TERM SHEETS AND LETTERS OF INTENT

"The Contractual Ether World"

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Some Reasons to Care About the Use and Abuse of the Letter of Intent (LOI) or a Term Sheet or a Memorandum of Understanding (MOU): We'll Refer to Them Collectively as "LOIs":

- As the quasi-deal before the "real" deal, LOIs are neither fish nor fowl, but can end up smelling very foul.
- A deal you never thought you signed off on could be enforceable against you or the basis for a damages lawsuit.
- A deal you loved and thought was solid could be deemed unenforceable.
- You could end up having to explain all this to your CEO or your Board.
- You could be sued for $60 billion.

What Are the Risks of Letters of Intent/Term Sheets? Do They Ever Really Go Wrong?

The New York Times
nytimes.com

October 5, 2008

Citigroup Says Judge Suspends Wachovia Deal

By ERIC DASH and JONATHAN D. GLATER

Late Saturday, after several hours of intense legal jockeying, Justice Ramos issued an injunction effectively blocking the Wells Fargo deal, pending a hearing scheduled for Friday.

The agreement with Wachovia that Citigroup has cited and that contains the ban on negotiating with any other potential bidders was not a final merger contract but rather a letter agreement to "continue to proceed to negotiate definitive agreements."

Lawyers not involved in the battle said Wachovia could defend the Wells Fargo deal by arguing that it was better for its shareholders. Wachovia is likely to claim that its fiduciary obligations — its responsibility to protect the interests of its investors — required it to consider the Wells Fargo bid and, given its higher price, to accept that bid.

The litigation could put regulators in a tough spot. The Wells Fargo deal may be better for taxpayers, but if it succeeds, in the future other financial institutions may not be willing to help the government, as Citigroup did, because of the risk that they might not reap the anticipated benefit.

Why Are You Considering A LOI?

You MUST know why you are considering a LOI in the first place and whether it advances your interests or not.

- Are you a motivated seller?
- Are you an eager buyer?
- What is your alternative?
- Is the need for due diligence driving the decision?
- Are you trying to insure that no binding deal exists yet?
- Is the transaction too complicated/detailed to finalize yet?

Why Are You Considering A LOI (cont.)

- Do you need approval for the deal?
- Investors/Lenders?
- What is your legal budget?
- Are all the necessary parties and contingencies covered in the LOI?
- Do you need to establish a timeline/deadline for a definitive deal closing?

If you don't have a clear idea of why it is in your interest to have a LOI, and whether terms should be binding or not, then you may not need one or it is not ripe to have one yet. It is nearly always possible to say, "We need to keep talking before we're ready for a document."

What Kind of LOI?

A fully binding, executed Letter of Intent, Term Sheet or "Memorandum of Understanding"—

- All material terms are included and binding, even though it is not the final definitive agreement.
- What is the pressing need for parties to be bound before there is a definitive agreement?
- What will be added when you execute a definitive agreement?

What Kind of LOI? (cont.)

A fully binding, executed Letter of Intent, Term Sheet or "Memorandum of Understanding" (cont.) —

- Are indemnities, limitations on liability, representations and warranties, schedules, scope and definition of intellectual property rights, fully fleshed out? Probably not.
- Entertainment deals- sometimes the lawyers negotiating for the "talent" vs. the studios intend the very detailed term sheets to be binding

What Kind of LOI? (cont.)

A fully non-binding document with no binding provisions.

- Intended as just a reflection of non-binding negotiations
- Allows the parties to focus on the material points of agreement without being bound
- Allows exchange of complicated business terms for consideration and refinement.
- Consider explicit disclaimers that include:
  - Document is non-binding in every respect and is for discussion purposes only
  - Parties will not be bound in any respect until and unless a written agreement is signed and executed
  - There is no other agreement relating to the subject matter, written or oral
  - The parties understand that the negotiation may not result in any enforceable contract
  - There is "no agreement to agree."

What Kind of LOI? (cont.)

A fully non-binding document with no binding provisions. (cont.)

- And you can go further:
  - Waiver of any claim of breach of contract, breach of any duty to negotiate in good faith, tortious inducement, fraud or conspiracy
  - Waiver of any claim against directors, officers or employees of a party
  - No estoppel created by the document
  - Document is neither an offer nor an acceptance of any offer
  - No exclusivity
  - Even if a party changes their financial position as a result of this document, or otherwise relies on it, there is no binding obligation or contract created
  - Statute of Frauds—the document is not intended to be an agreement to meet any requirements for a written agreement governed by Statute of Frauds (real estate sale, performance overtime, etc.)
- Final note - Is there a need to address confidentiality with an NDA? What information will be exchanged?

What Kind of LOI? (cont.)

