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LETTERS OF INTENT - HOW ENFORCEABLE ARE THEY?

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## INTRODUCTION

Parties in small and mid-sized transactions often face unexpected consequences when they sign letters of intent ("LOI's") without legal advice. Acting on the belief that they need to "strike while the iron is hot" and save on counsel fees, and wrongly assuming that a LOT (also called a Memorandum of Understanding or Heads of Agreement) is not really binding, clients create obligations for themselves (and potentially significant barriers for their counsel) that can come back to haunt them down the road. Thus, some LOT basics should be the subject of attorney-client discussions as soon as the client plans a transaction. This article will outline some of those basics and explain how an LOI can bring unpleasant surprises with it.

## WHY PARTIES SIGN AN LOI AND WHY THEY SOMETIMES DON'T

First, let's consider the motivations for entering an LOT: (i) to flesh out the basic terms of the deal, thereby avoiding convenient "loss of recollection" by one or both parties as the transaction progresses; (ii) if the parties are in agreement on the major items to be negotiated, to provide a roadmap for the drafters of the definitive agreements; (iii) to expose areas of misunderstanding or disagreement that require further negotiation or could be serious hurdles; and (iv) to induce action by third parties, such as financing sources or regulatory bodies, whose funding or assent may constitute conditions to closing. Conversely, it may not make sense to enter an LOI: (i) too early in the transactional process, before the major terms have been ironed out; (ii) if the parties are well into the specifics of documentation, in which case they ought to proceed directly to negotiating and drafting the definitive agreements, particularly if time is critical; (iii) if the parties do not wish to disclose – for many possible reasons - that they are in negotiations, since a publicly held company is still obligated to disclose the signing of a binding and material LOI; or (iv) if the transaction costs of the deal are low, so neither side faces a significant loss if the deal "craters" over a misunderstanding. Finally, as we will see, if a party worries about being held to a "good faith" standard of negotiating or even being bound by the LOI to complete the deal, it may not wish to have an LOI.

Each party to an LOI wants to have the freedom to negotiate and enforce the nascent deal or break it off without adverse consequences, but at the same time hopes to bind the other side as much as possible. Typically, buyer wants to set a maximum price likely to induce target to move forward and then to begin to reduce it as due diligence provides opportunities to trade the deal down. Buyer also seeks some assurance of target's seriousness in completing a deal before it expends significant amounts of time and money on the due diligence investigation. Target wants to maintain whatever price and terms were provisionally agreed upon and reduce to a minimum the price trade down. Simply stated, target usually seeks as binding an LOI as it can get and buyer wants mainly an exclusive period during which target will negotiate only with buyer while

due diligence, financing and other issues are being thrashed out. Both parties want some kind of confidentiality.

## BINDING PROVISIONS

Most LOI' s contain a mixture of binding and non-binding provisions. Confidentiality is usually a key, binding term. Obtaining information on target is often quite difficult, particularly if the parties are competitors, and also because the target's principal value increasingly lies in its intellectual property, trade secrets and know how, which - if disclosed - could be extraordinarily detrimental to it. The legally binding confidentiality provisions of the LOI provide a modicum of assurance on this point. Because of these sensitivities, the parties may agree in the LOI to a process of staged disclosure, with certain non-sensitive information (i.e., the target's charter, bylaws, management biographies and preliminary financial information) disclosed even prior to the LOI' s execution. More detailed information (i.e., description of day-to-day operations, workforce details and competitive environment) may be first disclosed in the period between the LOI, with its binding confidentiality provision, and the signing of definitive agreements.

As negotiations proceed, concerns may arise on both sides that antitrust regulators may regard the discussions as merely pretextual and mask – in the regulators' view - the parties' true desire, i.e. to collude on pricing or market allocation. This concern may call for prophylactic measures, such as having independent third parties summarize data on the prices offered to target's key customers prior to such data's being disclosed to buyer.

The most sensitive information (i.e. non public proprietary information, detailed regulatory and environmental issues and other contingent liabilities) may be reserved for the post contract – pre closing period, as a buyer's condition to closing. Some items may not even be disclosed in detail until the closing itself.

