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A Letter of Intent Should Not Spoil the Venture

Litigation and Dispute Resolution

42 ASSOCIATION OF CORPORATE COUNSEL ACC DOCKET OCTOBER 2020 43

CHEAT SHEET

- ***Purpose.*** A letter of intent (LOI) should not serve as an automatic response to the start of negotiations, but it can be helpful as a document that outlines intentions for a complicated transactional relationship.
- ***Binding or non-binding.*** In LOI litigation, the first question is whether the LOI created an enforceable contract or an obligation to negotiate in good faith.
- ***Court considerations.*** Five common factors courts considering when determining if an LOI is binding are: language, presence (or absence) of essential terms, partial performance, transaction complexity, and extrinsic evidence.
- ***Read (and draft) carefully.*** To avoid litigation, parties should carefully and intentionally draft terms, understanding what (if at all) will be binding, and adhere to binding terms.

A Letter of Intent (LOI), also referred to as a Memorandum of Understanding, is commonly thought of as an "agreement to agree." When the parties to a proposed transaction begin to outline and negotiate their deal, they may draft and or execute an LOI to state their general intentions for the transaction and the efforts to negotiate. Historically, LOIs were frequently treated as a non-binding, unimportant formality or boilerplate document. Today, many lawyers continue to draft LOIs despite the uneasy feeling that they may be exposing the company to litigation risks.

In the late 1980s, the Court of Appeals in the First District of Texas affirmed a trial court's decision that a certain LOI formed the basis of an enforceable contract. After reducing the punitive damage award, total damages against the breaching party and a third party accused of tortious interference with the "contract" totaled over eight billion dollars. A year later, the same court pointed out that the Texas Supreme Court had refused a writ of error filed by Texaco but that the parties ultimately settled the case as part of Texaco's bankruptcy proceedings.

Businesses, and their lawyers, were shocked by the decision and the large amount of damages. Practice articles published around the time of the decision and afterward pointed out that attorneys often failed to understand the danger they posed. The practice articles contended that the Texas case created anxiety and reluctance or refusal to use LOIs in transactions. One attorney went so far as to refer to LOIs as "an invention of the devil."

Despite the fear caused by this case, it was not the first time a court held that an LOI created an enforceable contract — or the last. That said, perhaps it is time we dust off the spider webs on some of these cases and review how LOIs are dealt with in litigation. This article provides considerations for drafting LOIs, which are singular documents that should be tailored to each project.

Role of LOIs in litigation

LOI litigation ensues when one party tries to enforce an LOI because the parties failed to execute a definitive final agreement. These cases follow two typical patterns. In the first instance, the plaintiff

will attempt to prove the LOI alone was sufficient to create a binding contract and the defendant breached that contract. In the second type of case, the plaintiff will attempt to prove the LOI created a duty to negotiate in good faith and the defendant breached that duty.

In some cases, third parties may also be involved. In this scenario, a third party may be brought in on a claim of tortious interference, with the plaintiff arguing that the third party knowingly lured the defendant away from an existing contract or obligation. When an LOI is involved, the first question is whether that LOI created an enforceable contract or obligation to negotiate in good faith.

In these cases, a court must determine if the parties entered into a binding contract (or agreement to negotiate in good faith) even though the parties did not execute the final document that they envisioned. Courts will look to both potentially applicable statutes and facts evidencing the intent of the parties to guide their decision.

Statutes

Specific statutes may serve as a litmus test for whether the parties formed a binding contract. The simplest example of this is an LOI where the parties agree to do something illegal. As every law student learns when studying for the bar exam, a contract to engage in illegal activity is void. In these instances, the treatment of LOIs is the same. Whether an LOI created a binding contract is immaterial, as it cannot be enforced.

Another example is the Statute of Frauds. A contract or sale which is subject to the Statute of Frauds is unenforceable unless it is in writing and is executed by the person against whom is it being enforced. Certain other requirements may also be at issue. For example, in the case of a sale of real property, the written document must also contain a sufficient description of the property. Likewise, an LOI's failure to comply with the Statute of Frauds, if applicable, will prevent the formation of an enforceable contract.

