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CYA On That LOI: Avoiding Liability Under Preliminary Agreements

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Parties to a potential transaction typically carry out their negotiations in a series of stages from conceptual discussions to definitive agreements. The initial stages often include the negotiation of material terms, which are then reflected in purportedly non-binding indications of interest, letters of intent and term sheets. During these initial stages, the parties may or may not seek the advice of counsel to ensure that they do not prematurely bind themselves. Despite the best of intentions, however, a seemingly non-binding "indication" can quickly turn into an alleged "preliminary agreement" through the hindsight of a scorned putative counterparty. Seldom-parsed variations in local state laws can further complicate an analysis of the exact moment when a possible transaction becomes binding and can create further potential liability for the unsuspecting.

Setting The Stage

Consider the following familiar scenario: A private company has identified a possible strategic acquisition, executed a valid confidentiality agreement and completed its initial business diligence on the target. The buyer and the target next exchange a series of e-mails outlining both (i) the agreed resolution of the material terms of the possible acquisition (possibly an attached term sheet) and (ii) the parties' intent to pursue the transaction on the terms described in the e-mail or term sheet. As a next step, the buyer requests that its counsel draft a letter of intent reflecting the material terms of the proposed transaction and providing for a period of exclusivity during which the parties agree to negotiate in good faith to enter into a definitive purchase agreement. The parties sign the letter of intent with boilerplate language indicating that it is non-binding except with respect to confidentiality and exclusivity. After working diligently toward a definitive agreement but prior to expiration of the exclusivity period, the buyer elects, based on its due diligence review, not to proceed with the transaction and promptly informs the target of its decision.

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Putting Preliminary Agreements Into Context

Is there a binding agreement of any kind in the above scenario? If the target is content to accept the would-be buyer's decision not to proceed with the acquisition, then the answer is academic. Issues of the existence and enforceability of so-called "preliminary agreements" arise primarily because one party seeks to enforce the terms of such an agreement. The question, then, is whether the parties' language was clear enough to either demonstrate or disprove that there was an actual intent to be bound. We next examine the hypothetical scenario to answer this question through the lenses of varying state laws.[1]

First Things First – Setting Expectations

There is certainly at least one binding agreement in our scenario above: the confidentiality agreement. If well drafted, a valid confidentiality agreement will typically include explicit language specifying that "neither party will be obligated to pursue the possible transaction unless and until the parties enter into a binding [definitive][2] agreement with respect thereto." Although not technically necessary in the context of most confidentiality agreements (as they lack material terms specific enough to be enforced as an acquisition agreement by themselves), this boilerplate serves the valuable purpose of negating another essential prong of a valid acquisition agreement: intent to be bound. This same wisdom applies to all forms of preliminary documentation including letters of intent, term sheets and even e-mails. For this reason, a well-drafted "invalidating clause" is essential in making clear the parties' intent not to be bound.[3] It is also worth noting that, even with an invalidating clause expressly disclaiming the binding nature of a letter of intent, the subsequent actions of the parties, including partial performance of obligations, can create issues of fact regarding intent to be bound.[4] For this reason, parties should consider additional language in the invalidating clause explicitly disclaiming the parties' intention to be bound as a result of subsequent actions.[5]

E-mail Agreements

In the above scenario, the buyer and the seller exchanged a series of e-mails agree-

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ing to resolution of all material terms. Is it possible that this e-mail exchange formed a binding contract? Yes, it is possible, and, depending on the surrounding circumstances, including the parties' intent and actions, this fact pattern creates precisely the kind of genuine issues of material fact that could preclude summary judgment. Delaware,[6] Massachusetts,[7] New York[8] and Texas,[9] for example, have confirmed that an e-mail chain or even a single e-mail may create a binding contract.

