1885). But see, e.g., M.F. Kemper Constr. Co. v. City of Los Angeles, 37 Cal. 2d 696, 235 P.2d 7 (1951) (a contractor is protected from a mistaken bid only if it is the result of a clerical error and not if it is a mistake in judgment).

22. See, e.g., Embry v. Hargadine, McKittrick Dry Goods Co., 127 Mo. App. 383, 105 S.W. 777 (1907); cf. RESTATEMENT (SECOND) OF CONTRACTS § 20 illustration 4 (1981) (relief might be allowed on grounds of mistake). If it is impossible for an outside observer to tell what the parties intended, so that neither of two conflicting interpretations is right, then under traditional doctrine there is no contract. Id. § 20 illustration 2.


Craswell is right, the rationale for treating mistake as a tort with reliance damages as a remedy, which has been grounded on what is essentially a concern for fairness, may also be grounded on concerns of efficiency and utility.

A. Craswell's Argument for Reliance Damages

Craswell argues that reliance damages encourage the optimal level of care against a false positive in a decision to contract. A false positive is a decision to enter into a losing or suboptimal contract. His basic analysis is fairly straightforward. The social cost of a mistaken decision to enter into an unprofitable contract is the resources expended or the opportunities forgone by the two parties before one party determines that the contract is unprofitable and breaches it. Such losses may be minimized by allocating them to the party who can best determine in advance that the venture might fail. But the liability should only be for these reliance losses. There should be no liability for lost expectations if a contract could not be performed efficiently; expectation damages are not a true social cost when the expectations are false.

Two propositions may be drawn from Craswell's analysis. First, one party ought to be liable for the other party's loss when a contract is breached if the first party can better avoid that loss. Second, that loss should be measured by reliance rather than expectation. Consider the following example: A firm fires a new employee on or before the first day he shows up for work. In this example, reliance and the ability to predict failure are one-

25. More accurately, concern about the unfairness of holding a person to a commitment that he did not intend to make when the other party to the contract suffered no loss.


sided and asymmetric; only the firm has access to the information needed to determine its own needs and to ensure the employee's suitability. In addition, the employee is likely to rely more on the relationship—perhaps he quits another job or relocates to take the new position. In such a case, the firm should bear the employee's loss should it quickly determine that it made a mistake. Holding the firm liable for the employee's reliance damages encourages the firm to take the optimal level of care in assessing its needs and the employee's credentials. But the employer should be liable only for the employee's reliance losses. A threat of paying expectation damages will overly deter employers. Requiring an employer to retain or pay the salary of a new employee who does not work out will tend to make it overly reluctant to hire an inexperienced worker. An inexperienced worker's real loss is small because he gave up very little to take the job; conversely, his expectation interest is great because he may not have another job to go to.

Craswell's analysis is far richer than this. One of his points is that under perfect competition, reliance and expectation damages will be equal because marginal cost will equal marginal profit. He also observes that reliance and expectation damages are identical under perfect monopoly because the monopolist will capture the other party's profit. Thus, Craswell demonstrates that the case for reliance damages depends on bilateral monopoly.


30. Craswell, supra note 24, at 419-20; see also Friedman, supra note 26, at 282-83.


32. Id. at 421. Craswell defines bilateral monopoly as a situation in which the respective bargaining powers of the buyer and the seller are such that any price they agree on will divide the expected surplus between them.
this is not a very restrictive condition because bilateral monopoly encompasses any exchange in which each party may command part of the gain from the exchange. Moreover, the identity between reliance and expectation damages in conditions of perfect competition and perfect monopoly is not an argument against awarding reliance damages. It only means that reliance and expectation damages will be equal in some situations.

B. The Peculiar Problem of False Negatives

Craswell devotes much of his analysis to the problem of false negatives.\(^3\) A false negative is a mistaken decision not to enter into what would be a profitable venture. The social cost of a false negative is the net surplus that would have been gained if the parties had contracted and the exchange had taken place. False negatives arise when no one person reaps the entire potential profit (or social benefit) from a venture. In such circumstances, no one has sufficient incentive to investigate the venture. For example, a landowner may not adequately investigate the possibility of developing arid land as a farm because the person possessing the water rights necessary to develop the land would reap most of the profit from farming it.

The problem of false negatives leads Craswell to conclude that expectation damages sometimes may be appropriate for mistakes in contract formation. Allowing expectation damages for breach exposes a party to greater liability under the contract and thus partly counteracts the lack of investigation that gives rise to false negatives.

Craswell’s solution to the problem of false negatives—granting expectation damages for breach of contract—is ingenious, but limited in application.\(^4\) In most situations, as Craswell concedes, allowing expectation damages for breach creates uneven incentives

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33. Id. at 413-14.
34. Id. at 424. Craswell would bind the seller to a contract before any investigation is done and require him to pay expectation damages if he repudiates the contract. Craswell argues that this gives the seller the optimal incentive to investigate a venture because he would be liable for the buyer’s losses in the event of either a false negative or a false positive. This result is clearly correct insofar as the concern is false negatives, because the external cost of a mistake is the buyer’s lost profit, which this solution internalizes to the seller.
for a person considering a venture. Consider our landowner: If she decides to proceed with the farming venture and it turns a profit, she will reap only part of the social gain because the owner of the water rights will claim part of the profit. If she decides to proceed and the venture fails, she will pay more than the full social cost of the failure because she will have to pay the owner of the water rights his expected profits and not his costs. This imbalance in incentives tends to make people overcautious in undertaking speculative projects.35

Perhaps Craswell is wrong in trying to solve the problem of false negatives through a remedy for breach of contract. It is perverse to encourage people to contract by increasing the penalties for contracting unwisely. The increased threat may encourage some people to look more closely before contracting, but it will deter others from looking at all.