Buyer too may seek to keep its confidential information (including the structure of the deal) away from the eyes of competitors or other bidders after any exclusivity period expires. In addition, it will usually want assurances that it is not expending substantial sums on a target only to see the target snapped up by another bidder. Thus buyer may require the LOI to state that, upon its execution, target will suspend discussions with any existing, third party and inform buyer of third party bids, even if these are immediately rejected. Conversely, however, targets do not want to be taken off the market for too long and may be expected to push back on lengthy exclusivity periods which, in any case, can be extended by a simple one-page amendment to the LOI if negotiations are proceeding apace.

Target may also seek a binding, "non-poaching" provision, forbidding buyer from soliciting or hiring its key people during the pendency of the deal and for a reasonable period thereafter.

Significantly, buyer wants the LOI to ensure as nearly as possible that target will preserve its business intact, an obligation that will also be memorialized in the definitive agreement. Thus, the LOI may bind target to continue to operate its business in the ordinary course without, for example, selling off assets essential to buyer's plans for target's business. Remember that these "assets" can also include human assets, such as key or gifted employees, who might be transferred to other divisions or affiliated companies.

The treatment of expenses and a break up fee is sometimes included in the LOI. Typically, each party bears its own expenses. But certain costs, such as the Hart Scott Rodino premerger notification fees, may be the subject of other arrangements. Break up fees are less likely if the transaction is kept confidential, because other potential bidders won't know that the target is for sale and are thus less likely to appropriate the fruits of buyer's time and expense.

Other binding LOI provisions often include: (i) "no shop" provisions; (ii) mutual consent before public disclosure of the LOI; (iii) governing law provisions – which we will see can be significant; (iv) dispute resolutions provisions – important in any binding agreement; and (v) designation of which sections of the LOI are to be binding.

## NON-BINDING PROVISIONS

Other provisions of the LOT are usually not intended to be binding, such as the type (assets or share, type of merger) and terms of the transaction (pricing and structure), which will often change following due diligence. Aspects of due diligence not covered in the binding confidentiality portion of the LOI are often covered here. But binding or not, these provisions typically change only due to circumstances that unfold following the signing of the LOI. Examples of changes include: (i) the structure of the transaction (for tax, consent, liability or other reasons); (ii) the parties (i.e., the formation of subsidiaries to become parties to triangular mergers); (iii) the price (which may change as a result of due diligence); (iv) the assets and liabilities to be a acquired and those that are to be left behind or spun off at or following the closing; (v) conditions to closing (such as antitrust approval or the availability of financing and third party consents); and (vi) material ancillary agreements, such as escrow and guaranty agreements, technology licenses, supply agreements, real estate leases, employment agreements and service contracts.

While, as will be seen, parties to an LOI are legally permitted to vary the non- binding terms of the deal without a change in circumstance or the unexpected discovery of facts unknown to the parties at the time the LOI was signed, prudence dictates that excessive deviations from such terms be avoided, lest the mutual trust that is the bedrock of any negotiating process be eroded.

It is a must that the LOI be clear on which terms are binding and which are not, lest the parties have differing expectations as to the enforceability of such terms. The rubber meets the road on this distinction when a target gets a better offer from a third, party, a buyer finds more attractive assets to acquire or either one gets cold feet and wants to walk away from the deal.

## LEGAL PREDICATES

U.S. law generally imposes some duty to perform a contract in good faith *once it exists.* But as Lake and Draetta point out in their book Letters of Intent and Other Precontractual Agreements, these duties do not arise in the *pre-contractual* stage. Neither the duty of good faith found in the Restatement (Second) of Contracts or the Uniform Commercial Code applies to this stage. Determining the practical effects of a duty of good faith during the pre-contractual stage is hard to determine. To succeed under a claim of promissory estoppel (a kind of breach of good faith theory) plaintiff needs to show its reasonable reliance on defendant's express promise and resulting damage from breach of that promise. US courts seldom find a sufficiently clear promise to create liability. Mere participation in negotiations and discussions does not create binding

obligations, even if agreement is reached on all disputed terms. Nor is this principle altered by the fact that parties may have entered into LOI's with the understanding that neither side would be bound until final agreement was reached. This absence of an obligation of good faith is in contrast to a concept known for example in Germany, which can in theory, award damages for bad faith negotiations *prior* to the signing of a binding LOI. Despite this concept, an LOI in Germany is generally taken less seriously than in the United States, perhaps precisely *because* this legal doctrine (a substitute for trust) exists but is seldom enforced.

