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The Enforceability Of Letters of Intent


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With the overall improvement in the economy and the accelerated pace of real estate transactions, parties are increasingly relying upon letters of intent to hold deals in place while formal contract terms are agreed upon and drafted. Letters of intent have several advantages, allowing parties to quickly agree upon and document the key deal points without negotiating full agreements beforehand. And, with broad deal points agreed upon, it can then be easier to identify the remaining open items and address them in the formal agreements that are prepared following the execution of the letter of intent. Letters of intent frequently permit the parties to begin due diligence, and may contain exclusivity and non-circumvention clauses as well.

But what happens when, instead of finalizing the transaction, the deal falls through, perhaps where one of the parties uses the letter of intent to shop the deal around for better terms? Is the letter of intent an enforceable agreement that would give rise to liability in such a case? This article examines the issue.

Determining Enforceability

In determining whether the breach of a letter of intent (LOI)can give rise to a cause of action, courts look to the intent of the parties as expressed in the LOI to determine whether the parties intended to be bound. Accordingly, "when the parties have clearly expressed an intention not to be bound until their preliminary negotiations have culminated in the execution of a formal contract, they cannot be held until that event has occurred."[1] Where an LOI "leaves for future negotiation [material] provisions,….[a]bsent any indication in the letter of intent of an objective method, independent of each party's mere wish or desire, upon which to make these provisions definite, [courts will] decline to supply them by implication."[2] This is because "an agreement to agree, which leaves material terms of a proposed contract for future negotiation, is unenforceable."[3]

On the other hand, where "[t]he plain language of the LOI manifests the parties' intent to be bound by its terms [and] it does not contain an express reservation by either party of the right not to be bound until a more formal agreement is signed," the LOI will be enforced.[4]

Accordingly, in determining whether an LOI is enforceable, courts are required to determine "whether the agreement contemplated the negotiation of later agreements and if the consummation of those agreements was a precondition to a party's performance."[5]

Parties all too often hastily sign letters of intent without considering whether any of its provisions will be enforceable if the deal falls through.

Application

Applying these standards, courts have refused to enforce LOIs where there was no indication that the parties intended to be bound, but have regularly enforced LOIs where such an intent is expressed.

For example, in *Amcan Holdings v. Canadian Imperial Bank of Commerce*, the plaintiffs approached CIBC seeking financing for the acquisition of a company as well a refinancing of existing debt.[6] The parties negotiated and executed a term sheet that, like most letters of intent, outlined the proposed terms of the financing. The term sheet provided that "[t]he Credit Facilities will only be established upon completion of definitive loan documentation, including a credit agreement…which will contain the terms and conditions set out in this Summary in addition to such other representations…and other terms and conditions…as CIBC may reasonably require."[7] The term sheet contained detailed descriptions of the credit lines to be provided, the amount of funding under each, amortization and interest rates, fees, security, a proposed closing date and definitions of key terms.[8]

After execution of the term sheet, CIBC broke off negotiations and the contemplated financing was never closed.[9] The plaintiffs thereafter commenced an action for breach of contract based on CIBC's failure to close the loan, breach of the covenant of good faith and fair dealing, and fraud. CIBC moved to dismiss, arguing primarily that the term sheet was not a binding agreement, but was merely an agreement to agree. In affirming the dismissal of the complaint, the First Department held that because the term sheet provided that the credit facilities would only be established upon the execution of loan agreements, the term sheet "was clearly dependent on a future definitive agreement, including a credit agreement. At no point did the parties explicitly state that they intended to be bound by the summary pending the final credit agreement."[10]

Moreover, the First Department rejected the plaintiffs' argument that the term sheet was enforceable because it contained all of the material terms of the agreement:

> [t]he fact that the [term sheet] was extensive and contained specific information regarding many of the terms to be contained in the ultimate loan documents and credit agreements does not change the fact that defendants clearly expressed an intent not to be bound until those documents were actually executed.[11]

Similarly, in *Aksman v. Xiongwei Ju*, the parties entered into an LOI in contemplation of entering into a joint venture agreement for the development of certain software.[12] The LOI set forth each parties' contemplated contributions to the joint venture and provided that the software was to be the joint property of both parties and could not be used outside of the joint venture.[13] After the software was developed, the defendant allegedly used the software in violation of the provision of the LOI that precluded the parties from using the software "outside of this partnership without explicit consent of both parties."[14]

