

On the Definition of the Scope of Damages for Breach of Pre-contract

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Abstract. The definition of the scope of damages for breach of pre-contract has long been subject to theoretical disputes and judicial divergences. Starting from the functional orientation of pre-contract, this paper points out that pre-contract serves multiple functions: locking transaction opportunities, fixing negotiation outcomes, setting a buffer period for contracting, and avoiding obstacles to the principal contract, and its validity cannot be generalized by a single standard. Taking transaction maturity as the clue, and the completeness of clauses and the fulfillment of contract conclusion conditions as key criteria, this paper categorizes the validity of pre-contract into "pre-contract with strong validity" and "pre-contract with weak validity", and clarifies the scope of damages under this framework: the breaching party of a pre-contract with strong validity shall compensate the non-breaching party for all losses incurred in preparing for the performance of the principal contract, while the compensation scope of a pre-contract with weak validity is mainly limited to reasonable expenses in the negotiation preparation stage. In addition, this paper notes that whether a pre-contract contains an exclusivity clause is a key factor in determining whether opportunity loss has definitely occurred.

Keywords: pre-contract, validity, scope of damages, transaction maturity

1. Introduction

A pre-contract is a contract by which the parties agree to conclude a contract with specified contents in the future [1]. In complex civil and commercial transactions, the parties often reach consensus through repeated negotiations, during which they choose to conclude a pre-contract to retain transaction opportunities and fix negotiation results. Therefore, the parties establish a binding relationship through the pre-contract, and the party who violates contractual obligations shall bear the liability for breach of contract in the form of damages. From Article 2 of the *Interpretation on Several Issues concerning the Application of Law in the Trial of Sales Contract Disputes* in 2012, which stipulates damages as a remedy for breach of pre-contract, to Article 495 of the *Civil Code of the People's Republic of China* (hereinafter referred to as the "Civil Code"), which provides that violation of pre-contract obligations shall give rise to liability for breach of contract, and further to Article 8 of the *Interpretation on Several Issues concerning the Application of the General Provisions of the Contract Part of the Civil Code of the People's Republic of China* (hereinafter referred to as the "Interpretation on General Provisions of Contract Part"), which clarifies the

comprehensive discretionary standard for the scope of damages for breach of contract, the above norms have never clearly defined the scope of damages for breach of pre-contract. In practice, court judgments also diverge: some courts order the breaching party to compensate for reliance interest losses, some courts sentence the breaching party to bear performance interest losses, and the determination of whether to compensate for opportunity losses is also inconsistent [2].

In view of this, this paper conducts an in-depth discussion on the definition of the scope of damages for breach of pre-contract, focuses on the functional orientation and validity determination of pre-contract, and analyzes the significance of validity types, transaction maturity, as well as reliance interest losses, performance interest losses and opportunity losses for determining the scope of damages.

2. Functional orientation of pre-contract and determination of breach

2.1. Functional orientation of pre-contract

The functional orientation of pre-contract is the key to understanding its value in transaction practice. Combined with the practical application of pre-contract, its main functions are reflected in the following aspects:

First, lock transaction opportunities and generate contractual binding force in advance. In complex commercial transactions, it may take a long time from initial contact to the final conclusion of the principal contract, during which the market environment, the will of the parties and other factors may change. A pre-contract can fix the transaction willingness of both parties and reduce the possibility that one party withdraws from the transaction or turns to other transactions through contractual binding force. In addition, in practice, the parties conclude exclusive pre-contracts to prevent their negotiation efforts from being in vain, stop the counterparty from contracting with a third party, and improve the security of transaction opportunities.

Second, fix negotiation results and simplify the subsequent contracting process. Paragraph 2 of Article 6 of the Interpretation on General Provisions of Contract Part requires that the establishment of a pre-contract shall "determine the subject, object and other contents of the contract to be concluded in the future", which indicates that the conclusion of a pre-contract means the parties not only have the intention to contract, but also have reached preliminary negotiation results. Therefore, a pre-contract can not only fix previous negotiation outcomes, but also simplify the subsequent contracting process and improve contracting efficiency [3].

