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Real Estate Loan Commitment Letters and Terms Sheets: Negotiating Key Terms

Structuring Binding Finance Commitments and Balancing Interests of Both Lenders and Borrowers

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THE ENFORCEABILITY OF LETTERS OF INTENT

1. INTRODUCTION & OVERVIEW

a. **Contracts Law Revisited**. In Lucy v. Zehmer, 196 Va. 493 (Va. 1954), two parties meet for dinner. After several drinks the conversation turns to the possibility of Lucy buying a farm from Zehmer for $50,000. Zehmer actually has no intention of selling the farm; instead, Zehmer wants Lucy to admit that Lucy doesn't have $50,000. To further this, Zehmer writes on the back of a napkin "We hereby agree to sell to W. O. Lucy the Ferguson Farm complete for $50,000.00, title satisfactory to buyer." Both parties sign the document (including Zehmer's wife, who initially balks but agrees when her husband informs her it is a joke). The plot twist comes when Lucy, who doesn't have $50,000, immediately goes to his brother and obtains a $50,000 loan. After a quick title search, Lucy contacts Zehmer to close the deal. Zehmer finally lets Lucy in on the joke, but Lucy isn't amused. Instead, Lucy hires an attorney and sues for specific performance. The court then introduced us to the doctrine of mutual assent, explaining that mutual assent is determined by objective words and actions and not by hidden, subjective intent.

b. **Issues to Consider.** 1) the standards for establishing mutual assent regarding LOIs, 2) good faith duties to negotiate, 3) the binding effect of e-mails and 4) the lingering effect of LOI's post-close.

2. **STANDARDS FOR MUTUAL ASSENT REGARDING LOIs**. The standard for determining whether parties have reached mutual assent regarding a LOI varies by jurisdiction. There are two primary approaches.

i. **New York Approach**. The first approach is a 4-5 factor test, which we'll call the "New York approach". The New York approach, which is loosely based off of the Restatement (Second) of Contracts handling of the issue, looks at 1) whether there is express non-binding language, 2) whether all essential terms are in the LOI, 3) whether there has been any partial performance, 4) whether the transaction is a type that normally requires a formal, final contract and 5) whether the context of the negotiations make it seem like a formal, final contract would be expected.

ii. **California Approach.** The "California approach" is a two-prong element test. The first prong considers each of the above factors as well as other facts and circumstances to determine whether mutual assent has been reached. The Second prong then looks at whether all essential terms are present in the LOI. Each element must be met in order for a LOI to be determined binding.

iii. **The Five Factors**

1. **Express Language**. An LOI can state that it is binding, be silent, or state that it is not binding.

a. Express Binding Language. If a LOI states that it is binding, then a court will likely find that the LOI is binding. *See* Hajdu-Nemeth v. Zachariou, 309 A.D.2d 578 (N.Y. App. Div. 1st Dep't 2003). In Hajdu-Nemeth, the parties entered into a LOI for plaintiff to perform consulting service. The LOI said that the LOI "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." The parties never entered into a more definitive agreement; however, Plaintiff performed all services under the LOI. When defendant failed to pay plaintiff in full, plaintiff successfully sued to enforce the terms of the LOI. The court agreed.

b. Silence. If a LOI is silent, then a court will likely find that the parties meant for the LOI to be binding. *See* IBEX Construction, 32 A.D. 3d 414 (2008) (finding that a contract was binding as there was "not an express reservation by either party of the right not to be bound until a more formal agreement [was] signed."

c. Express Non-Binding Language.

i. **General Rule.** If a LOI expressly states that it is non-binding, then the general rule is that the court will find the LOI non-binding. *See* Amcan Holdings, Inc. v. Canadian Imperial Bank of Commerce, 70 A.D.3d 423 (N.Y. App. Div. 1st Dep't 2010) (holding an LOI to be non-binding where the LOI stated 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 ... as CIBC may reasonably require."); Feldman v. Allegheny International, Inc., 850 F.2d 1217 (7th Cir. Ill. 1988) (holding an LOI to be non-binding where the LOI contained an unambiguous statement requiring other documents to be executed prior to the parties being bound); Aksman v. Xiongwei Ju, 21 A.D.3d 260 (N.Y. App. Div. 1st Dep't 2005) (holding that where parties signed an LOI to enter into a joint venture to develop a program, which prohibited the use of the program outside of the scope of the joint venture, when one of the parties used the program at his new job (after the venture failed), the LOI was not binding as it only expressed an "intention to enter into a contract at a 'later date' and nowhere state[d] that they intend[ed] to be legally bound until such future agreement