Following the plaintiff's commencement of an action seeking damages for breach of the LOI,

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the defendant moved to dismiss, arguing that it was an unenforceable agreement to agree. The First Department agreed, holding that the terms of the LOI demonstrated that it was "a preliminary, nonbinding proposal to agree, conclusively negat[ing] plaintiff's breach of contract claim."[15] The First Department reached this conclusion based on the fact that the LOI "expresses the parties' intention to enter into a contract 'at a later date' and nowhere states that they intend to be legally bound until such future agreement is reached."[16]

In *Piller v. Marsam Realty 13th Ave.*,[17] the parties entered into a letter of intent for the sale of two commercial buildings in Brooklyn. The LOI set forth the purchase price, provided that the parties would enter into a contract of sale at closing and provided that the contract of sale was to be in a form substantially similar to a form agreement annexed to the LOI.[18] When a dispute arose at closing, the purchasers brought an action to enforce the LOI. The court dismissed the purchaser's action, holding that because the terms of the LOI provided the purchaser only with an option to purchase the properties in the event future negotiations were successful and because the LOI failed to set forth material terms (including the method of payment and financing contingencies), it was unenforceable.[19]

By contrast, in *Bed Bath & Beyond v. Ibex Construction,* the First Department enforced the provisions of an LOI because "[t]he plain language of the LOI manifests the parties' intent to be bound by its terms."[20] Specifically, the Bed Bath & Beyond court found that the LOI was enforceable because (i) it did "not contain an express reservation by either party of the right not to be bound until a more formal agreement is signed;" and (ii) the LOI set forth "[the] price, scope of work to be performed, and time for performance," thus containing all of the necessary material terms for the formation of a binding agreement.[21]

In so holding, the First Department rejected the defendant's argument that a provision of the LOI stating that it was "subject to" the execution of a construction agreement rendered it a mere agreement to agree, explaining that the fact that an LOI "is denominated a 'Letter of Intent' and calls for the execution of a more formal… agreement does not render it an unenforceable agreement to agree."[22]

Finally, in determining whether a letter of intent is enforceable, courts rely on the language of the LOI itself. Thus, in *Hajdu-Nemeth v. Zachariou*,[23] the First Department enforced an LOI because it expressly provided that it "constitutes a binding contract until such time as the definitive agreements referenced [therein] are executed" and that "the parties shall be legally bound [thereby] once this Letter of Intent has been executed."

Accordingly, where the language of an LOI demonstrates that the parties intended to be bound by it, courts will not hesitate to enforce it even though it may contemplate the future execution of a more definitive agreement. Indeed, even where parties provide in an LOI that only certain provisions will be binding pending the execution of a more definitive contract, courts regularly enforce those binding provisions.[24]

Good Faith Clauses

Letters of intent often also include good faith negotiation clauses. When they do, a question arises as to whether the good faith negotiation clause is enforceable where the parties fail to come to terms on a definitive agreement.

In order for a party to succeed in the enforcement of a good faith negotiation clause, courts require that the LOI actually specify a framework by which to analyze the parties' performance. It is therefore not enough to merely state in a good faith negotiation clause that the parties will undertake the duty to negotiate a definitive agreement in good faith.

To assure the enforceability of a good faith negotiation clause, the parties should include a clear set of guidelines by which a court can measure a party's performance in the negotiation of a definitive contract.

For example, in *McDonald Ave Realty v. 2004 McDonald Ave. Corp*., the parties entered into a letter of intent to lease a building, expressly providing that it was not a binding agreement except to the extent specified in the LOI.[25] Further, the landlord agreed in the LOI to negotiate the lease agreement "in good faith" with the tenant and the good faith negotiation clause was specifically identified as a binding provision in the LOI.[26] The negotiations between the parties failed and the prospective tenant brought an action seeking enforcement of the good faith negotiation clause. The Second Department, affirming the lower court's dismissal of the complaint, held that the LOI was unenforceable and it refused to enforce the "good faith" negotiation clause because it failed to set forth an objective set of guidelines by which to measure the defendant's performance of its duty to negotiate in good faith. Specifically, the court held:

> The plaintiff's contention that the defendant breached its duty pursuant to the LOI to negotiate the terms of a formal agreement in good faith is also unavailing. Where, as here, we are called upon to construe a clause expressly providing that a party is to negotiate in good faith, a clear set of guidelines against which to measure a party's efforts is essential to its enforcement. No objective criteria or standards against which the defendant's efforts can be measured were stated in the LOI, and they may not be implied from the circumstances of this case.[27]

Therefore, where parties have agreed to include a good faith negotiation clause in an LOI, in order to assure the enforceability of that clause, the parties should include a clear set of guidelines by which a court can measure a party's performance in the negotiation of a definitive contract.