Third, set a buffer period for contracting and retain the final decision-making power over transactions. In some complex transactions, the parties may need to complete a series of preparatory work before concluding the principal contract, such as due diligence, approval and filing, financing arrangements, etc. A pre-contract can provide a reasonable buffer period for these preparatory work. In general transactions, the parties only hope to leave some clauses for further discussion, while reserving room for subsequent changes to the agreed clauses [4], and make the decision to conclude the principal contract cautiously.

Fourth, wait for obstacles to the principal contract to be eliminated and avoid the risk of impossibility of performance caused by direct conclusion of the principal contract. This is especially true when there are obstacles to concluding the principal contract. For example, according to Article 2 of the *Judicial Interpretation on Commercial Housing Sales Contracts*, if the seller has not obtained the commercial housing pre-sale permit, the commercial housing pre-sale contract concluded with the buyer is invalid. In this case, only the pre-contract can bind the parties before the objective obstacles are removed.

According to the above discussion on the functional orientation of pre-contract, it can be seen that the conclusion of a pre-contract does not necessarily aim at the inevitable conclusion of the principal contract in the future; in many cases, the pre-contract only prepares for the next stage of negotiation. Therefore, given the diversity of pre-contract functions, pre-contracts reflect different functions along with dynamic changes in the contracting process [5].

2.2. Typological determination of the validity of pre-contract

The determination of pre-contract validity is an important prerequisite for defining its liability for breach of contract and the scope of damages [6]. Due to the complexity and diversity of pre-contracts, their validity cannot be generalized, but presents typological characteristics.

2.2.1. Reflection on traditional validity doctrines

Before the promulgation of the Civil Code, there were basically three doctrines on the validity of pre-contract in China's theoretical circle and judicial practice: the "doctrine of mandatory contracting", the "doctrine of good-faith negotiation" and the "doctrine of content determination". These doctrines reflect understandings of different aspects of pre-contract to a certain extent, but also have their own limitations.

The doctrine of mandatory contracting holds that the parties must conclude the principal contract to fulfill the obligations of the pre-contract. This doctrine ignores the functional diversity of pre-contracts. Especially for pre-contracts with low content certainty, the parties have a reasonable expectation that no agreement may be reached even after honest negotiation, and do not require the mandatory conclusion of the principal contract [7]. If the validity of all pre-contracts is uniformly recognized as mandatory contracting, it will infringe on the parties' freedom of non-contracting protected by incomplete contracts [8]. For example, in Case (2008) Zhong Zhong Fa Min Yi Zhong Zi No. 54 [9], the parties did not reach an agreement on the payment method. Requiring mandatory contracting in this case would impose an unreasonable restriction on the parties to the pre-contract.

The doctrine of good-faith negotiation defines the obligation of the parties to the pre-contract as the obligation to negotiate in good faith, rather than the obligation to conclude the principal contract. Comparatively speaking, the obligation of good-faith negotiation is a universal obligation for pre-contracts. Regardless of whether the conclusion of the principal contract is required, it is inherent in the pre-contract that the parties conduct honest negotiation in accordance with the contract. However, for some pre-contracts that are already fairly complete, or even where the principal contract can be concluded once objective obstacles are removed, interpreting the validity of the pre-contract as merely good-faith negotiation violates the actual will of the parties [10], and may even give the party who originally promised to contract an inappropriate opportunity for exemption. For example, the *Subscription Agreement* in Case (2020) Chuan 01 Min Zhong No. 14437 [11] contains all core clauses of the principal contract, and the court accordingly held that the parties' obligation is to conclude the principal contract in accordance with the pre-contract, rather than merely the obligation of good-faith negotiation.