The problem of false negatives can be solved through other means. Consider this fairly common situation: A consumer has an idea for a new product or marketing strategy that will benefit an established company.36 The consumer lacks the incentive to develop his idea or to propose it to the company because the company will reap the profits. The two parties may solve the problem privately if the consumer bargains for part of the profit from the idea in return for disclosing it to the company.37 Or the problem may be solved legally by making it possible for the consumer to disclose his idea and then recover in restitution.38
False negatives will occur in other situations having different strategic structures; for example, a venture may profit many other individuals so that a person who has identified the opportunity cannot practically bargain for a part of their profit. Some situations may require the radical solution of creating a right to recover expectation damages when a person fails to enter into what would have been a profitable contract. Still other situations may best be dealt with collectively. For example, state or municipal governments may offer benefits to entice firms that otherwise might lack the incentive to explore the possibility of locating in a particular area. These problems need to be analyzed, but when that analysis is done, I am confident that a remedy for breach of contract will not rank highly among the possible solutions. If I am correct, we need not worry about solving the problem of false negatives in designing a remedy for breach of contract.

C. Countervailing Arguments for Expectation Damages

There are several other economic arguments for granting expectation damages: they (1) provide the optimal deterrence for mistakes in performance, (2) serve as a surrogate for reliance when reliance is difficult to establish, and (3) provide the optimal incentive for search by bargain hunters. However, as we will see, only the last of these arguments may apply to the contract between Getty and Pennzoil.

1. Expectation Damages Provide the Optimal Deterrence for Mistakes in Performance.—Some scholars argue that although reliance damages provide the optimal deterrence for mistakes in contract formation, expectation damages provide the optimal deterrence for mistakes in performance. This argument follows from the traditional economic analysis of contract remedies: expectation damages ensure that a person will breach only if the benefits to him outweigh the costs to others. For example, S promises to sell a good to B1 for $10. B1 values the good at $12. B2 offers to

39. Generally, there is no right to recover in tort for failure to contract, even when it is a matter of grave necessity. See, e.g., Hurley v. Eddingfield, 156 Ind. 416, 59 N.E. 1058 (1901) (physician not liable for refusing to aid a dangerously ill patient). This case is usually cited for the proposition that there is no duty to aid others in distress.
40. See, e.g., Friedman, supra note 26, at 302-04.
buy the good from $S$. $S$ should breach and sell to $B2$ only if the good is worth more than $12$ to $B2$. This result is ensured if $S$ is required to pay $B1$ $2$, $B1$’s lost profit, if $S$ breaches.

Thus, we must know whether a breach results from a mistake in contract formation or a mistake in performance to determine the appropriate measure of damages for breach of contract. In the above example, the nature of the mistake and the proper remedy depends on whether $B1$ or $B2$ values the good more. If the good is worth more to $B2$ than to $B1$, then it is socially desirable for $S$ to breach and sell to $B2$. From a social perspective, $S$’s decision to sell the good to $B1$ is a mistake, and the social loss from this mistake is $B1$’s loss in reliance on the contract. This type of mistake is a mistake in contract formation.

On the other hand, if the good is worth more to $B1$ than to $B2$ and if $S$ breaches and sells to $B2$, then a social loss occurs equal to the difference between $B1$’s and $B2$’s valuation of the good. This loss may occur, for example, if $B1$ contracts to buy the good for $10$ and values it at $12$, and then $B2$, who values the good at $11$, outbids $B1$ at a price between $10$ and $11$, inducing $S$ to breach. This type of mistake is a mistake in performance.

This analysis can be incorporated into a legal rule by making the right to recover expectation damages depend upon a showing by $B1$ that she values the good more than $B2$. But this solution is difficult to implement. The value of the good to $B1$ and $B2$ is not easily established because the value to them invariably exceeds the good’s market price; otherwise, there would be no issue. A better solution is to consider the different structures of the two types of mistakes to see if either can be discounted as unlikely to occur or as remediable through private means. A strong argument can be made that mistakes in contract formation are more significant than mistakes in performance in situations involving bidding for a resource by sophisticated firms such as those in *Pennzoil v. Texaco*.

Mistakes in performance generally should not be a problem. If $B1$ is outbid at a price below the maximum price she is willing to pay, she can simply re-enter the bidding and outbid $B2$. It is

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41. The assumption that postcontractual bargaining is free is crucial to the analysis in this paragraph.
in S's interest to invite such a bid and in B1's interest to make it. Thus, S should not have to compensate B1 for her lost expectation interest to avoid a loss-creating breach. Giving B1 the right to expectation damages if S breaches actually may have the negative consequence of keeping B1 from re-entering the bidding because B1 will receive her profit in any event—at least in theory.\footnote{In reality, B1 will be torn between several conflicting fears. For example, she may fear undercompensation in a lawsuit for breach of contract. This will encourage her to re-enter the bidding to obtain the good at a higher price to secure the remaining profit, with the plan of suing to recover the difference between the price she pays and the original price. Indeed, a buyer may be required to do this under the rules of mitigation. \textit{Cf.} Lawrence v. Porter, 63 F. 62 (6th Cir. 1894) (where plaintiffs were able to buy and did not, they cannot recover any special losses incident to their own failure to mitigate). Alternatively, B1 may fear that if she re-enters the bidding to secure the good she will be held to have relinquished her rights under the original contract. \textit{Cf.} United States v. Progressive Enters., Inc., 418 F. Supp. 662 (E.D. Va. 1976) (when the buyer had agreed to an increase in purchase price, the buyer could not seek to enforce the lower price stated in the original contract). This fear will encourage her to stand aside.}

In sum, expectation damages are not necessary to control mistakes in performance, at least in cases such as \textit{Pennzoil v. Texaco}. In fact, granting expectation damages may keep resources from their best use.