A hybrid document with non-binding economic and business terms and binding special "process" provisions – most typical.

- Clearly separate and identify the non-binding terms from the binding ones
- **Non-binding terms** typically include the material points of the business deal:
  - Price and price adjustments
  - Obligations of parties
  - Deliverables
  - Identity of real property, tangible property and/or intangible property (like I.P.) being sold, transferred, licensed
  - Milestones/Benchmarks
  - Management
  - Risk allocation/General Indemnification
  - Conditions/Contingencies (i.e., "no material changes")
  - General description of reps and warranties ("customary?")
  - And infinite variations

What Kind of LOI? (cont.)

A hybrid document with non-binding economic and business terms and binding special "process" provisions – most typical (cont.)

- **Binding terms** can include:
  - Confidentiality, limited access to information, designation of contacts for confidential information, return of confidential materials, etc.
  - Exclusivity/ "no shop" provisions: time limit?
  - Non-circumvention?
  - Standstill/no trading covenant?

What Kind of LOI? (cont.)

A hybrid document with non-binding economic and business terms and binding special "process" provisions – most typical (cont.)

- Break up fee or non-refundable deposit
- Expenses (travel, legal, prototypes?)
- Termination of LOI? Survival of confidentiality?
- Dispute resolution process for any dispute over a breach of the binding terms?

Worst Practices: Learning From Mistakes

1. Worst of the worst:
   - "This binding letter of intent will outline the Agreement to be reached by the parties…"
   - "The precise scope and detail of the Project will be approved by the Parties and incorporated into the agreement…"
   - "The enterprise and its principals will be compensated in accordance with the Agreement. The Agreement will establish the purposes, contributions, member interests, voting rights, profit/loss interests, and executive authority of the enterprise…. "
   - "Upon execution of this LOI, the parties will not solicit any third party as a participant of any kind in the enterprise…. "

Worst Practices - Drafting Pitfalls and Nightmares To Avoid (cont.)

- "Each party agrees that it has a fiduciary duty to the other parties to perform under this LOI in good faith for the primary benefit of the enterprise…."
- "This LOI is intended by the parties to be a binding contract…."
- "This LOI will be effective for an indefinite term until the Agreement has been executed…."
- "This LOI is the only agreement between the parties and will be superseded and replaced by the Agreement…."
- "For a breach of this LOI, the prevailing party is entitled to recover its contract damages, its attorneys fees and punitive damages for any breach of fiduciary duty. This LOI may be enforced by injunctive relief or specific performance…"

Worst Practices - Drafting Pitfalls and Nightmares To Avoid (cont.)

2. A purchase offer and acceptance with an afterthought: A real property purchase offer letter including all material terms, contingency periods, price, deposit, escrow, title insurance, representations, closing costs, right of entry, etc., etc. , and:
   - "Buyer and Seller will use their best efforts to enter into an agreement which shall supersede the terms of this letter. Buyer shall submit a draft Purchase Agreement within ___ days of execution of this letter…"
   - "This offer to purchase shall remain open for Seller's acceptance until 5pm P.D.T. on ____, 2008…"
   - "With the signatures of their authorized agents below, Buyer and Seller acknowledge and agree to the terms of this proposal… "
   - (Buyer Seller Signatures)

Worst Practices - Drafting Pitfalls and Nightmares To Avoid (cont.)

Stapled to the signed letter agreement, following signatures, is a page with this paragraph:

"Seller and buyer acknowledge that this proposal is not a purchase agreement, and that it is intended as the basis for the preparation of a purchase agreement by buyer. The purchase agreement shall be subject to seller and buyer approval, and only a fully executed and delivered purchase agreement shall constitute a legally binding purchase agreement for said property. Buyer makes no warranty or representation to seller that acceptance of this proposal will guarantee the execution of a purchase agreement for the property."

(No signatures)

"I feel like a fugitive from th' law of averages."

General Rules Re: Enforceability

- Creation of a valid contract requires mutual assent
  - If there is a **manifest** intention that formal agreement is not to be complete until reduced to formal writing, there is no binding contract
  - Courts will look to the language of the letter of intent to determine if the parties intended to be bound
    - Does the LOI contain all essential elements of the agreement
    - Is there a clear statement that LOI is not binding
    - Complexity of the transaction – expect a more formal agreement

General Rules Re: Enforceability (cont.)