The doctrine of content determination holds that whether a contracting obligation or a negotiation obligation arises should be judged according to whether the pre-contract contains the main clauses of the principal contract. Compared with the first two doctrines, this doctrine is more flexible and can better adapt to the diverse functions of pre-contracts and various contracting purposes of the parties in reality. However, the limitation of this doctrine is that it simply equates the completeness of contract content with the binding intention to conclude the principal contract in the future. One

important function of pre-contract is to retain the parties' decision-making power. Even if the pre-contract fully contains all clauses of the principal contract, as long as there is an expression similar to "to be negotiated in the future", the will of the parties shall be respected [12]. In addition, since main clauses vary with different types of contracts, determining contract validity based on general main clauses may deviate from the true intention of the parties [13].

2.2.2. Validity types of pre-contract and transaction maturity

Since the doctrine of mandatory contracting and the doctrine of good-faith negotiation adopt an overly simplistic approach to determining pre-contract validity, and the doctrine of content determination has limited practical value due to its vague standard for distinguishing validity, it is necessary to construct a typology of pre-contract validity. Pre-contracts in practice take various forms and have varying contents, covering almost all contracting stages from the emergence of contracting intention to the conclusion of the principal contract. At this point, taking pre-contract functions as the clue to set typological criteria can give full play to the value of the pre-contract system.

The value of the pre-contract system lies in recognizing the dynamic contracting process [14], and pre-contract is the product of staged transactions. At different transaction stages, the purpose for which the parties conclude a pre-contract and the expected functions of the pre-contract differ, and the interests of the parties protected by the corresponding pre-contract also vary, so the validity of the pre-contract differs accordingly. The foregoing analysis summarizes four main functions of pre-contract. The first three functions operate in the early and middle stages of the contracting process, where trust between the parties is not strong, so the parties use pre-contracts to lock transaction opportunities or leave room for formal contracting. In this case, the parties expect that the principal contract may or may not be concluded after the performance of the pre-contract. On the contrary, when the transaction is highly mature and the principal contract has not been concluded only due to objective obstacles, the contracting process has advanced to the point where the parties can almost be certain that the transaction will be reached, and the validity of the pre-contract should accordingly be upgraded to mandatory contracting. Accordingly, pre-contracts can be roughly divided into two types according to their validity: "pre-contract with weak validity" and "pre-contract with strong validity", corresponding to good-faith negotiation and mandatory contracting respectively.

In specific cases, the most critical standard for distinguishing the above two validity types is whether the parties intend to definitely conclude the principal contract [15]. If the parties have clearly agreed in the contract that they "must" conclude the principal contract at a certain time in the future, it can be deemed that the purpose of concluding the pre-contract is to reach the principal contract subsequently, so the pre-contract is a pre-contract with strong validity. But in most cases, the parties do not make such a clear statement in the pre-contract. At this time, it is necessary to judge the true intention of the parties based on the contract content and the objective conditions of contracting. Paragraph 2 of Article 8 of the Interpretation on General Provisions of Contract Part adopts the concept of "transaction maturity" to describe the dynamic nature of pre-contract, and also puts forward criteria for judging transaction maturity: the completeness of content and the degree of fulfillment of conditions for concluding the principal contract.

First, a pre-contract differs from a principal contract and does not require consensus on all transaction details. If the key clauses for concluding the contract are not specified in the pre-contract, the parties will inevitably negotiate them when performing their negotiation obligations. Where there is negotiation, there is a possibility of negotiation failure. Recognizing the pre-contract as having mandatory contracting validity in this case would impose improper restrictions on the

parties. Taking Case (2016) Yun 0122 Min Chu No. 914 [16] as an example, the *Agreement* signed by both parties only agreed on the building area of the shop, but did not specify core clauses such as price and payment method. The court held that the content was incomplete and denied its mandatory contracting validity. By analogy, only when the pre-contract has reached consensus on the decisive clauses for concluding the principal contract, but the parties choose to conclude the pre-contract first due to various legal or factual obstacles, it is feasible to recognize the pre-contract as having mandatory contracting validity. At this point, there is almost no risk that the principal contract cannot be concluded due to negotiation failure. Even if the parties fail to reach agreement on non-essential points of the principal contract, the gaps can be filled through supplementary interpretation of the contract [17], which will not affect the establishment of the principal contract. Therefore, a "pre-contract with strong validity" must meet the requirement that consensus has been reached on the essential points of the principal contract in terms of content.