Contemplating A Definitive Agreement

The signed letter of intent in our scenario contemplated a later definitive agreement. Is that sufficient to obtain summary judgment on the issue of contract formation? It is important to note that simple reference to a later definitive agreement may not prevent a term sheet, letter of intent or similar discussion draft from becoming a binding contract.[10] Instead, the primary issue will be whether the parties intended to be bound by the preliminary documentation. As one Massachusetts court has framed the issue:

> While it is true that the parties' intention to execute a final written agreement justifies a strong inference that the parties do not intend to be bound until the agreement is executed, it is also true that if all the material terms have been agreed upon, it may be inferred that the [definitive agreement] to be drafted and delivered is a mere memorial of the contract.[11]

Letter Of Intent As Binding Preliminary Agreement

The letter of intent in our scenario could potentially give rise to two kinds of binding preliminary agreements: (1) an agreement obligating the parties to consummate the transaction based on the agreed material terms ("Type I"), and (2) an agreement obligating the parties to negotiate in good faith toward a definitive agreement based on the material terms described in the letter of intent ("Type II"). The potential enforceability of our letter of intent as a Type I or Type II preliminary agreement and the standard to prove enforceability of the letter of intent differ based on the applicable state law.

Texas: Type I Only

Under Texas law, valid contract formation requires that a present intention to be bound be coupled with terms specific enough to determine the existence of a breach and provide an appropriate remedy.[12] Additionally, a binding contract in Texas must not leave any essential or material term open to future negotiation.[13] Which terms are essential or material will be examined on a case-by-case basis.[14] If a Type I preliminary agreement satisfies the requirements of contract formation, then Texas courts will enforce its terms, even if a later definitive agreement is contemplated[15] and even if parties leave open immaterial provisions for later negotiation.[16] Unlike Delaware and New York, Texas categorically rejects Type II preliminary agreements:[17] "[U]nder Texas law, an agreement to negotiate in the future is unenforceable, even if the agreement calls for a 'good faith effort' in the negotiations."[18]

Massachusetts: Type I Only

Massachusetts will enforce Type I preliminary agreements if the parties express an intent to be bound by definite terms, but it does not recognize Type II preliminary agreements.[19] In Massachusetts, contract formation requires an agreement between the parties as to material terms and a present intention to be bound by that agreement.[20] Although all terms need not be explicitly spelled out, Massachusetts requires that the parties "have progressed beyond the stage of imperfect negotiation."[21] The Commonwealth's approach to Type I preliminary agreements is similar to the approach taken by courts in Texas. Given a sufficient description of material terms (which are examined on a case-by-case basis), some courts in Massachusetts have imposed on parties an obligation to close a transaction lacking certain terms if there is a procedure for arriving at resolution of those terms,[22] even going so far as to read out closing conditions and judicially impose definitions for undefined terms in granting specific performance of a preliminary agreement that explicitly contemplated a definitive agreement.[23]

Delaware & New York: Type I & Type II

Delaware and New York courts have enforced both Type I and Type II preliminary agreements.[24] Similar to Texas, Massachusetts and Delaware, Type I preliminary agreements are only created under New York law "when the parties agree on all the points that require negotiation (including whether to be bound) but agree to memorialize their agreement in a more formal document."[25] Likewise, Type I contract formation in Delaware requires sufficiently definite terms.[26] In both states, the question of which terms are material will be examined on a case-by-case basis. Delaware and New York also permit enforcement of Type II preliminary agreements if the parties evidence the desire to be bound to negotiate open issues in good faith in an attempt to reach agreement.[27] Commitment papers for an acquisition financing are the most common example of a Type II preliminary agreement.[28] Typical commitment papers are not enforceable as a definitive agreement, but instead contemplate a definitive loan agreement to contain "such representations and warranties, closing conditions, other covenants, events of default and remedies, requirements for delivery of financial statements, and other information and provisions as are usual and customary."[29] Under Delaware and New York law, our letter of intent is likely at minimum a Type II preliminary agreement with a binding obligation to negotiate in good faith based on the agreed material terms. Depending on the facts and circumstances, our letter of intent is perhaps even a Type I preliminary agreement. In either event, our scenario is unlikely to result in summary judgment for the party seeking to avoid enforcement under Delaware or New York law.[30]

Key Takeaways

- Preliminary agreements take many different forms, and obligations and liabilities under such agreements differ by state (or foreign jurisdiction).
- Be careful discussing material terms via e-mail, as e-mails can create a binding contract.
- Parties should make conscious efforts to avoid evidencing an intent to be bound and should use an appropriate invalidating clause whenever possible (including language disclaiming intent to be bound by future actions).
- Explicitly contemplating a definitive agreement is helpful, but it is not dispositive as to whether a binding agreement exists.
- Some jurisdictions will enforce "agreements to agree" even if not all terms have been discussed or included.
- Whether a term is considered "material" will vary on a case-by-case basis, so parties should be certain to either identify any open material terms or otherwise indicate that essential terms remain unresolved.