[was] reached."); 168th & Dodge, LP v. Rave Reviews Cinemas, LLC, 501 F.3d 945 (8th Cir. Neb. 2007) (holding that a LOI that required board approval before a definitive agreement could be signed is not enforceable absent such board approval); Cochran v. Norkunas, 398 Md. 1 (Md. 2007) (holding that a LOI that was conditioned upon executing the state's form of contract negated the enforceability of the LOI); and Miami Heights LT, LLC v. Home Depot U.S.A., Inc., 283 Ga. App. 779 (Ga. Ct. App. 2007) (holding that a LOI giving 10 days until drop dead negates enforceability of LOI).

ii. **Rationale for General Rule.** "The point of these rules is to give parties the power to contract as they please, so that they may, if they like, bind themselves orally, or by informal letters, or they may maintain 'complete immunity from all obligation' until a written agreement is executed". R.G. Group, Inc. v. Horn & Hardart Co., 751 F.2d 69 (2d Cir. N.Y. 1984).

iii. **Exception to the General Rule**. The exceptions to the general rule consider a party's "bad" words or acts that undermine the effect of an express non-binding provision. For example:

1. If parties reach an oral agreement prior to distribution of a LOI that contains express non-binding language, a court may hold the parties to the prior oral contract. *See* Wharf (Holdings) Ltd., 649 F. Supp. 861, 867,-68 (D. Colo. 1996) (holding that where an oral contract existed prior to drafting a prenegotiation agreement, which contained an express non-binding provision, the oral contract is still binding).

2. If parties reach an oral agreement after distribution of a LOI that contains express non-binding language, a court may hold the parties to the later oral contract. *See* Lamle v. Mattel, Inc., 394 F.3d 1355, 1360 (Fed. Cir. 2005) (holding parties "may abrogate a prior written agreement with a subsequent oral one, if they so mutually intend")

3. If parties issue press releases about the deal using indicative terms rather than hypothetical terms, a court may uphold a jury's findings that the parties had an intent to be bound. *See* Texaco, Inc. v. Pennzoil Co., 729 S.W.2d 768 (Tex. App. Houston 1st Dist. 1987) (holding that the

Memorandum of Agreement with the later increased pricing indicated an intent by the parties to be bound).

4. If the parties orally agree to a contract after the non-binding provision of an LOI lapses due to an expiration provision, then a court may uphold a jury's finding that the parties are bound by the oral agreement. *See* Turner Broad. Sys. v. McDavid, 303 Ga. App. 593 (Ga. Ct. App. 2010) (holding that despite the parties expressly indicating that the contract would not be binding until they executed "Definitive Agreements" in the LOI, because the LOI had expired, the non-binding provision of the LOI had also expired and finding that the actions between the parties provided sufficient evidence for a jury to find that the parties had indicated an intent to be bound and upholding $281 Million in damages).

2. **Essential Terms**. Under the New York approach, whether a LOI contains all essential terms is just one factor in determining mutual assent; however, under the California approach, whether a LOI contains all essential terms is the second prong of the two prong test.

a. New York Approach: Under the New York approach, a court is permitted to supplement non-essential terms. *See* V'Soske v. Barwick, 404 F.2d 495 (2d Cir. N.Y. 1968) (holding that where parties intended the agreement to be binding, so long as the essential terms are set out, a court may supply missing terms based on "accepted business practices" or prior dealings). However, if a LOI is missing essential terms, then it weighs against the LOI being enforceable as a manifestation of the parties' mutual assent. *See* Piller v Marsam Realty 13th Ave., LLC, 41 Misc. 3d 1217(A) (N.Y. Sup. Ct. 2013) (holding that a LOI that said the later agreement would be substantially in the form annexed to the LOI, but where the courts found missing essential terms (i.e. method of payment and financing contingencies), then the LOI was not binding) *and*

b. California Approach. A similar struggle exists under the California Approach, where courts have shifted away from the "established view" toward the "modern trend", each as described below.

i. **Established View**. Under the established view, if all essential terms are not present in the LOI, then a court will not enforce the LOI. *See* Ablett v. Clauson, 43 Cal. 2d 280 (Cal. 1954) (finding that "although a promise may be sufficiently definite when it contains

an option given to the promisor or promise, yet if an essential element is reserved for future agreement of both parties, the promise can give rise to no legal obligation until such future agreement. Since either party by the terms of the promise may refuse to agree to anything to which the other party will agree, it is impossible for the law to affix any obligation to such a promise.")

ii. **Modern Trend**. Under the modern trend, the courts have not abolished the requirement of essential terms being present; however, they are more lax on what is "essential". Okun v. Morton, 203 Cal. App. 3d 805 (Cal. App. 2d Dist. 1988) (finding that a court should not frustrate the intent of the parties to be bound when it is possible to reach a fair result); Patel v. Liebermensch, 45 Cal. 4th 344 (Cal. 2008) (holding that an option to purchase was enforceable and finding that the only essential terms to a sale of real property was the parties' names, the purchase price and the identification of the property).