Second, the conditions for concluding the principal contract can serve as an auxiliary factor for judging whether a pre-contract has strong validity. If the conditions for concluding the principal contract have been basically met, requiring the parties to conclude the principal contract faces no obstacles on the one hand, and on the other hand, it shows that the transaction has progressed to the final stage of contracting, the trust between the parties is at the highest level, and concluding the principal contract is a natural outcome for the parties [18]. In addition, if the pre-contract is concluded because there are objective obstacles to the principal contract, such as the situation under Article 2 of the Judicial Interpretation on Commercial Housing Sales Contracts, the function of the pre-contract here is to provide protection for the parties while waiting for the obstacles to be eliminated, and the trust between the parties is close to that when the principal contract is established. Therefore, in this case, the pre-contract can also be recognized as a pre-contract with strong validity when considered together with the completeness of the contract content.

Overall, the fundamental standard for judging the validity type of a pre-contract is whether the parties have the intention to definitely conclude the principal contract in the future. When it is not clearly stated in the contract, the validity type of the pre-contract shall be evaluated as a whole based on the criteria of transaction maturity, the completeness of contract content and the degree of fulfillment of conditions for concluding the principal contract.

3. Definition of the scope of damages for breach of pre-contract

The functional orientation of pre-contract affects the type of contract validity, and validity is a prerequisite for breach determination and remedies [19]. The transaction maturity stipulated in Paragraph 2 of Article 8 of the Interpretation on General Provisions of Contract Part can link contract validity and the scope of damages. Transaction maturity describes the state of trust between the parties in the contracting process as reflected by the pre-contract. What a pre-contract must protect is the loss caused by the breakdown of trust, and the magnitude of such loss varies with transaction maturity. Therefore, the key to determining damages for pre-contract is to identify what expenses the parties cannot recover after trust collapses due to their reliance on the contract.

3.1. Scope of damages for pre-contract from the perspective of transaction maturity

Current discussions on pre-contract damages still mainly revolve around performance interest and reliance interest. Most views hold that damages for breach of pre-contract cannot be equated with the performance interest of the principal contract, nor with the reliance interest loss of the principal contract [20], but shall be determined by the judge within the range between the two [21]. These

discussions basically start from the relationship between pre-contract and principal contract, and between pre-contract and liability for contracting negligence, and delimit the scope of pre-contract breach losses by reference to the principal contract breach losses. However, not all pre-contracts are of strong validity, and the completeness of the principal contract content in such cases is not sufficient to allow easy determination of losses. A more appropriate perspective for discussing the scope of damages for pre-contract is to determine the specific content of losses based on how the pre-contract influences the parties' behavioral choices.

A pre-contract with strong validity corresponds to high transaction maturity, and the parties have strong trust that the principal contract will be concluded. Under such trust, the parties will be motivated to make transaction arrangements in advance and prepare for the performance of the principal contract on the premise that the principal contract will be concluded. Common expenses in practice include costs incurred in concluding supporting contracts with suppliers, leasing venues and equipment, recruiting personnel, etc. All these expenses arise from the transaction arrangements made by the parties based on the pre-contract. If the pre-contract is performed normally and the principal contract is concluded, these expenses will realize their due value; but if the pre-contract is breached and the principal contract fails to be concluded, all these expenses become losses, namely the performance interest loss of the pre-contract itself [22].