On the other hand, mistakes in contract formation are best regulated by a rule granting reliance damages for breach of contract. Under any measure of damages, B2 will obtain the good from S or B1 if he values it more than B1 does, even if B1 has a right to specific performance.\footnote{The introduction of transaction costs, or "lock-in effects" (factors that prevent B2 from acquiring the good from B1 though he values the good more), would generally tend to favor organizing the exchange as an auction in which B1 and B2 would simultaneously bid for the good. For an argument that these factors are insignificant in tender offers, see Schwartz, \textit{supra} note 3, at 191-94.} Allowing expectation damages does not prevent the user who values the goods most from obtaining them. Rather, the problem with granting expectation damages is that it may deter S from selling to B1 in the first instance. Sometimes S, out of fear of losing a better deal, will refuse to sell to B1 even though B1 places the highest value on the goods.

Consider the following example: B1 offers S $100X for a year's lease. B1 will pay $90X for the year's lease in one month. The $10X difference in price represents the lease's diminution in value to B1, taking into account the one-month delay. S also is negotiating with B2 to lease the same property for a year for
$110X, but B2 needs thirty days to decide whether he wants the lease. Neither B1 nor B2 can substitute another lease. S must choose whether to forgo the $10X and await B2’s decision or to lease to B1.

S’s search cost equals the $10X lost if S delays leasing to B1. The right choice depends upon the potential loss if B1 leases and later B2 wants the property. These “sunk costs” are the resources B1 will use to exploit the property, resources that are otherwise of no value to B1 or B2. If B1 has no sunk costs, then S should lease to B1. If B2 decides after a month that he wants the lease, he may lease from either B1 or S. Nothing is lost since B2 obtains the lease and B1 has no sunk costs. Moreover, B1 gains the $10X value she places on an immediate lease. But if B1 has sunk costs equaling $10X in the first month, S should not lease to her if a better than even chance exists that B2 will want the property.

These outcomes are ensured if S can break his lease with B1 and lease to B2, so long as S compensates B1 for her sunk costs. If S cannot break the B1 lease, he will be overcautious in contracting because he will fear losing the potential gain from leasing to B2. For example, S should refuse to lease to B1 for $100X, even if B1’s sunk costs equal zero, so long as it is more likely than not that B2 will want the property. S also has the option to lease to B1, charging B1 a premium for the potential profit S could make on the lease to B2. If B1 has no sunk costs and the chances that B2 will want the property are even, B1 should pay a $5X premium. However, the parties will reach this outcome only if B1 has the same information and risk preference as does S.

2. Expectation Damages Are Appropriate When Reliance Cannot Be Measured Accurately.—Sometimes reliance on a contract

44. This result can be shown by comparing the various payoffs under each outcome:

1. Lease and B2 wants property: $110X - $10X sunk costs = $100X.
2. No lease and B2 wants property: $110X.
3. Lease and B2 does not want property: $100X.
4. No lease and B2 does not want property: $90X.

The outcome of leasing is $100X in either case. There is a $10X gain over $100X on no lease if B2 wants the property and a $10X loss if B2 does not want the property. Thus, the no-lease alternative is preferable if there is a better than even chance B2 will want the property.
involves forgoing opportunities or the development of nontransferable skills, factors that cannot be valued easily. Expectation damages may be substituted for reliance damages in these cases because projected revenues and out-of-pocket expenses, which net to yield projected profits, are more easily calculated than the elements of reliance. This substitution makes some sense, for if the promisee acts rationally and is not mistaken, her expected profits should not be lower than her costs.

The argument that expectation damages should be used because reliance cannot be measured accurately does not apply to the breach of a preliminary agreement. Usually, reliance on a preliminary agreement is small and easily measured, especially when the parties plan and negotiate for only a short time. And when the parties negotiate a preliminary agreement or hammer out a final agreement in just two or three months, they have little time to forgo other opportunities. In addition, the parties probably will not restructure their operations until they have completed the final agreement. Management time and the cost of lawyers, accountants, and others involved in negotiating the preliminary and final agreements compose the only significant expenses, but while these amounts may be large, they are trivial in comparison to the overall stakes involved in a large business deal.

3. Expectation Damages Provide the Optimal Incentive for Bargain Hunters.—If an argument exists for giving a disappointed buyer expectation damages in a bidding war over resources involving sophisticated firms, it arises from the need to compensate and so encourage the buyer and other bargain hunters to undertake the effort to find profitable acquisitions. Up to this point, the analysis has assumed that S is the only one searching for a profitable deal. In reality, both B1 and B2 will be searching for S at the same time S is searching for them. If we modify the facts so that S and B2 remain passive while B1 tries to identify a potentially profitable acquisition, we can see why giving B1 a right to the profit from

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45. Pennzoil seems to have begun serious planning for a potential acquisition of Getty Oil in November 1983. T. Petzinger, supra note 6, at 126-27. However, Pennzoil identified Getty Oil as a likely target earlier. Pennzoil and Getty concluded the agreement in principle on January 3, 1984, and the final agreement was to be concluded a few days thereafter.
her discovery encourages optimal searching. Assume the following: $S$ owns property with potentially valuable minerals but has no way of testing that potential. $B1$ has the technology to test for the minerals, but the technology is costly to use. $B1$ must be given the profits from any minerals she discovers, otherwise she has no incentive to invest in determining the value of $S$'s property. This is a reason why some think that a buyer who has acquired information that enhances the value of a seller's good should not have to disclose that information to the seller. And it is a reason why some favor permitting unregulated tender offers that enable an acquirer to reap whatever profit she can find in a potential target without having to announce her offer and then submit to an auction.

However, this argument is not conclusive. It may be that much searching is inefficient because efforts to find companies undervalued in the market produce private but not public gain. A search would be considered inefficient if a potential buyer's efforts produced information about a target's operations or assets showing that the target's stock was undervalued in the market but not enhancing the value of the operations or assets themselves (for example, information about an as-yet unpublicized corporate venture).