3. **Partial Performance.** While rarely determinative in itself, a party's partial or continued performance is clear signal of such party's belief of the existence of a binding contract. This is obviously more clear where performance has been accepted by the party disclaiming the contract. *See* Viacom International Inc. v. Tandem Productions, Inc., *368 F. Supp. 1264, 1270 (S.D.N.Y. 1974)* (finding that the parties performance for a year in the production of "All in the Family" was "strong circumstantial proof that the minds of the parties had met on the essential elements, and that they were not waiting for a formal written instrument"),

4. **Type of Contract**. If a contract is complex, for a large amount or duration, or is normally of a type that would typically require a formal, written contract, then the absence of such a contract is persuasive as to whether the parties had an intent to be bound. While we see the court find that this factor favors the party claiming that no binding contract exists in R.G. Group, Inc. v. Horn & Hardart Co., where the initial investment was two million dollars and it was for a franchise agreement for a term of 20 years, in both Texaco and Pennzoil above, the courts give little weight to its analysis of this issue, in admittedly complex and large deals.

5. **Context**. The court will likely give equal weight given to factor four to facts that the parties have been observing contractual formalities throughout the deal or where the context otherwise indicates that it would be unlikely for the parties to enter into a binding agreement absent a formal writing.

3. **GOOD FAITH DUTY TO NEGOTIATE.** The law on the effect of a good faith duty to negotiate varies drastically depending on the jurisdiction. However, the effect of a good faith

duty to negotiate will depend largely upon two things. First, does the state recognize the enforceability of a good faith duty to negotiate provision? Second, does the LOI contain an express good faith duty to negotiate or is one implied by law?

i. **Enforceability of a Good Faith Duty to Negotiate**.

1. **Unenforceable Agreements to Agree**. In some jurisdictions, a good faith duty to negotiate is deemed an unenforceable "agreement to agree" (with such term used in the most derogatory manner). *See* Feldman v. Allegheny International, Inc., 850 F.2d 1217 (7th Cir. Ill. 1988) (finding that "[n]o particular demand in negotiations could be termed dishonest, even if it seemed outrageous to the other party. The proper recourse is to walk away from the bargaining table, not to sue for 'bad faith' in negotiations").

2. **Enforceable with a Framework**. In other courts, they will recognize a good faith duty to negotiate, but they require that the parties expressly provide the framework for analyzing whether a party acted in bad faith. *See* 2004 McDonald Ave. Realty, LLC v. 2004 McDonald Ave. Corp., 50 A.D.3d 1021 (N.Y. App. Div. 2d Dep't 2008) (holding that the court could not enforce a LOI with missing terms based on the parties not acting in good faith regarding the negotiation of open items where there was no framework for how to determine what constituted good faith).

3. **Enforceable.** Other courts find that a good faith duty to negotiate is enforceable.

a. *See* Teachers Ins. & Annuity Asso. v. Tribune Co., 670 F. Supp. 491 (S.D.N.Y. 1987) (holding that where a LOI stated that it was a binding agreement to borrow, "subject to the preparation and execution of final documents satisfactory to both sides and the approval of Borrower's Board of Directors" and required the parties to negotiate in good faith, a borrower that stopped negotiations in order to take advantage of a drop in interest rates violated such duty to negotiate the open terms in good faith).

b. *See* SIGA Techs., Inc. v. Pharmathene, Inc., 67 A.3d 330 (Del. 2013)

i. **Facts:** SIGA develops a smallpox antiviral with enormous potential, but was running low on money. SIGA approaches PharmAthene for money. Pharmathene wants to frame it first as a licensing agreement and then as a merger. Parties exchange several term sheets on the license agreement. SIGA tells Pharmathene the "have got a deal on the term sheet" subject to Pharmathene's acceptance of two minor changes. The term sheet has a "Non-Binding Terms" provision as the footer. Pharmathene