An overview of a leading New York State decision puts the risks in perspective. The decision in *Teachers Insurance & Annuity Association v. Tribune Co.,* sets forth a frequently cited framework for analysis. *Teachers* found that a binding *preliminary* agreement existed. Here, the document was an extensively negotiated loan commitment, but the parallel to an LOI is clear. As a result of the court's finding, the lender and borrower *were* required to negotiate in good faith the open issues of the deal. The obligation did *not* require that a complete contractual understanding had to be reached. Rather, it prevented the party seeking to withdraw from the deal (in this case, the bar-rower, since interest rates had fallen) from simply abandoning the negotiations or insisting on conditions in material non-conformity to the LOI. The learning from *Teachers* is interesting because from it, LOI's can be classified as belonging to one of three discrete types that we call: Type 1, Type 2 and Type 3. (While *Teachers specifically* described only the first two binding types, by implication, there is a third, a non-binding type.

1. Type 1: Fully Binding – In a Type 1 LOI, all the material terms have been agreed to and the parties need only negotiate a more detailed version of those terms to close. This type prevents a party from backing out of the transaction or permits the other party to sue for damages. Here, the spoken or unspoken threat of such legal action may be enough to affect the relationship or the parties' future negotiations. A party seeking to minimize litigation exposure should take special pains to be certain its LOI is not this type.

2. Type 2: Duty to Negotiate – Only some of the key terms have been agreed to in a Type 2 LOI, but the parties clearly agree to be bound by it and to negotiate the rest of the terms in good faith. While this is an enforceable obligation, if the parties do not reach a final agreement, despite their good faith attempts, the obligation has been fulfilled. A party that can prove breach of the good faith negotiation duty can seek specific performance of the LOI but can't claim that it lost the benefit of its bargain. A party that wishes to enforce the LOI as a Type 2 LOI must be certain that it is quite explicit as to the parties' legal and binding duty to negotiate in good faith. In *Teachers,* it was clear that the borrower wanted the lender's firm commitment, but not after interest rates dropped.

3. Type 3: Non-Binding – This type of LOI is not intended to be binding and, as noted, *Teachers* did not expressly describe it as a type of LOI. Here there is *no* obligation to negotiate in good faith and the underlying transaction lacks too many significant points to be enforced as an expression of the parties' intent. Either party may break off negotiations for any reason or for no reason, subject to whatever binding provisions the parties have agreed on.

As is the case with the construction of any agreement, courts will review the facts to determine which type of LOI is present and whether the minds of the parties met. The four key factors in finding a Type 1 LOI are:

(i) whether there has been an express reservation of the right not to be bound in the absence of a writing; (ii) whether there has been partial performance of the contract; (iii) whether all of the terms of the alleged contract have been agreed upon (subject to the Statute of Frauds requirement of a written contract for the sale of goods exceeding a modest amount); and (iv) whether the agreement at issue is the type of contract that is usually committed to writing.

Other considerations include (i) the presence or absence of language showing mutual intent to be bound (i.e., language explicitly *stating* that the parties intend to be bound even in the absence of a more formal, detailed agreement), (ii) unsigned signature lines (evidencing absence of agreement); (iii) the requirement that certain actions be taken immediately (implying that the party required to act may do so in reliance on the LOI); and (iv) whether there is a "merger" clause (that the LOI supersedes all prior agreements) and language indicating that open terms are mere formalities.

In weighing partial performance, courts will consider whether the performance was significant given the whole transaction and whether a deal can readily be undone. Indeed, a party seeking to make an ambiguous LOI binding may start to perform to help ensure the LOI's enforceability. Its counterparty should not assume that it can accept or ignore the benefit of partial performance without consequences. • Lower level managers should thus be warned not to accept such performance if their employer does not yet wish to be bound.