Craswell's analysis suggests that awarding expectation damages may not be efficient even if a search may produce socially valuable information. Although a rule allowing expectation damages encourages bargain hunters to search for profitable deals, the rule also encourages sellers to be overcautious. Any positive impact from the incentive given bargain hunters to search must be offset by the negative impact of the disincentive for resource owners to sell. Also, in a world with many searchers, a rule of

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47. See Easterbrook & Fischel, supra note 3, at 1177-78; Easterbrook & Fischel, Auctions and Sunk Costs in Tender Offers, 35 Stan. L. Rev. 1, 3-7 (1982).


49. See Craswell, supra note 24, at 403-04 & n.6. (noting that the effect of the measure of damages or the search by other parties may enter the analysis). However, Craswell does not develop this point.
expectation damages puts an enormous premium on being first to identify a profitable venture. Thus, expectation damages may encourage excessive searching by firms as they intensify their search for bargains. These firms may end up inefficiently duplicating each other's efforts.

Finally, this argument is not very persuasive given the facts in Pennzoil v. Texaco and the nature of the issue. The measure of expectation damages—$500 million to over $7 billion—is grossly disproportionate to the effort expended by Pennzoil in pursuing Getty Oil. This disproportionality is probably due to imperfections in the market for large oil companies; only a few firms had the resources to bid for Getty. And it is not clear why a rule granting reliance damages to disappointed searchers provides an inadequate incentive. If reliance damages are measured properly to include opportunity costs, searchers will not be made any worse off by a breach. They only lose the windfall profits that result from market imperfections.

In sum, economic analysis points to reliance as the most efficient remedy for breach of contracts in many situations. This is especially true in situations such as Pennzoil v. Texaco, in which sophisticated firms are engaged in bidding for resources and in which the agreement is executory and not relied upon. The one argument for awarding expectation damages in such situations is that they encourage buyers to search for profitable ventures. However, this argument is at best inconclusive.

V. Economic Analysis, Trade Practice, and the Rules on the Interpretation of Preliminary Agreements

The economic analysis in Part IV suggests a strange world in which sales are provisional and contracts not relied upon are freely broken if a better offer comes along. This analysis is strongly counterintuitive. Undoubtedly, most people believe in the "sanctity of contract." When Hugh Liedtke, the chairman of the board of Pennzoil, learned of the deal between Texaco and Getty Oil, he reacted in what was probably a typical fashion. His initial thought upon hearing the news was "Those bastards! . . . Those bastards have stolen this company away from me!"50 However,

50. T. Peitzinger, supra note 6, at 235-36.
some facts of Pennzoil v. Texaco indicate that the strange world we have just constructed from economic theory is the real world on Wall Street.

A. Preliminary Agreements in the Strange World of Wall Street

One of the central issues in Pennzoil v. Texaco involved Texaco's claim that an agreement in principle was not considered binding on Wall Street. Texaco presented evidence that the lawyers for Getty Oil and the Museum acted on this belief when they insisted that "agreement" in the press release be changed to "agreement in principle." This, the attorneys said, was done so that everyone would understand that no commitment had yet been made. The lawyers, Getty Oil's board members, and investment bankers involved in the deal testified that it was a well-established practice on Wall Street to consider agreements in principle as not binding.\(^5\)

Texaco argued that if the parties to the preliminary agreement had intended to prevent the target from seeking another buyer, they could have included a "no-shop" provision.\(^2\) Interestingly, the draft of the final agreement included a no-shop provision.\(^3\) This testimony is consistent with the advice given Texaco at the time it entered the picture. Everyone seems to have advised Texaco that the agreement in principle would not bind Getty.\(^4\)

Lockup options\(^5\) in preliminary agreements also may be evidence that the agreements are considered nonbinding. The Memorandum of Agreement and press release included a lockup option on behalf of Pennzoil to purchase eight million treasury shares of Getty Oil at $110 per share.\(^6\) The use of such an option may indicate the parties' belief that the primary agreement did not give the buyer any rights. However, it is possible that an option

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51. Record at 14,441-48, 15,984-86 (Winokur); Record at 14,855-56 (Vlahakis); Record at 16,657-61 (Boisi); Record at 17,424-26 (Wendt); Record at 17,593-95, 18,400-04; Record at 18,948-54, 18,956-60, 18,964 (Wasserstein); Record at 19,245-46 (Medberry); Record at 20,311 (Tisch); Record at 22,461-64 (DeCrane).

52. Record at 23,137-38 (DeCrane).

53. Record at 7087-89 (Liman cross-examination).

54. See supra note 6.

55. Lockup options give the buyer the option to buy a block of stock or an asset of the target at a bargain price should the deal not go through.

56. However, several board members and others present at the meeting testified that this provision, along with the other provisions of the Memorandum of Agreement, was not ap-
might be included in an agreement in principle to provide the buyer an alternative remedy to enforcing the agreement. Or if a preliminary agreement is an agreement to negotiate in good faith, a lockup option might ensure the buyer of some reward should the negotiations fail for reasons that do not constitute bad faith.

The evidence on trade practice was not entirely in Texaco’s favor. The testimony of Texaco’s witnesses was at best self-serving. So, too, was the advice allegedly given Texaco when it was considering making an offer, because the advice earned the investment bankers higher fees and earned Getty a higher price for its stock. And there are some inconsistencies in the testimony of Texaco’s witnesses. Pennzoil’s counsel confronted Martin Lipton with the fact that in at least one prior deal he had used an agreement to bind the target. Sid Petersen testified that an agreement in principle obligates parties to negotiate the final agreement in good faith. Alfred DeCrane and John McKinley (who was not a lawyer) testified that a person is morally but not legally bound to negotiate in good faith under an agreement in principle.