decided to pursue the merger with the term sheet for the licensing agreement a backstop if the Merger is terminated. Parties enter into a Bridge Loan and a term sheet for the Merger, each of which explains that upon termination of the Merger, "SIGA and PharmAthene will negotiate in good faith with the intention of executing a definitive License Agreement in accordance with the terms set forth in the License Agreement Term Sheet." Terms survive termination of respective documents. SIGA begins experiencing "seller's remorse" coincidentally when they receive several grants from the National Institute of Health and get approved for human trials. The due diligence period on the Merger is ending, and SIGA terminates the Merger. PharmAthene sends the license agreement saying that it contains "all essential terms of a license agreement and is completely consistent with the [term sheet]. Meanwhile, SIGA is already internally discussing alternative structures of the license agreement. [*pulled probably during discovery from interoffice e-mails]. SIGA emphasized the need to change some of the terms, highlights include: upfront payment from $6MM to $100M, milestone payments from $10MM to $235MM, royalties from a base of 8% to one of 18%, control provisions, blocking distribution provisions, and exclusive rights to terminate the license agreement upon certain events. PharmAthene says they'd consider some revisions, but not to that extent. SIGA hides behind non-binding footer. SIGA gives ultimatum: Proceed w/o preconditions regarding term sheets binding nature or we have "nothing more to talk about." Pharmathene brings suit and wins in court of chancery. SIGA appeals.

ii. **Issue**: Did SIGA violate its Good Faith Duty to Negotiate by attempting to change an expressly non-binding LOI?

iii. **Ruling**: Trying to renegotiate terms already agreed to in the LOI is a breach of a party's duty to negotiate in good faith. Parties aren't obligated to reach a deal on terms not in LOI, and if they can't reach a deal based on open items, it is ok for parties to walk away. However, courts will make a factual determination as to what caused deal to fall through.

ii. **Express or Implied in Law**. Upon determining whether the jurisdiction recognizes a good faith duty to negotiate, the next question is whether such a provision exists. While in most jurisdictions, this will simply require a reading of the LOI, in certain states like California, if the parties have entered into a contract to negotiate, then

the court will imply a duty to negotiate in good faith. *See* Baskin Robbins, 96 Cal. App. 4th 1251 (2d Dist. 2002) (holding that where the parties had entered into an agreement to enter into a later co-packaging agreement and one party unilaterally terminated negotiations, "the covenant of good faith and fair dealing attach[es], as it does in every contract" and provides the parties with some assurance that "their investments in time and money and effort will not be wiped out by the other party's footdragging or change of heart or taking advantage of a vulnerable position created by the negotiation.").

iii. **Damages**. SIGA also found that if a court determines but for the bad faith, the parties would have finalized a deal, then the breaching party may be liable for the other party's expectation damages, i.e. lost profits! *But see*, Baskin Robbins, 96 Cal. App. 4th 1251 (2d Dist. 2002) (holding that an aggrieved party is limited to reliance damages for a violation of a duty to negotiate in good faith).

4. **BINDING EFFECT OF E-MAILS.** Did the e-mails create mutual assent?

i. **The Duration and Content of E-mails** Several courts have found that where e-mails are ongoing and contain express terms, a court may find that such e-mails are binding. *See* Forcelli v Gelco Corp., 109 A.D.3d 244 (N.Y. App. Div. 2d Dep't 2013); Preston Law Firm, L.L.C. v. Mariner Health Care Mgmt. Co., 622 F.3d 384 (5th Cir. La. 2010).

ii. **Electronic Signatures**. Signatures at the bottom of e-mails can be binding. See Williamson v. Bank of N.Y. Mellon, 947 F. Supp. 2d 704 (N.D. Tex. 2013).

5. **EFFECT OF LOI ONCE DEAL HAS CLOSED**. The majority of the above contemplates a scenario where final documents are never executed as once the parties execute final, integrated documents, what effect can an LOI have? The answer is not clear.

i. **THE THRIFTY CASE.** Thrifty Payless, Inc. v. The Americana at Brand, LLC, 218 Cal. App. 4th 1230 (Cal. App. 2d Dist. 2013)

1. **Facts:** Parties executed a LOI that said certain taxes, insurance and common area maintenance payments were to be divided (between commercial and retail) and estimated that amount at $267,399.60. Landlord provided express language that the amount was an estimate and should not be relied upon. Parties then entered into an agreement with an integration clause, which stated that the tenant would have to pay their portion of such expenses. Payments ended up being around three times the estimated amount. Tenant sued and asked the court to look to the LOI.

2. **Issues**: Could Thrifty Rely on estimates in LOI despite express language that they were unreliable estimates and on an integration clause? Was it bad faith to allot apportionment of payments?

3. **Holdings:** The court overturned the trial court's granting of a demurrer in favor of the Landlord on several issues. Specifically, relying on Riverisland, the court found that the LOI could be used to prove fraud, further finding that caveats aren't sufficient where two key elements of fraud are present (i.e. negligent or intentional misrepresentation & justifiable reliance). The court further found that Landlord's apportionment of the expenses could prove both a breach of contract and breach of Landlord's implied covenant of good faith and fair dealing.