- However, courts will frequently look beyond the LOI and to the conduct of the parties to determine if there was an intention to be bound by the LOI
  - This may occur even if the LOI contains language indicating subsequent formal agreement is required
  - Extrinsic evidence may undo the "protective" language in the LOI

LOI Enforceability - The Easy Case

- **LAKS v. Coast Federal Savings** 60 Cal.App.3d 885 (1976)
  - Suit over failure of bank to make loan
  - Plaintiff argued that LOI was enforceable agreement
  - Court focused on bank's "conditional commitment" (Which was fairly detailed)
    - Held: **No contract**
      - "Conditional Commitment" put offeree on notice that further negotiations were required
      - Essential terms were missing
        - Silent on lead lender's loan commitment
        - Lack of payment schedule
        - Security for loan not identified
        - Rights and remedies in event of default

LOI Enforceability - The Easy Case (cont.)

- **Regent Properties v. Mercedes Benz of N.A.**
  2000 U.S. App. Lexis 14092 (9th Cir. 2000)
  - Plaintiff sued defendant for failure to sell real property
  - Claimed LOI was binding
  - Held: **No contract**
    - LOI contained the following language:

      'This is not intended to be a binding agreement . . . all communications between the parties are not contractual [and] it is intended that no legal rights or obligations shall come into existence . . . unless and until mutually acceptable Purchase Contract is executed by both parties."
  - Language was unambiguous -- **No contract**
    - Language also insured that parties post LOI conduct would not be interpreted as creating an agreement

LOI Enforceability - The Easy Case (cont.)

- **BUT SEE; New Line Productions v. Little Caesar Enterprises**, 2001 U.S. App Lexis 10537 (9th Cir. 2001)
  - Trial court granted summary judgment on basis of language in LOI which stated: "**this is not a contract**"
  - 9th circuit reversed summary judgment
    - Court identified questions of fact
      - The language could mean only that a more formal contract was to follow
        - Reference to a subsequent writing does not preclude a finding that parties were bound by the LOI
      - Fact that LOI left certain terms undefined is not dispositive since there needed to be a finding that the missing terms were essential

LOI – Relevance Of Conduct Of The Parties

- **California Food Service v. Great American Insurance Co.**, 130 Cal.App.3d 892 (1982)
  - Lawsuit related to an issue of ownership of a business – who was responsible for fire insurance
  - LOI executed by plaintiff to buy business
    - LOI contained a number of steps that needed to be completed before sale would be consummated
      - Including 1) execution of promissory notes, 2) assignment of lease, 3) grant of a franchise
      - None of these items were defined in LOI

LOI – Relevance Of Conduct Of The Parties (cont.)

- **California Food Service v. Great American Insurance Co.,** 130 CAL.APP.3d 892 (1982)
  - Held: LOI was binding
    - LOI contained all essential terms
    - Appellant occupied the property and ran the business

"[P]arties expectations may be inferred from the conduct of the parties and surrounding circumstances."

. . . . . .

"The fact that Sandy's allowed CFS to take possession of the premises and to begin operating it as a restaurant strongly suggests both parties considered terms of the letter of intent as being binding without the need for the execution of additional documents."

Moral: be careful of post-LOI/pre-contract conduct

The Mother Of All Letter Of Intent Cases

Texaco, Inc. v. Pennzoil Co. 79 S.W. 2d 768 (Tex. App. Ct. 1987)

FACTS

- Memorandum of agreement between Getty interests and Pennzoil to purchase Getty oil
  - Moa established stock purchase price ($110 a share)
  - Agreement to restructure Getty within a year
  - Subject to agreement of Getty board
- MOA's price/share rejected by board
- Board voted to authorize negotiation of counteroffer
- Pennzoil accepted counteroffer

The Mother Of All Letter Of Intent Cases (cont.)

Pennzoil v. Texaco (cont.)

- Parties issued separate press releases
  - Announced "agreement in principle"
  - Stated "transaction is subject to execution of a definitive merger agreement"
  - Draft agreement: parties not bound until agreement is signed
- Subsequently, Texaco made better offer ($125/share)
- Board withdrew its counter-proposal and entered into agreement with Texaco
- Pennzoil sued for intentional interference with contract
- **Issue**: was there a binding contract?
- **Jury awarded $10.7 billion to Pennzoil**

The Mother Of All Letter Of Intent Cases (cont.)

Pennzoil v. Texaco (cont.)

- Appellate Court upheld jury's verdict
  - Test applied by court:

    "(1) Whether a party expressly reserved the right to be bound only when a written agreement was signed; (2) whether there was any partial performance by one party that the party disclaiming the contract accepted;(3) whether all essential terms of the alleged contract had been agreed upon; and (4) whether the complexity or magnitude of the transaction was such that a formal executed writing would normally be expected.

    . . . . . .

    Although the intent to formalize an agreement is some evidence of an intent not to be bound before signing such a writing, it is not conclusive. The issue of whether the parties intended to be bound is a question of fact to be decided from the parties acts and communications."