Texaco also had trouble explaining a provision of the Memorandum of Agreement that stated that the Museum was not legally bound until the board approved the agreement. This provision suggested that the Museum was bound once the board did approve the agreement. Thus Judy Vlahakis, a lawyer for the Museum, admitted that the Museum was bound to negotiate in good faith once the board approved the deal. She, as well as other Texaco witnesses, dealt with this damaging point by claiming that the board had not approved the Memorandum of Agreement. But the witnesses’ claims were contradicted by the inclusion of the terms of the Memorandum of Agreement in the press release.

Pennzoil offered its own evidence of trade practice, including the testimony of one impartial expert, Thomas Barrow, a retired

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57. Record at 17,708-12.
58. Record at 5436-37.
59. Record at 12,472-77; Record at 21,341. DeCrane also described this obligation as a business practice. Record at 23,147-49.
60. Record at 17,858-72 (Lipton cross-examination); Record at 18,355 (Wendt cross-examination); Record at 19,320-23 (Medberry cross-examination).
61. Record at 15,080-85.
62. Record at 15,120.
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oil industry executive. Pennzoil argued that an agreement in principle means a person is obligated to negotiate in good faith and cannot abandon a deal simply because a settled price can be bettered. Barrow testified that if the board had not intended to be bound by its vote, one of the board members would have made a motion that the transaction had to be brought back before the board for further approval and that the need for further approval would have been noted in the press release.

The economic analysis tends to support Texaco on this crucial issue. Generally we would expect trade practices to be efficient. As we have seen, the efficient rule in this situation is not to enforce an agreement. Actually, reliance should be protected, but this aspect of the practice is not too troubling given the likely insignificance of reliance. The use of lockup options also is consistent with the economic analysis. Lockup options may be used to reward the buyer’s search by providing a buyer with part of the expected gain. Pennzoil’s option to buy eight million treasury shares of Getty Oil at $110 per share would have provided Pennzoil with roughly a nine percent interest in Getty Oil. Had Texaco purchased the company for $10.12 billion, which was the eventual price, Pennzoil would have received approximately $116.24 per share, for a net profit of approximately $50,000,000—not bad for a few days’ work.

B. The Disregard of Trade Practice in Pennzoil v. Texaco

One troubling aspect of Pennzoil v. Texaco is that the counsel for Pennzoil repeatedly told the Texas jury that it should decide

63. Record at 3534-37, 3560-62, 3600, 3687-98, 3701, 3940 (Kerr); Record at 6796-803 (Liman); 10,574, 10,587-95 (Barrow); Record at 11,787, 11,799-800 (Liedtke).
64. Record at 10,579-82, 10,901-02 (Barrow). Pennzoil also developed this point on cross-examination. Record at 18,414-36 (Lipton); Record at 16,113-18 (Winokur); Record at 15,195-97 (Vlahakis).
65. Interestingly, in one reported case in which a party was expected to expend significant amounts in reliance on a preliminary agreement, the other party promised to absorb this loss should the negotiations fail. See Arcadian Phosphates, Inc. v. Arcadian Corp., 884 F.2d 69, 70 (2d Cir. 1989). The economic analysis precisely predicts the result.
66. The use of such options also may be explained by a desire to discourage sales to others. Record at 3676-79 (Kerr testifying that this disincentive was the purpose of the option in the Memorandum of Agreement).
67. There were roughly 79 million shares outstanding before the merger. The issuance of 8 million additional shares would increase outstanding shares to 87 million.
68. The actual dollar amount was $49,982,000.
whether a contract existed by using its own standards, not those of the trade. In his opening argument, John Jeffers stated that although it might be the practice of investment bankers to break promises, "We think one of the things that has to be done in this case, that ought to be done in this case is to bring that circle of people square within the law. That may be their tactics, but it's not right and it's not the law." 69 Pennzoil's counsel repeatedly hammered on the themes of the immorality of New York and Wall Street and the need to send "a message" to Wall Street. 70

The analysis in Part IV suggests that the moral criticism of the trade practice is misplaced. There are valid reasons for treating preliminary agreements as nonbinding. And, as Professor Russell Weintraub explains, the argument that the trade practice should be disregarded is wrong legally. 71 Intent should be judged by the standards of the trade. 72 Therefore, the judge should have instructed the jury to evaluate the parties' intent in light of the relevant practices in New York.

Ironically, had the jurors re-examined their assumption that contracts are binding, they may have realized that most of the contracts in their experience are not really binding until one party relies on the contract. Probably the most significant contract in most people's lives is the contract for the sale or purchase of a home. Usually the only remedy for the buyer's breach of such a contract is forfeiture of the earnest money, either because the contract expressly makes forfeiture the exclusive remedy or because it is impractical to bring a lawsuit for breach of contract. This result is consistent with the economic analysis because the seller's reliance is likely to be small.

The same thing is true of everyday contracts for the purchase of consumer goods. A consumer usually may return unused non-defective goods. And the purchase contract usually limits a consumer's remedy for a defect that has not inflicted an injury to

69. Record at 2848.
70. Record at 1328, 1349 (Jamail voir dire); Record at 23,808 (Jeffers closing argument); Record at 23,954-56 (Terrell closing argument); Record at 24,536, 24,612 (Jamail closing argument).
the return of the good and refund of the price. This result, too, is consistent with the economic analysis, for a seller is harmed only when a good is used, and the buyer is harmed only when an injury is sustained because of a defect. The trade practice that offended the *Pennzoil v. Texaco* jury may not be so unusual after all.

C. The Misapplication of the Rules for Interpreting Preliminary Agreements in *Pennzoil v. Texaco*

A second error in *Pennzoil v. Texaco* was the judge’s failure to instruct the jury that the size and complexity of the deal, the number and significance of the issues left to be resolved in the final agreement, and the lack of reliance were evidence that the parties did not intend to be bound by the preliminary agreement. Generally, preliminary agreements are considered to be nonbinding when these factors are present. At the very least, the judge should have corrected the intimations by Pennzoil’s lawyers that having different standards for large and small contracts was somehow insidious.