> **When an LOI is involved, the first question is whether that LOI created an enforceable contract or obligation to negotiate in good faith.**

Under certain circumstances, whether an LOI created an enforceable contract, will depend on whether statutory requirements were met with respect to a specific type of agreement. In a case decided in early 2020, the Texas Supreme Court considered whether preliminary agreements and term sheets were sufficient to form the basis of a partnership under the Texas Business Organization Code. Notably, however, the court pointed out that in addition to its enumerated factors, the statute allowed for other principles of law and equity to be taken into account. The court's analysis involved both the statutory guidelines and more traditional factors, like intent of the parties.

An additional consideration is which state law applies, especially when the LOI contains a choice of law provision. Certain courts have pointed out that the choice of law provisions in an LOI only apply if the parties intended the LOI (or the specific choice of law provision) to be binding. If this is not the case, courts often apply the law of the jurisdiction with the most significant connections or interest in the action.

Intent of the parties

Cases involving LOI enforcement focus on whether the parties intended to enter into a binding agreement. Though it may not be true for every possible factor, generally, the intent of the parties is considered a question of fact which, in some cases, leaves the determination up to a jury. Acknowledging that there is some variation in different jurisdictions, we consider five common factors here.

Language

Similar to other contract disputes, courts assume that the wording used by the parties in drafting an LOI is the best indication of what they intended. Initially courts will look at any clauses that directly indicate whether the LOI is to be binding or not. Courts have also indicated that it is possible to create an LOI which specifically indicates that certain terms are binding, while others are not. In some states, the analysis need not go beyond this language, so long as it is unequivocal.

However, some situations are more nuanced. The LOI may lack specific language regarding its binding nature but include language from which it can be inferred. This requires a deeper analysis of the language and potentially an investigation into other factors. Importantly, words that initially seem straightforward may actually have dual meanings.

Imagine the LOI's language requires the parties to reduce their agreement into a final written contract. On the one hand, this language may be read as a condition precedent — the agreement will not be an enforceable binding contract unless and until the parties have executed the final written document. Alternatively, the language may be read as a condition subsequent — the parties will create a written contract to memorialize their agreement, but the agreement is enforceable regardless of whether that final writing is created.

The analysis is similar in cases involving good faith negotiation. If the LOI clearly states the parties must negotiate in good faith, they will be required to do so. If there is specific language indicating that the parties can walk away at any time and or for any reason (or no reason at all), a court is unlikely to find that the LOI requires negotiation in good faith. Lacking specific language on the subject, a court may consider whether other LOI terms provide indications that the parties intended that such a requirement exist. Especially where language is lacking or ambiguous, a court may consider other factors.

Presence or absence of essential terms

To successfully show that an LOI is an enforceable contract, a plaintiff must show that it contains agreed upon terms that the court can enforce. While a court may apply the presumption that an agreement with open terms will be unenforceable, it will not require that all possible terms be present.

Letters of Intent around the world

Elsewhere in the world, LOIs may be known as heads of agreement, accords de principe, *absichtserklaerungen,* preliminary agreements, or preparatory agreements. Unsurprisingly, the United States is not the only country where the legal consequences of entering into such an agreement should be considered. In some countries, the potential duty to negotiate in good faith is also an issue.

As you might expect, the United Kingdom's approach is similar to that taken in many US

jurisdictions. Whether an LOI is binding and enforceable in the United Kingdom depends largely on the intent of the parties, and court will analyze different factors to determine that intent.

Commentators have stated that the role of accords de principe in France are somewhat uncertain in that some jurists believe that these preliminary agreements are binding or at least create some sort of limited obligations, while others disagree. French law also imposes a duty of good faith during negotiations (regardless of the existence of an LOI or similar document).

In some countries, the requirements for creating a binding LOI are more formal. In Russia, for instance, an LOI is not binding unless it meets certain statutory requirements, causing it to be considered a "preliminary contract." The code sets forth the guidelines for such an agreement.

Under Brazillian law, the parties must be wary of the language and level of detail they use. Generally, the use of an LOI will not bind the parties, but if a preliminary agreement contains language or terms sufficient to show that the parties intend to be bound, it may be considered a legally enforceable "pre-contract." Parties in Brazil are also expected to act in good faith, even during negotiations, and acting otherwise may lead to a claim for damages.

Similarly, in China, parties who enter into negotiations owe each other a duty of good faith (regardless of whether or not the parties have entered into an LOI). Additionally, if one of the parties walks away from the deal after entering into an LOI containing the terms of the proposed deal, they may be liable to the aggrieved party for damages under those terms.