- Reviewed press release
  - Worded in indicative terms ("seller will"), not subjunctive or hypothetical ones
  - Reference to future agreement established timing and not a precondition of agreement

The Mother Of All Letter Of Intent Cases (cont.)

Pennzoil v. Texaco (cont.)

- Looked to see if all essential elements were present
  - There were several "open issues"
    - Who would control sale
    - Guarantees
    - Dividend policy
  - But evidence presented that most critical concern of Getty board was the price per share.

The Mother Of All Letter Of Intent Cases (cont.)

Pennzoil v. Texaco (cont.)

- Court agreed with Texaco that with a transaction of this sort one would expect the necessity for a signed contract.
  - "This factor alone is not dispositive"
- Court held: sufficient evidence to support jury verdict
- $10.7 billion award was reduced to $3 billion

THE NEXT LAWSUIT?
CITIBANK V. WELLS FARGO?

Good Faith Duty Of Negotiation

- In some jurisdictions, notwithstanding a finding that a LOI does not constitute a contract, courts may impose a "good faith duty of negotiation" relating to the parties efforts to finalize the contract
  - Includes California, New York, Illinois, Maryland, Massachusetts
- In other jurisdictions, no such right is recognized
  - Includes Tennessee, Kentucky, Texas, Washington
- General rule: look to the terms of the LOI to determine if the duty has been breached

Copeland v. Baskin Robbins, 96 Cal.App.4th 1251 (2002)

FACTS:

- Prospective purchaser of ice cream plant appealed dismissal of claim based on letter of intent
- LOI to purchase ice cream plant and to enter into supply agreement to supply 7 million gallons of ice cream to Baskin Robbins
- LOI said negotiations to be concluded in 30 days
- Supply agreement was critical to the deal.
- Baskin Robbins broke off negotiations on supply agreement
- Court of appeals found LOI did not contain essential terms : **No contract**

COPELAND v. BASKIN ROBBINS, 96 CAL.APP.4TH 1251 (2002) (cont.)

- BUT PLAINTIFF ALSO ARGUED THAT LOI CREATED GOOD FAITH DUTY TO NEGOTIATE
- COURT RECOGNIZED CLAIM

  "Failure to agree is not itself, a breach of the contract to negotiate. A party will be liable only if a failure to reach ultimate agreement resulted from a breach of the party's obligation to negotiate or negotiate in good faith

  . . . . . .

  Contracts today are not formed by discrete offers, counteroffers and acceptances. Instead they flow from a gradual flow of information between the parties followed by a series of compromises and tentative agreements on major points which are finally refined into contract terms. These slow contracts are not only time consuming but costly. For these reasons, the parties should have some assurance 'their investments in time and money and effort will not be wiped out by the other party's foot dragging or change of heart or taking advantage of a vulnerable position created by the negotiation.'"
- KEY FACT: BR KNEW THAT SUPPLY AGREEMENT WAS CRITICAL TO DEAL AND IT DECIDED TO ENTER INTO A SUPPLY AGREEMENT WITH THIRD PARTY
- DAMAGES: PLAINTIFF ENTITLED TO RELIANCE DAMAGES (OUT OF POCKET COSTS)

CHANNEL HOME CENTERS v. GROSSMAN, 795 F.2d 291 (7th Cir. 1986)

FACTS:

- Mall owner and box store enter into a LOI for a long term lease
  - LOI provides that owner will take property off the market
  - Parties negotiate terms of the lease
  - Competitor store offers more money for the space
  - Owner terminates negotiation with prospective leasee
- Court held: good faith duty of negotiation was breached by negotiation with third party
  - Relied on provision that space would be taken off the market.

LETTERS OF INTENT

Lessons -- Enforceability

- Most litigation concerning enforceability of LOI arises with respect to LOI's that do not clearly reflect the intent of the parties on the issue of enforceability
- Absent an unequivocal expression of the intent of the parties to the contrary, a significant possibility exists that a court will find a letter of intent binding if it includes the material provisions of the agreement

LETTERS OF INTENT

Lessons -- Enforceability

- Omission of what you may consider critical terms (representations, warranties and covenants) may not be sufficient to render the LOI unenforceable
- Some courts are willing to supply the missing terms – characterized as "boilerplate" where there certain key terms are present
- Courts will look to the conduct of the parties
- Not a question you want to leave to a jury

LETTERS OF INTENT

Lessons: Good Faith Duty To Negotiate

- Duty to negotiate in good faith does not exist in all jurisdictions
- Even if LOI is non-binding, in some jurisdictions, such a duty may arise
- Courts will look to the terms of the LOI to determine whether a duty exists and what the scope of the duty is
- If a party violates that duty, aggrieved party is entitled to reliance damages