Two opinions by federal courts applying New York law, handed down after the *Pennzoil v. Texaco* decision, suggest that in New York these interpretive rules rise to “a strong presumption against finding binding obligation in agreements which include open terms, call for future approvals and expressly anticipate future preparation and execution of contract documents.” Pennzoil’s claim that the preliminary agreement was binding probably would fail under such a strong presumption.

The two federal courts may not have stated New York law accurately. No New York case expresses the interpretive rule in terms of a “strong presumption.” And such a strong rule is not

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needed to explain the two federal cases. The first case to formulate the rule, *Teachers Insurance and Annuity Association v. Tribune Co.*,\(^76\) actually held that a preliminary loan commitment bound the borrower to negotiate in good faith because language in the agreement suggested that the parties intended to be bound\(^77\) and because the lender relied on the commitment and did not seek other investments during a period of declining interest rates.\(^78\) In the second case, *Arcadian Phosphates, Inc. v. Arcadian Corp.*,\(^79\) the Second Circuit upheld a trial court’s finding in a summary judgment that a preliminary agreement was nonbinding because terms in the contract plainly contemplated that negotiations might fail.\(^80\) But the court reversed the summary judgment on a claim of promissory estoppel because it thought that the plaintiff might be able to recover its losses in reliance on the defendant’s alleged promise to bargain in good faith.\(^81\)

Nevertheless, such a presumption may be justified on the basis of the economic analysis in Part IV. A presumption that preliminary agreements are not binding conforms to what is generally the efficient rule. This result should only be a presumption and not an absolute rule of nonenforceability because, as we have seen, there are circumstances when expectations warrant protection.\(^82\) The presumption ensures that most cases will be governed by the rule that is most likely to be efficient. Yet it permits parties to a contract to adopt alternative arrangements in case they have special needs.

Finally, the analysis in Part IV suggests that reliance should be a pre-eminent, not a secondary, factor in determining whether an agreement is binding and that reliance may be the appropriate

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77. *Id.* at 499-500.
78. *Id.* at 502.
79. 884 F.2d 69 (2d Cir. 1989).
80. *Id.* at 72-73.
81. *Id.* at 73-74. The parties in *Arcadian Phosphates* behaved exactly as the analysis in Part IV would predict. The preliminary agreement was made nonbinding, but the seller, who backed out of the deal to sell a phosphate plant, had agreed to compensate the buyer for its investment in the plant should the negotiations fail. *Id.* at 70.
82. Expectations on contracts should be protected when (1) there is immeasurable reliance, (2) the concern is a mistake in performance, (3) the buyer warrants compensation for its search efforts, or (4) the buyer internalizes the risk of a false positive by paying a premium for the possibility of a later resale at a higher price.
measure of recovery for breach of any preliminary agreement, particularly if the breacher is in a better position to avoid the loss. Interestingly, *Arcadian Phosphates* took this precise tack. By rejecting the buyer's claim that a preliminary agreement for the purchase of a factory is a binding contract but allowing a claim in promissory estoppel for breach of an alleged promise to negotiate in good faith, the court denied the buyer expectation damages but made possible the recovery of the loss in reliance on the agreement. The outcome of *Arcadian Phosphates* is similar to other cases that permit recovery of losses from failed negotiations on a theory of promissory estoppel. Economic analysis suggests that, regardless of doctrinal problems, this is the efficient outcome.

VI. Theory Meets Reality

The analysis in Part IV, like most economic analysis, rests on fairly controversial assumptions about human behavior: It assumes that people are rational, egoistic utility maximizers. In particular, most economic analysis assumes that the law can modify human behavior and resource allocation by imposing costs on conduct. However, certain aspects of *Pennzoil v. Texaco* call into question the validity of economic analysis because they belie assumptions about human behavior that are crucial to the analysis. Little in *Pennzoil v. Texaco* calls into question human selfishness. But some aspects of the case do call into question the ability of people to respond rationally to legal rules. I will briefly sketch several of these.

A. It's Much Easier on Paper, or How Humans Spoil the Model

The economic analysis in Part IV assumes that a seller will rationally weigh factors such as the amount of the offer, the

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83. See supra text accompanying notes 79-81.
84. See Wheeler v. White, 398 S.W.2d 93 (Tex. 1965); Hoffman v. Red Owl Stores, Inc., 26 Wis. 2d 683, 133 N.W.2d 267 (1965).
85. How can there be estoppel without a promise? If there is a promise, why not grant expectation damages? I explore these and other issues in Gergen, *Liability for Mistake in Contract Formation*, which is forthcoming in *Southern California Law Review*.
86. The only major player who did not seem to act out of greed or fear for his own interests was Gordon Getty, who may have been influenced by a desire to carry out his...
offeror’s reliance should she accept, the cost of searching for a
better offer, and the probability of finding a better offer in deci-
ding whether to sell. But this model seems hopelessly naive when
we look at how Getty actually behaved in voting on the Pennzoil
offer.

First, Pennzoil placed the board of directors under enormous
pressure. Pennzoil made an initial tender offer of $100 per share.
This offer was well above the market price before the tender offer
was made, but it was well below the value placed on the stock
by the board’s advisers. 87 Then Pennzoil made an offer of $110
per share to the board, but the offer was contingent upon imme-
diate acceptance. 88 Pennzoil’s strategy put Getty into a bind be-
cause if Getty rejected the higher offer, it faced the prospect of
Pennzoil almost certainly acquiring sufficient shares at the lower
price to join with Gordon Getty. Together, Pennzoil and Gorden
Getty, who as trustee of the Trust controlled forty percent of the
shares of Getty Oil, could have ousted the board. Indeed, Pennzoil
had made a private deal with Gordon Getty to do just that if
the board rejected the offer. The deal between Pennzoil and Gor-
don Getty was eventually disclosed to the board at the meeting. 89
The Museum, which controlled twelve percent of Getty Oil, also
was party to this agreement, but its obligation was conditional
upon approval of the plan by the board. 90

Thus, the board faced the unhappy choice of taking a bad
offer or rejecting it and probably being stuck with a worse one.
Geoff Boisi, of Goldman, Sachs & Co., explained to the board in
the meeting: “In the terms of the trade . . . Pennzoil is using a
‘bear hug.’ ” 91 Some of the board members described the tactic
as blackmail. 92 The directors initially resisted, rejecting the $110
offer because they could not get an opinion that this was a fair
price. But the board accepted the offer of $110 plus a “stub”

father’s wish to preserve and expand the family’s control of Getty Oil. See T. Petzinger,
supra note 6, at 162-65.