These examples illustrate that knowing the applicable law in your jurisdiction is paramount, regardless of where you are in the world.

Rather, it will only require the presence of essential terms. A court may supplement missing non-essential terms with terms that are "commercially reasonable."

Unlike most other factors in the intent analysis, whether an agreement contains all essential terms is a question of law. Notably, a party may disagree on whether a particular term is essential and even if a term is non-essential, a party may have good reason for that term to vary from what is considered "commercially reasonable." This can create additional risks for a party, as a court may choose not to take these disagreements or unique situations into account if it finds that the LOI includes the essential terms.

Partial performance

For cases involving LOIs, partial performance typically occurs when a party is certain that the LOI and negotiations will ultimately lead to a final contract or they believe that the LOI has already created binding obligations. Essentially, they deem the contract as a done deal and they begin performing on their obligations. In certain cases, it may be sufficient that a party started their performance. Other cases indicate that the partial performance of one party must be accepted by the other party in order for it to be a factor in determining the force and effect of the LOI. By accepting partial performance, the other party indicates that they agree that a binding contract has been

created.

Complexity of the transaction

Another factor a court may consider is the complexity of the transaction. The more complex a transaction, the more likely the parties are to go through rounds of significant negotiation, spelling out their understandings in LOIs, term sheets, or other documents in order to facilitate continued negotiation and drafting of the final definitive agreement. Courts understand that complex transactions are normally finalized by a formal, detailed, executed writing and may be more likely to find that the parties did not intend for an LOI to create that final binding contract. However, the expectation that such a complex deal will be finalized in an equally complex, executed contract may not alone be sufficient to render an LOI non-binding. Even in complex or large transactions, however, a court may find that a preliminary agreement is binding (as a final agreement or a commitment to continue to negotiate and close the transaction) if that type of agreement is a customary part of the particular type of transaction.

Extrinsic evidence

A court may also look to extrinsic evidence when determining whether an LOI created an enforceable contract or a requirement to negotiate in good faith. This extrinsic evidence could include the parties' history of negotiations, communications between the parties, communications the parties made to the public, unused drafts, circumstances surrounding the negotiations, etc. In certain states, these expressions could be very important. Under New York law, for example, if a party states that it will not be bound until a final written agreement is executed, then no oral discussion of terms or agreements create a binding contract. In regular contract interpretation cases, the parol evidence rule restricts courts from looking at extrinsic evidence. However, courts have pointed out that their initial role in LOI cases is not contract interpretation, but determining whether an enforceable contract exists in the first place. For that role, they argue, the parol evidence rule does not apply.

Items that make it more or less likely that a court will say the LOI is binding

LOI states that it is "non-binding."

LOI states that the parties must negotiate in good faith.

LESS LIKELY

- LOI states that it is "non-binding."
- Parties are negotiating an agreement to do something illegal.
- LOI does not meet the Statute of Frauds or other statutory requirements (where applicable).
- LOI states that the parties may exit negotiations at any time.
- Parties entering a complex transaction typically requiring rounds of negotiations and or a detailed final contract.

MOST LIKELY

- LOI states that the parties must negotiate in good faith.
- LOI contains all essential or material terms of the agreement.
- A party begins performance.
- A party accepts performance or partial performance.
- Inter-party communications treated the LOI as binding.
- LOI clearly indicates that execution of final agreement is condition precedent (not subsequent).
- Press releases state the parties have reached an agreement.

Considerations in drafting

While it is true that you do not need to use LOIs in every contract development situation, they are not monsters or the devil. It is unnecessary to fear or avoid them at all costs. Rather, each transaction should be treated as unique and each party (in conjunction with their in-house and/or outside counsel) should take the time to consider whether to use an LOI and what it should contain. Some key drafting considerations include determining if the situation necessitates an LOI, whether the parties actually want one, whether it should be binding, and how the parties' actions may affect the LOI's enforceability.

Is an LOI necessary?

The necessity of an LOI rests, at least in part, on the complexity of the transaction and the anticipated length of negotiations. If a significant contract or set of contracts is envisioned, the parties may need a place to hammer out the initial sketch of how the transaction and their relationship will develop. The more time, money, and other resources a party will put into negotiations and the transaction's development, the higher the cost of the deal falling through. Essentially, the more risk each party is taking on by engaging in negotiations, the more necessary it is to protect themselves from a deal's untimely termination.