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1 This review focuses on the four states whose governing law most commonly controls agreements that the authors are asked to review: Delaware, Massachusetts, New York and Texas.

2 The bracketed word is sometimes omitted during the negotiation of the confidentiality agreement. For the reasons outlined below, it is preferable to make clear the parties' intent that the only binding agreement will be the definitive agreement.

3 A typical invalidating clause reads as follows: "Each of the parties acknowledges that no party hereto shall be bound to consummate the potential transaction described herein unless and until the parties execute a definitive agreement with respect to the potential transaction and then only upon the terms and conditions set forth in such definitive agreement."

4 *See COC Servs., Ltd. v. CompUSA, Inc.,* 150 S.W.3d 654, 667 (Tex. Ct. App. 2004) ("courts will consider whether performance conforming to the terms of

the parties' writings is probative of the issue whether there is a binding, enforceable contract"); *see also Brown v. Cara,* 420 F. 3d 148, 154-57 (2d Cir 2005) (finding that "partial performance" is one factor to be considered in determining contract formation via preliminary agreement); *20 Atlantic Avenue Corp. v. Allied Waste Indus*., 482 F.Supp.2d 60, 75 (D. Mass 2007) (examining subsequent actions of parties to determine intent to be bound).

5 *See* Glenn D. West & Sarah E. Stasny, "Corporations," 58 SMU L. Rev. 719, 728 (2005) (discussing Texas cases concerning potential binding obligations arising from the subsequent actions of parties to an expressly non-binding letter of intent).

6 *See Bryant v. Way,* C.A. No. 11C-01-164 RRC, 2011 WL 2163606 (Del. Super. 2011) (e-mail chain contained all required elements of a valid contract).

7 *See Basis Tech. Corp. v. Amazon.com, Inc.,* 878 N.E.2d 952 (Mass. Ct. App. 2008) (e-mail from counsel summarizing key settlement terms was accepted binding agreement upon opposing counsel one-word e-mail response "correct.").

8 *See Stevens v. Publicis, S.A.,* 854 N.Y.S.2d 690 (N.Y. App. Div. 2008) (e-mails constituted valid amendment to employment agreement).

9 *See APC Capital Corp. v. Mesa Air Group, Inc.,* 580 F.3d 265 (5th Cir. 2009) (single e-mail presented genuine issue of material fact sufficient to defeat summary judgment on the issue of contract formation).

10 *See, e.g.*, *Targus Group Int'l v. Sherman*, 922 N.E.2d 841 (Mass. Ct. App. 2010) (holding that parties to a preliminary agreement in principle were bound by its terms despite never reaching agreement on a contemplated definitive settlement agreement); *Kurker v. Shoestring Props. Ltd. P'ship,* 864 N.E.2d 24 (Mass. Ct. App. 2007) (holding that an offer to purchase, which contemplated a definitive purchase agreement, was enforceable on its terms).

11 *Situation Mgmt. Sys., Inc. v. Malouf, Inc.,* 724 N.E.2d 699, 704 (Mass. Sup. Jud. Ct. 2000) (internal quotations and citation omitted).

12 *Martin v. Martin,* 326 S.W.3d 741, 749 (Tex. Ct. App. 2010).

13 *Id.* at 751.

14 *Id.* at 753.

15 *Id.* at 751.

16 *See* West & Stasny, *supra* note 6 at 727-31.

17 *Martin*, 326 S.W.3d at 749.