87. The market price for the Getty Oil stock was around $80 per share, but the
board’s advisors valued the stock at around $120 per share.

88. T. Petzinger, supra note 6, at 174.

89. Id. at 179-80; see infra text accompanying note 96.

90. T. Petzinger, supra note 6, at 169.

91. Id. at 175.

92. Id. at 174.
worth at least $2.50, though the board members were advised that the price was low and that a better offer might be found.93

Human frailties also may have played a part in the board’s decision to sell. The meeting was emotionally tumultuous. A great deal of personal animosity existed between Gordon Getty and the original board members.94 Animosity plus a desire to control the family company may have influenced Gordon Getty’s refusal to agree with Sidney Petersen’s plan to seek a higher bidder in response to Pennzoil’s tender offer.95 This animosity surfaced at the board meeting, particularly when Tim Cohler, Gordon Getty’s lawyer, disclosed the side deal between Gordon Getty and Pennzoil.96 The directors also were under enormous personal pressure. They faced the prospect of litigation and personal liability regardless of the choice that they made,97 a prospect undoubtedly made worse by their investment banker’s refusal to approve the deal.98 In addition, the directors were exhausted. Prior to reaching a decision, they had met almost continuously for twenty-four hours.99

The analysis in Part IV also assumes that people are sensitive to legal rules. But in *Pennzoil v. Texaco*, lawyers and experienced businessmen, people who should have known better, seemed oblivious to crucial legal rules. Pennzoil’s lawyers failed to realize that questions might arise concerning the legal effect of a preliminary agreement. Because of that failure, the lawyers did not determine the precise nature of the obligation the agreement entailed100 or specify whether the agreement was binding. In ad-

93. *Id.* at 188-89.
94. *Id.* at 118-19, 140-42 (describing the animosity over the October “standstill agreement”).
95. *Id.* at 150-52, 162-64. As the majority owner under the Pennzoil plan, Gordon Getty’s interests were adverse to those of the public shareholders and the Museum. Insofar as the price paid to the public shareholders and the Museum came from the company—and it did to the extent the price was paid with proceeds from the sale of the insurance subsidiary—Gordon Getty would want the other shareholders to receive the lowest possible price.
96. *Id.* at 179-80.
97. *Id.* at 189.
98. *Id.* at 188-89.
99. The meeting began at 6:00 p.m. on January 2 and did not break up until 2:30 a.m. Several directors worked through the night. The meeting formally reconvened at 3:00 p.m., and the deal closed around 7:00 p.m. on January 3. *Id.* at 171-91.
100. Was the agreement a promise to negotiate the remaining terms in good faith or a promise to go through with the deal with a court filling in the terms that the parties could not agree on?
dition, Pennzoil's lawyers did not think to stipulate that the agreement was binding in the Memorandum of Agreement or in the press release, although both were drafted with care. Only Martin Lipton seemed aware that this might be an issue. He added a provision to the initial Memorandum of Agreement between the Museum, Gordon Getty, and Pennzoil stating that the Museum was not bound and would "have no liability or obligation" if the board did not approve the agreement.

The failure of Pennzoil's lawyers to anticipate this issue is inexplicable. The attorneys clearly assumed they had some sort of binding commitment, otherwise they would not have relaxed as they did after securing the agreement. But as we have seen, the attorneys' assumption may not have been consistent with the applicable trade practice, and their assumption certainly was not warranted under the law. Whether a preliminary agreement is binding is a question of fact to be determined by the parties' intent; generally, when many issues are left open in a large deal involving complex matters, a preliminary agreement is not interpreted as binding.

For the same reason, it is incomprehensible that the lawyers for Getty and the Museum blithely assumed that changing "agreement" in the press release to "agreement in principle" resolved beyond doubt the question whether a binding contract existed. Given the indeterminate legal standard and the inconsistent case law, the attorneys had no basis for believing this with such con-

101. The Memorandum of Agreement was drafted by a team of a dozen lawyers and investment bankers between 8:00 p.m. on January 1 and 9:00 a.m. on January 2. T. Petzinger, supra note 6, at 157-67. It was reviewed by Gordon Getty's advisers and the Museum lawyers on January 2. Id. at 167. The agreement was presented to the board that evening, id. at 174, but the only term discussed was price. The press release was hammered out by a team of lawyers representing all concerned over the night of January 3 and 4. Id. at 195-98. The major issue in those discussions was the Museum's demand that it be cashed out immediately and Getty's concern that this would put Gordon Getty into a position to change the deal unilaterally. These issues were left open. Id. at 197.

102. Id. at 169.

103. Pennzoil delivered the draft of the final agreement on January 4 (twelve hours late). Id. at 204-06. On January 5, it waited while Getty leisurely reviewed the draft. Id. at 213-15. By the time the parties met on the night of January 5 to hammer out the details, Texaco was negotiating with Getty. Id. at 221-22. Even then, Pennzoil did not seem disturbed as Getty's lawyers left the negotiations. Id.

104. See E. Farnsworth, Contracts § 3.8 (1982).

105. See supra text accompanying note 73.
fidence. Getty’s attorneys seemed to have realized that a legal issue existed, but they grossly misjudged the law.