A Type 2 LOI is rare but may be found and enforced to prevent a party from acting in bad faith by arbitrarily renouncing the deal, abandoning negotiations or insisting on conditions materially at odds with provisions in the LOI. Specific performance relief *is* a remedy in such circumstances, but *not* benefit of the bargain damages.

Under what circumstances can plaintiff persuasively argue that defendant failed to negotiate in good faith? (i) When defendant is shown to have acted arbitrarily or can be shown never to have seriously intended to complete the transaction; (ii) when defendant aborts the negotiation for no reason or for capricious ones (i.e., previously undisclosed budget constraints, the absence of financing, evidence that the party is negotiating several transactions concurrently with an eye to closing only one, whether or not buyer had an exclusive to negotiate with target as part of the LOI, contriving hitherto undisclosed conditions to closing, pretextual assertions of lack of authority or a manifest attempt to negotiate solely for the purpose of setting a price for reasons other than consummating the deal in question (i.e., treating buyer as a "stalking horse" or seeking to obtain a valuation metric to be used in financing negotiations with the another investor); (iii) when defendant's post-LOI negotiations show a clear inconsistency with the LOI's terms, unjustified by discovery of material changes in facts or circumstances in the counterparty; (iv) when defendant's negotiating positions demonstrate an intent to harm the counterparty or frustrate it from pursuing another opportunity.

One may reasonably expect that the stronger the evidence of bad faith, the more likely the LOI will be deemed enforceable, simply as a matter of equity and human nature. Conversely, the party seeking to terminate the transaction will improve its position by disclosing legitimate factors prompting it to opt out of the deal. Parties with material, undisclosed reservations about the transaction should avoid LOI's that expressly, or by clear implication, impose a good faith standard during the negotiation process. Should a good faith standard be part of the LOI, defendant will argue that the standard is overly vague, assert the absence of agreement on

material points and hope it excluded from the LOI those terms by which it did not intend to be bound. Reluctant dragons of this sort will attempt to impose restrictions on any announcement of the LOI's signing. Thus, the party seeking to break off the negotiations should avoid the appearance of having acted in bad faith by providing plausible reasons for its withdrawal.

## CROSS BORDER CONSIDERATIONS

Generally, New York law discussed above lies somewhere between English law and continental civil law on the issue of the obligations that arise in negotiations. Like U.S. law, English law generally imposes some duty to perform a contract in good faith *once it exists.* But, unlike the application of civil law in certain jurisdictions, these duties do not arise in the *pre-contract* stage. In civil law countries, whole bodies of law have grown up around the obligation to negotiate in good faith.

These differences in obligations at the LOI stage depending on applicable law make the determination of the location of negotiations important and a binding choice of law in the LOI quite necessary. Similarly, choice of remedies and submission to exclusive jurisdiction, apparently of only secondary importance at the LOI stage, could be important if the laws of a non-US country imposed substantial obligations on the unsuspecting U.S. party before the definitive agreement was signed.

## CONCLUSION

To avoid a dangerous gray zone where a party's rights and obligations are less than clear, the following minimum steps should be taken in drafting the LOI: (i) clearly differentiate between binding and non-binding provisions, usually by reference to the specifically numbered paragraphs of the LOI, making clear that only the ones intended to be binding *are* in fact binding; consider splitting the binding and non-binding provisions into two separate LOI sections or to be safer yet, two documents, one containing binding and other non-binding LOI provisions; (ii) make certain the deal points not yet finalized are known to be such (possibly by inserting blank spaces at such junctures or listing the open points and describing them as "material"), thus clearly manifesting the intent to make them subject to further negotiation; (iii) if possible, state in a legally binding paragraph, that only a later agreement signed by both parties is the final, binding expression of their intent; (iv) do not knowingly permit the other party to begin substantial performance of the agreement, at least to the point it cannot be easily reversed; (v) make no announcement that the key terms of the deal have been agreed to; (vi) specify the applicable law, especially in cross-border transactions, giving due attention to possible pre-final agreement obligations; (vii) when possible, avoid references to good faith in the LOI; and (viii) as in any contractual negotiation, wherever possible take the lead in drafting the document.

In sum, LOI's are serious documents with potential serious consequence, an insight that should inform their negotiation by both sides and claim the time and attention they deserve.