Is an LOI wanted?

An LOI should not serve as a boilerplate, catch all, or an automatic response to the start of negotiations. Rather, the parties, individually and together, should determine what items they want in this initial stage and need to draft documents specifically addressing the same. For example, if the parties are only concerned with trade secrets and confidentiality, they can simply draft a confidentiality agreement. If their only concern is to ensure exclusivity, prevent "shopping," or at least provide for a right of first refusal, they can draft an exclusivity agreement or a separate right of first refusal agreement. However, if the parties' desires are more complex or there are multiple interrelated items that they wish to set out, an LOI (alone or in conjunction with other agreements), may be the best option.

Will the LOI be binding?

If the parties choose to use an LOI, they need to decide if they want it to be binding. With those intentions in mind, the attorneys drafting the LOI should look at statutes and case law to determine what elements or language make an LOI binding in the applicable state. Regardless of the jurisdiction, the LOI should clearly state whether or not it is binding. If needed, drafters should create separate sections for terms that are binding and non-binding and should specifically identify the terms in this way.

Drafters should be careful with the language used to indicate that the contract will be binding or non-binding. As described earlier, a statement that the parties must execute a final written contract may be interpreted as a condition precedent to creating a contract or merely an additional term of an already enforceable contract, to be treated like any other. Drafters should avoid language that may have alternate meanings or create ambiguity.

> **An LOI should not serve as a boilerplate, catch all, or an automatic response to the start of negotiations. Rather, the parties, individually and together, should determine what items they want in this initial stage and need to draft documents specifically addressing the same.**

Drafters should also include or exclude the essential terms of the deal, depending on whether or not they want the LOI to be binding. A court will be more likely to determine that an LOI is a fully enforceable contract if it includes all essential terms. Again, a careful reading of the state's case law is needed here, however, as courts and drafters may disagree on whether a term is "essential."

Each party should also determine whether they want to bind themselves and the other party to negotiate in good faith. This, of course, will vary based on the type of deal, the level of risk each party is taking on, and whether they think better offers or options may present themselves during negotiations. If the party anticipates that the market may change or better options may arise, they should include language in the LOI allowing them to walk away from the negotiations at any time and for any reason. However, if the party is concerned that there is a risk that they may be out significant time, money, or other resources if the other party walks away, they should consider language which clearly indicates that the parties must negotiate in good faith. Both parties should consider whether a time limit should be placed on this requirement.

> **One of the goals of any transaction is to avoid litigation. Avoiding a courtroom once an LOI is drafted seems simple enough — follow the binding terms, if any, of the LOI and everything will be fine.**

How should a party modify its actions?

Events and communications occurring around or after the LOI's creation may inform a court's decision as to whether it is binding. Therefore, the parties should not assume that the presence or absence of something in the LOI will fully protect them. Making subsequent promises, communicating with the other party, and even public announcements are actions that should be weighed carefully. A party should consider putting language in the LOI (especially one that they intend to be binding) that prevents such statements from being enforceable. Additionally, with only an LOI in place, a party should not accept partial performance unless they are required to, as it may negate their ability to

later argue that the LOI was non-binding.

Moving forward

One of the goals of any transaction is to avoid litigation. Avoiding a courtroom once an LOI is drafted seems simple enough — follow the binding terms, if any, of the LOI and everything will be fine. If there is a "no shopping" provision, simply do not shop. If there is a requirement to negotiate in good faith, do not walk away just because the market changed. If it were this simple, however, there would not be so much fear and anxiety regarding the use of LOIs, and there would be a far less robust selection of case law on the subject.

If the parties chose to use an LOI, as opposed to more narrowly focused preliminary agreements or no agreements at all, then they must recognize that the terms of that LOI are important and have the potential be intensely analyzed by a court. That said, LOIs are not as scary as imagined. By using them only when appropriate and desired, parties can avoid confusion over whether an LOI is binding and what its terms mean. Similarly, by taking the time to develop the terms of the LOI rather than treating it as an automatic or boilerplate document, a court involved in the LOI's interpretation will be working with language that the parties actually intended to use. Finally, by conducting themselves in alignment with the terms of the LOI and how they intend it to be interpreted, parties can avoid "breaching" the LOI, even if a court determines it is binding.

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