Conclusion

Letters of intent are many times a fundamental starting point for the negotiation of a complex transaction between sophisticated parties. However, in an understandable desire to "lock in a deal" and begin due diligence, parties all too often hastily sign LOIs without considering whether any of its provisions will be enforceable if the deal falls through. Therefore, before executing an LOI, it is essential that parties include provisions stating whether any of the provisions are to be binding in the event a definitive agreement is not reached. Furthermore, to the extent a good faith negotiation clause is included, parties should make sure to clearly explain the expectations of the parties in negotiating in good faith.

1. *Brause v. Goldman*, 10 A.D.2d 328, 332, 199 N.Y.S.2d 606, 611 (1st Dept. 1960), aff'd, 9 N.Y.2d 620, 210 N.Y.S.2d 225 (1961).
2. *Bernstein v. Felske*, 143 A.D.2d 863, 865, 533 N.Y.S.2d 538, 540 (2d Dept. 1988).
3. *2004 McDonald Ave. Realty, v. 2004 McDonald Ave. Corp.*, 50 A.D.3d 1021, 1022, 858 N.Y.S.2d 203, 204 (2d Dept. 2008) (citations omitted).
4. *Bed Bath & Beyond v. Ibex Constr.*, 52 A.D.3d 413, 414, 860 N.Y.S.2d 107, 108 (1st Dept. 2008) (citations omitted).
5. *IDT Corp. v. Tyco Group, S.A.R.L.*, 13 N.Y.3d 209, 213, 890 N.Y.S.2d 401, 403 (2009).
6. 70 A.D.3d 423, 894 N.Y.S.2d 47 (1st Dept. 2010).
7. Id. at 424, 894 N.Y.S.2d at 48.
8. Id.
9. Id.
10. Id. at 426, 894 N.Y.S.2d at 50.
11. Id. at 427, 894 N.Y.S.2d at 50.
12. 21 A.D.3d 260, 799 N.Y.S.2d 493 (1st Dept. 2005).
13. Id.
14. Id.
15. Id. at 261, 799 N.Y.S.2d at 495 (citations omitted).
16. Id.
17. 41 Misc. 3d 1217(A), 2013 N.Y. Slip. Op. 51722(U) (Sup. Ct. Kings Co. 2013).
18. Id. at ***3.
19. Id. at ***10.
20. 52 A.D.3d 413, 414, 860 N.Y.S.2d 107, 108-109 (1st Dept. 2008) (citation omitted).
21. Id. (citations omitted)
22. Id. at 414, 860 N.Y.S.2d at 109 (citation omitted).
23. 309 A.D.2d 578, 578, 765 N.Y.S.2d 597, 597 (1st Dept. 2003) (quotations omitted).
24. See *2004 McDonald Ave. Realty v. 2004 McDonald Ave. Corp.*, 50 A.D.3d 1021, 1022, 858 N.Y.S.2d 203, 205 (2d Dept. 2008) ("Here, the letter of intent at issue…expressly stated that '[t]his Letter is not a binding agreement *except to the extent specifically stated below*.' According to its terms, only *three provisions were binding*, to wit: the due diligence indemnification provision, the non-shop provision, and the deposit provision") (emphases added).
25. Id.
26. Id. at 1023, 858 N.Y.S.2d at 205 (citations omitted).
27. Id. at 1022-23, 858 N.Y.S.2d at 205 (citations omitted). As one commentator has explained, parties should specify in a letter of intent what negotiation in good faith means and whether it allows the other party to shop around for better terms: it "makes very good drafting sense to state that the parties agree to negotiate in good faith, and to specify what they mean by that: May a party to a potential merger talk with third parties? May a lender consider factors other than credit-worthiness? It is common to be specific in non-disclosure agreements made during negotiations. The same care should be taken with the agreement to negotiate itself." 6 Corbin on Contracts §26.9 (Rev. ed. 2010).