18 *Id.* at 750; *see also Kevin M. Ehringer Enterprises v. McData Servs. Corp.,* 646 F.3d 321, 327 (5th Cir. 2011) (interpreting Texas law and holding that a contractual requirement to use "best efforts" was too indefinite and vague to provide a basis for enforcement).

19 *See Rosenfield v. U.S. Trust Co.,* 195 N.E. 323, 326 (Mass. 1935) ("An agreement to reach an agreement is a contradiction in terms and imposes no obligation on the parties thereto"); *PDC-El Paso Meriden, LLC v. Alstom Power, Inc.,* No. 04-P-1452, 2006 WL 902253 (Mass. Ct. App. 2006) (holding that an agreement to enter into a letter of understanding was not itself enforceable as the essential terms of the letter of understanding were not established).

20 *Dennis v. Kaskel,* 950 N.E.2d 68, 73 (Mass Ct. App. 2011); *see also*, *20 Atl. Ave. Corp. v. Allied Waste Indus., Inc.,* 482 F.Supp.2d 60 (D. Mass. 2007) (holding that a letter of intent was not a binding agreement as the parties lacked an intent to be bound).

21 *Situation Mgmt. Sys., Inc. v. Malouf, Inc.,* 724 N.E.2d 699, 703 (Mass. Sup. Jud. Ct. 2000) (internal quotations and citation omitted).

22 *See Goren v. Royal Invs. Inc.,* 516 N.E.2d 173 (Mass. Ct. App. 1988) (offer specifying that a mutually acceptable purchase and sale agreement would be executed was itself a binding contract where parties intended to be bound and all material terms were agreed).

23 *See Rand-Whitney Packaging Corp. v. Robertson Group,* 651 F.Supp. 520 (D. Mass. 1986).

24 *Vacold LLC v. Cerami,* 545 F.3d 114, 124 (2d Cir. 2008) (upholding enforceability of a Type I preliminary agreement under New York law and summarizing the dichotomy between Types I and II). It is worth noting that the Federal District Court for the District of Connecticut has interpreted Second Circuit precedent to prevent the enforceability of Type II preliminary agreements for a federal court sitting in diversity. *See Kopperl v. Bain*, No. 3:09-CV-1454 (CSH), 2010 WL 3490980, at *6 (D. Conn. 2010). The court in *Kopperl* also questions the continued validity of the Type I versus Type II distinction in general. *Id.*

25 *Vacold,* 545 F.3d at 124.

26 *Bryant v. Way,* C.A. No. 11C-01-164 RRC, 2011 WL 2163606, at *4 (Del. Super. 2011).

27 *Vacold,* 545 F.3d at 124; *J.W. Childs Equity Partners v. Paragon Steakhouse Rests.,* No. 16371, 1998 WL 812405, at *3 (Del. Ch. 1998) (agreement to "negotiate further terms in good faith" was binding, but parties had no binding obligation to actually enter into a future agreement); *see also Pharmathene, Inc. v. Siga Techs., Inc.,* No. 2627-VCP, 2011 WL 4390726 (Del. Ch. 2011). For those involved in cross-border transactions, the implied or express covenant to negotiate in good faith found in Delaware and New York can expand in certain jurisdictions to include a pre-contractual duty to negotiate a contract in good faith. The civil codes of France and Italy and the contractual provisions of Israeli statutory law, for example, create additional liability for pre-contractual damages if a party fails to negotiate in good faith. *See generally* Sylviane Colombo, "Present Differences Between the Civil Law and Common Law Worlds With Regard to *Culpa in Contrahendo*," 2 Tilburg Foreign L. Rev. 341 (1993).

28 *See, e.g.*, *Teachers Ins. & Annuity Ass'n of Am. v. Tribune Co.,* 670 F.Supp. 491 (S.D.N.Y. 1987) (holding that lender's commitment papers were binding Type II preliminary agreement).

29 *Id.* at 496.

30 It may, however, result in summary judgment for the party seeking enforcement. In *Vacold v. Cerami*, the Second Circuit held that when the evidentiary foundation for determining formation of a contract consists of writings only, contract formation is a question of law, not of fact. *Vacold*, 545 F.3d at 123.