Shotgun Wedding? When a 'Proposal' Can Turn into a Forced Consummation of a Transaction

By Liana Epperson

A recent court of appeals decision drives home the importance of including non-binding language in letters of intent. Based on a one page, nine paragraph, 205 word document, labeled "Final Proposal," the court of appeals in *First National Mortgage Company v. Federal Realty Investment Trust*, 631 F.3d 1058 (9th Cir. 2011), found an enforceable contract—resulting in a multi-million dollar damage award. The court reached this conclusion even though the instrument provided that the "terms are hereby accepted by the parties *subject only to approval of the terms and conditions of a formal agreement*" and the duration of the contemplated lease was not expressly set forth in the Final Proposal.

The details of this case are instructive. The developer, Federal Realty Investment Trust, is a publicly-traded real estate investment trust, which, beginning in the late 1990's, sought to purchase or enter into a ground lease for the San Jose property in connection with its efforts to develop a mixed-use project known as Santana Row. To that end, the developer and First National Mortgage Company engaged in protracted negotiations over the course of several years. The parties exchanged various proposals including a "Counter Proposal", a "Revised Proposal", and a "Final Proposal".

Instead of providing that it was non-binding, the instrument provided that the "terms are hereby accepted by the parties . . .." The court minimized the latter part of that sentence, which provided that this so-called acceptance was *"subject only to approval of the terms and conditions of a formal agreement*." The consequences were significant for this highly complex, multi-million dollar real estate transaction, with the court awarding damages of $15.9 million to First National for lost rent and for the loss of a "put" option under the Final Proposal.

Instrumental in the court's decision that the Final Proposal was a binding contract was the fact that the initial proposals included the developer's standard "non-binding clause," indicating that the proposals were not binding on the parties. However, the Final Proposal intentionally omitted the non-binding clause. Principals of First National testified at trial that when the developer's President and CEO learned that prior versions of the proposal could not be enforced against First National, he allegedly stated: "If we're going to do anything together, I want both parties signing off[on] the document, and I want an enforceable contract now." On August 24, 2000, the developer, for the first time during the negotiations, omitted its standard non-binding provision from a signed offer presented to First National, and the Final Proposal was executed by the parties shortly thereafter.

The Final Proposal provided for rent of $100,000 per month, granted First National a ten-year "put" option that allowed it to require the developer to buy the property at any time during such ten-year period, and granted the developer a "call" option at the end of ten years, pursuant to which the developer could require First National to sell the property. The Final Proposal also provided that the developer would reimburse First National $75,000 to buy out the then current tenant of the property, New Things West. Under the Final Proposal, the developer

was to “prepare a legal agreement for First National's review to finalize the agreement,” and the last clause of the Final Proposal provided that “[t]he above terms are hereby accepted by the parties subject only to approval of the terms and conditions of a formal agreement.”

After the Final Proposal was signed, First National held an employee meeting stating that it had reached an agreement with the developer. The developer also appeared to treat the Final Proposal as binding by including costs for tenant buyouts, brokerage costs, and costs for acquisition of the property in its internal reports. While the parties continued their negotiations toward a formal lease pursuant to the Formal Proposal, First National gave the tenant of the property, New Things West, a notice to vacate and sought reimbursement from the developer for lost rental income. However, in a letter dated May 11, 2001, the developer rejected any indication that it had to reimburse First National and noted that “[b]ecause we have never resolved a number of significant business issues relating to the acquisition of the Property, we still do not have a binding agreement in place for that acquisition.” First National then sued the developer for damages as a result of the developer's anticipatory breach of the Final Proposal.

In its complaint, First National alleged that the developer had breached its contract by refusing to pay rent and repudiating First National's “put” to require the developer to buy the property. The district court rejected the developer's argument that the Final Proposal was not binding because of the last clause calling for a formal agreement, with the court of appeals affirming.

The court of appeals recognized the important role of non-binding preliminary instruments and acknowledged that an "agreement to agree" is not a binding contract. However, it also acknowledged that “[w]hether a writing constitutes a final agreement or merely an agreement to make an agreement depends primarily upon the intention of the parties…” After examining evidence to determine the parties' intent, the court concluded that an enforceable agreement had been created. The court stated that “[w]here the parties ... have agreed in writing upon the essential terms of the lease, there is a binding lease, even though a formal instrument is to be prepared and signed later. As such, the fact that the parties in this case were negotiating a new contract to replace the Final Proposal did not relieve either of them from their obligations under the Final Proposal, which was an existing contract.

The court of appeals also rejected the developer's argument that the Final Proposal was not binding because it omitted the duration of the lease, an essential provision. The court stated that the mere fact that a lease term is “essential” does not mean that it has to be express in the contract. While extrinsic evidence cannot be used to supply an essential term, it can be used “to explain essential terms that were understood by the parties.” In this instance, extrinsic evidence was admitted to determine whether the duration of the lease was completely absent or whether it could be implied from the ten-year put and call provisions. The court concluded that substantial evidence supported a finding that the parties intended the put and call options in the Final Proposal to set the duration of the lease term for ten years.

Several industry trade groups expressed concerns over this case and filed an amicus brief arguing that a ruling in favor of First National would discourage parties from entering into preliminary documents that are typical and useful in negotiating real estate transactions. The brief also argued that the court's ruling will create "unexpected and unintended obligations in an industry where the near universal practice requires that final and

binding transactions be documented by detailed and comprehensive agreements that unmistakably evidence the intent of the parties to be bound."

The lesson to be learned from this decision is that one must take special precautions to ensure that preliminary instruments exchanged by parties during negotiations remain non-binding. To that end, parties should be mindful of the following principles:

- Attorneys should be engaged at the early stages of negotiations.
- Including terms such as “preliminary” or “proposal” in the title of an instrument does not necessarily render that instrument as not binding, if circumstances suggest otherwise.
- If portions of a preliminary instrument are to be binding (i.e. right of entry or confidentiality provisions), the instrument should expressly state that only those specific provisions are intended to be binding and the instrument is otherwise non-binding.
- All correspondence exchanged by the parties should include standard language indicating that such correspondence is for discussion purposes only and no contractual obligations arise from such exchanges.

Letters of intent and other preliminary instruments should expressly indicate that they are non-binding and that the parties may stop negotiations at anytime, for any reason, at their sole discretion.