Letters of Intent: Creating Inadvertent Obligations

By Marshall P. Horowitz and Joshua Schneiderman

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Parties have long used letters of intent, term sheets and memorandums of understanding (otherwise known as "LOIs") to express a preliminary interest in a transaction and to outline the general business terms of the potential transaction. LOIs save parties time and money, as they allow the parties to identify and resolve high level business issues before drafting more detailed transaction documentation. Since LOIs are often signed before the parties have hammered out the details of the transaction, the parties generally do not intend to create legally binding obligations (other than with respect to certain limited provisions addressing such matters as confidentiality and exclusivity). It is not uncommon, however, for parties unwittingly to create legally binding obligations in a hastily crafted LOI. If all or part of the LOI is determined by a court to be legally enforceable, a party that walks away from subsequent negotiations may be surprised to find itself liable for monetary damages.

Parties to an LOI typically intend for the document to serve as the framework for negotiating a legally binding transaction. Before investing substantial time and money into due diligence and incurring significant fees for outside advisors, parties like to ensure there is a "meeting of the minds" on fundamental deal terms. The intended nonbinding nature of the LOI also enables principals to reach general agreement on terms by simple reference to complex business concepts, which can later be expanded and refined with the assistance of counsel and other advisors in the final deal documents. A line of case law, however, demonstrates that the issue of whether an LOI creates any legally enforceable obligations is not black-and-white.

In a 2002 case, *Copeland v. Baskin Robbins U.S.A. et al.*, the 2nd District Court of Appeal ruled that a document intended to set out the general terms of a transaction may serve as the basis for a binding obligation to negotiate in good faith. Kevin Copeland was engaged in negotiations with Baskin Robbins over the purchase of an ice cream manufacturing plant. Baskin Robbins sent Copeland a letter outlining the proposed terms of the transaction and requesting that Copeland sign and return a copy of the letter, along with a non-refundable deposit. Copeland signed the letter and returned it to Baskin Robbins together with the requested deposit. After further negotiations, Baskin Robbins broke off the discussions and returned Copeland's deposit.

The 2nd District found that the parties had entered into a legally binding agreement – at least to negotiate – and that Baskin Robbins' termination of discussions without a valid reason constituted a breach of contract. The court explained that a "contract to negotiate" is distinguishable from an unenforceable "agreement to agree" and noted that, unlike the case with an "agreement to agree," the parties to a "contract to negotiate" can fulfill their obligations under such contract even if a definitive agreement is never reached. The *Copeland* ruling suggests that if parties to an LOI do not intend to create an obligation to negotiate a definitive agreement, they should expressly state that the LOI does not create such an obligation. Alternatively, if the parties do intend to create an obligation to negotiate in good faith, they should specify concrete actions that the parties must take to satisfy that standard.

A similar result was reached in a late 2009 case out of the Delaware Court of Chancery, *Global Asset Capital LLC v. Rubicon US Reit Inc.* With Rubicon facing potential bankruptcy, Rubicon and GAC entered into an LOI contemplating that the parties would enter into an agreement for GAC to act as a stalking horse bidder if Rubicon's assets were auctioned off through bankruptcy. The LOI also prohibited Rubicon from disclosing the terms of the LOI to third-parties and from soliciting additional offers. Shortly after signing the LOI, Rubicon resolved its liquidity problems after disclosing the terms of the LOI to its creditors as a negotiating tactic. GAC delivered a draft of the definitive agreement, and Rubicon did not respond. GAC filed suit to enforce the LOI, alleging breach of Rubicon's non-disclosure and non-solicitation obligations, as well as Rubicon's obligation to negotiate a definitive agreement under the LOI in good faith. Among other things, Rubicon claimed that resolution of its liquidity problems caused the LOI to expire.

The court held that Rubicon had breached the terms of the LOI. It specified that the duty to negotiate in good faith is an obligation that the court will recognize and protect. The court stated that Rubicon's failure to respond to GAC's draft of the definitive agreement was evidence that it had not satisfied its obligation to negotiate in good faith. If parties intend for an LOI to be nonbinding, the court said, they "can readily do that by expressly saying that the letter of intent is non-binding." The court continued, "parties enter into letters of intent for a reason. They don't enter into them…[to] be disregarded

whenever situations change. They enter into them because they create rights."

Adding to the complexity of case law surrounding LOIs, a 2011 decision by the Delaware Court of Chancery, *PharmAthene Inc. v. SIGA Technologies Inc.*, suggests that even a nonbinding term sheet presents risks for the parties. SIGA had been in the process of developing a new drug but needed funding. In 2006, SIGA and PharmAthene entered into a merger agreement, which provided that, in the event the merger failed to close, the parties would negotiate in good faith a license agreement consistent with the terms of a nonbinding term sheet between the parties attached to the merger agreement. After the merger failed to close, SIGA terminated the merger agreement and the parties commenced negotiations regarding a license. By that time, SIGA's drug had achieved some critical milestones, making it potentially much more valuable than was the case at the time the term sheet was negotiated. Subsequently, SIGA proposed economic terms for the license agreement that were "vastly different" from those in the term sheet. PharmAthene sued SIGA claiming it was obligated to execute a license agreement on terms consistent with the term sheet.

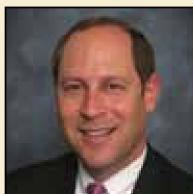
The court rejected PharmAthene's claim that the term sheet was a binding license agreement, but ruled that PharmAthene was entitled to damages for breach of SIGA's obligation to negotiate in good faith. It found SIGA liable for damages in light of PharmAthene's having provided financial and operational support to SIGA. The *SIGA* case provides a valuable lesson for parties to a term sheet even where the term sheet is unambiguously nonbinding: The parties' course of conduct in reliance on the term sheet can serve as the basis for liability.

As *Copeland* and *Rubicon* demonstrate, parties to an LOI may unwittingly create an enforceable obligation to negotiate in good faith absent obvious language to the contrary. For this reason, if parties do not want to create any such obligation, they must include an express statement that they do not intend to create *any* enforceable obligations by entering into the LOI. The parties should further specify that either party may terminate discussions at any time for any reason, and that the parties are not obligated to negotiate a definitive agreement.

If the parties intend for certain provisions of the LOI to be binding, the parties should insert those provisions in a separate and distinct section of the LOI and specify, both in the introductory paragraph and at the end (and perhaps as a header to each page), that other than those specific provisions, the LOI is not intended to create any legally binding obligation among the parties.

In addition, if the parties intend to create an obligation to negotiate a definitive transaction in good faith, they should specify concrete actions that the parties must take to satisfy that standard so the parties can determine with certainty when they are free to walk away from the deal. As the *SIGA* case demonstrates, parties to an LOI must be cautious in their dealings with one another as their course of conduct in reliance on a nonbinding LOI may itself serve as the basis for liability.

While LOIs are a tool of convenience and can be simple on their face, if the parties are not careful in their drafting and are not cautious in their subsequent conduct, they can easily find themselves tied up in costly and distracting litigation.



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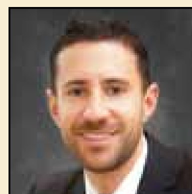

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