B. The Difficulties of Assessing Risk, or “I Screwed Up—I Trusted the Jury”

Finally, the facts of Pennzoil v. Texaco give some cause for skepticism about the possibility of intelligent risk analysis. Theoretically, when Texaco outbid Pennzoil and agreed to indemnify Getty for any losses it might have with respect to the Pennzoil agreement, Texaco should have counted the potential liability as a cost in determining whether it could afford the deal. This liability, properly discounted for time and risk, should have been subtracted from the price paid to Getty. Texaco agreed to Martin Lipton’s request for indemnification for the Museum and later to requests from Gordon Getty and the board for similar protection without asking for a price adjustment.106 This decision suggests that Texaco seriously underestimated the potential liability, although another possible explanation exists. The price may have been such a bargain that the promise to indemnify Getty only reduced Texaco’s profit. If this was true, Texaco may not have tried to renegotiate price for fear of upsetting the deal.107

But one wonders whether Texaco could have intelligently assessed its potential liability under the indemnity provisions or under tort law. If one believes the testimony, everyone who advised Texaco was wrong on the question of whether the preliminary agreement was binding.108 Only Martin Lipton was concerned enough about the potential for liability to insist on a sweeping indemnity clause for the Museum and to disclaim any warranties as to the Museum’s right to sell its stock under the agreement with Pennzoil.109 Some sense of the risk that the agreement between Getty and Pennzoil might be held binding can be obtained from the results of three mock trials conducted by Richard Miller, chief trial counsel for Texaco. Texaco won two of the mock trials

106. See T. PETZINGER, supra note 6, at 231-33.

107. Another possibility is that Texaco had already factored the potential liability into the price because it realized it might be sued for interference with contract. However, this conclusion seems implausible.

108. See supra note 6.

109. See T. PETZINGER, supra note 6, at 231-33.
because the jury thought that Getty was not bound until the final agreement was signed, but it lost the third mock trial because the jury thought "a deal is a deal." The Delaware Chancellor also concluded in a preliminary hearing that he was likely to find the agreement binding. When the real jury was first polled, seven jurors thought that there was a contract and five thought that there was not. These results suggest that Texaco might have evaluated the odds that the preliminary agreement would be considered a contract as about even.

This sort of risk assessment may be manageable. However, it is harder to see how Texaco could have anticipated the enormous judgment. The lower end of Texaco’s range of liability on the indemnification provisions was probably around $500 million—the difference between the price Pennzoil agreed to pay for three-sevenths of Getty and the price Texaco paid. This is the difference between the contract price and the market price (as established by Texaco’s contract) for Getty’s stake in the company.

Pennzoil’s recovery of a far higher amount turned on a number of chance events. Among these events was Texaco’s failure to present any evidence on damages. Another important factor was the jury’s personal dislike for three of Texaco’s most important witnesses: Bart Winokur, Getty’s chief outside attorney; Geoff Boisi, Getty’s investment banker; and Martin Lipton, counsel for the Museum. In assessing punitive damages, the jury focused on these three, going so far as to send a note to the judge asking, “To what extent is Texaco liable for the actions of Lipton, Winokur, and Boisi?” Finally, the jury’s calculation of

110. Id. at 291-92.
112. T. Petzinger, supra note 6, at 401-02.
113. The jury awarded damages of $11 billion, which included punitive damages, interest, and $530 million in expectation damages.
114. Petzinger reports that the jury was uncomfortable with the size of the verdict but that it did not think it could look outside the evidence presented to it. T. Petzinger, supra note 6, at 403-04.
115. Id. at 356 (quoting a juror’s description of Winokur as an “arrogant ass”).
116. Id. at 361 (describing juror “resentment” toward Boisi).
117. Id. at 373 (quoting a juror’s description of Lipton as “a real genius who can’t tie his shoes. . . . Texaco [the same juror remarked] should have left Marty Lipton in New York.”).
118. Id. at 406.
the punitive damages—one billion dollars for each of the indemnities given by Texaco—was completely irrational. And such unpredictable factors as the relative skills of trial counsel and the alleged biases of the trial judges also may have affected the outcome.

This sort of ex ante risk assessment may be improper. Perhaps only a one-in-a-thousand (or smaller) chance of an enormous verdict existed, and it just happened to occur in this instance. Texaco might have rationally discounted the tiny risk of an enormous verdict ($11 billion) and the significant risk of a moderate verdict ($500 million) and gone ahead with the deal, even without a price adjustment once indemnification was demanded by Getty. However, the chance events that led to the verdict suggest a different story—one in which undertaking legal risks is like gambling at long odds or playing Russian roulette—because juries and the fates of trial are so unpredictable.

VII. Conclusion

The two points of this Article are at odds with one another. Economic analysis of remedies for mistakes in contract formation indicates that a rule granting reliance rather than expectation damages is appropriate in many situations. Thus, preliminary agreements should not be enforced in corporate mergers and acquisitions when little or no reliance exists. This point is of descriptive and positive relevance. It may explain the apparent trade practice that agreements in principle are not binding, and it justifies a rule treating these and other forms of preliminary agreements as presumptively nonbinding. The second point is that the facts of Pennzoil v. Texaco give us little confidence that people behave (or can behave) as the economic model supposes they will. This reminds us that the model is, finally, heuristic.

119. Id. at 408.

120. Id. at 409. At least one participant in the trial believed that the relative skills of trial counsel affected the outcome of the trial. When asked to cite the major factor in the case, Joe Jamail replied, "I was."

121. Id. at 21. Richard Miller, Texaco's chief trial lawyer, stated after the case was completed, "When you get out of school, you think the right side is going to win a case . . . . Then you learn the side with the best lawyer is going to win. Then you learn that if the judge has an interest in the case, you're fucked."