For a pre-contract with weak validity, the parties' expectation of the performance result is that the principal contract may or may not be concluded. Therefore, the parties usually do not prepare for the performance of the principal contract in advance, and at most prepare for further negotiation and discussion. Possible expenses include travel expenses, attorney fees, evaluation fees, due diligence fees, etc. paid for negotiating the principal contract. In Case (2020) Min 0625 Min Chu No. 934 [23], since the agreement clearly stipulated that clauses such as equipment and material specifications, payment methods and acceptance standards would be left to a "later supplementary agreement", it belonged to a pre-contract with weak validity. The court finally took various expenses paid for concluding the contract and expenses paid for preparing to sign the contract as reference for the scope of damages. The performance interest loss of a pre-contract with weak validity varies with the contract content. Different agreed contents will lead to different behavioral choices of the parties, which need to be analyzed on a case-by-case basis, but the main scope is limited to losses incurred in the negotiation and further negotiation stages. If the party claiming damages includes expenses for preparing to perform the principal contract, it is necessary to carefully judge whether the provisions on the principal contract in the pre-contract can justify the party's reliance that such expenses will generate necessary economic value.

In sum, the two types of contracts with different transaction maturity guide the parties' behaviors in different directions. All losses incurred by the parties to a strong-validity pre-contract in preparing for the performance of the principal contract are compensable, while the breach losses of a weak-validity pre-contract mainly consist of negotiation preparation losses and part of the losses from preparing for principal contract performance.

3.2. Opportunity loss in pre-contract damages

Some scholars propose that the loss of opportunity interest is the core loss in damages for breach of pre-contract [24]. In practice, compensation for opportunity loss faces the problem that it carries a certain degree of contingency: whether the non-breaching party can reach a transaction with a third party, and how much benefit it can obtain, are often uncertain when the breach occurs [25]. In the context of pre-contract, the functions of the contract include locking transaction opportunities and even restricting the counterparty from contracting with a third party. Abandoning other transaction

opportunities can also be understood as one of the preparations for concluding the principal contract. When one party's breach causes the other party to lose the opportunity locked by the pre-contract, opportunity loss actually occurs, which belongs to the performance interest loss of the pre-contract and the indirect reliance interest loss of the principal contract [26].

Regarding the proof and determination of the scope of opportunity loss, the primary factor to consider is the function of the pre-contract. If the pre-contract contains an exclusive contracting clause, the parties' transaction opportunities are restricted. Regardless of the transaction maturity of the contract, once a breach occurs, the parties will inevitably suffer opportunity loss, because they cannot seek alternative transaction opportunities under the constraints of the pre-contract. Since the parties have not negotiated with a third party before the breach, the amount of opportunity loss can be determined by the alternative transaction method, taking the difference between the contract price and the alternative transaction price at the time reliance terminates as the loss amount [27].

If there is no exclusivity clause in the pre-contract, the parties are not contractually restricted from seeking other transaction opportunities. At this point, the key factors to consider are: the validity type of the pre-contract and the progress of the transaction between the parties and the third party. If the pre-contract itself is of the weak validity type, it is unconvincing for the parties to claim that they rejected other opportunities in reliance on the pre-contract, as mature transaction subjects are capable of negotiating with multiple counterparties at the same time. Furthermore, after the existence of opportunity loss is proved, further attention should be paid to the progress of the transaction between the parties and the third party. The degree of negotiation reflects the possibility of the parties obtaining other transaction opportunities [28], which can be used to determine the specific amount of opportunity loss.

4. Conclusion

To define the scope of damages for breach of pre-contract, we should return to the functional logic and validity types of the contract itself. Traditional doctrines such as the "doctrine of mandatory contracting" and the "doctrine of good-faith negotiation" cannot meet practical needs due to their excessive simplification, and adopting transaction maturity as the basis for typology is a better approach. Accordingly, pre-contracts can be divided into two categories: those with strong validity and those with weak validity. The former gives rise to a high expectation of the parties for the establishment of the principal contract, and all expenses incurred for preparing for the performance of the principal contract shall be compensated; the latter only creates a reasonable expectation of subsequent negotiation, and compensable losses are limited to reasonable expenses in the negotiation stage. As for opportunity loss, the key to judging whether the loss has definitely occurred is the presence of an exclusivity clause, and the amount shall be comprehensively evaluated in combination with the degree of negotiation between the parties and the third party. A unified standard is not suitable for damages for breach of pre-contract. Instead, necessary room for judicial discretion should be reserved within the typological framework, so as to achieve accurate protection of the parties' reasonable reliance.

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