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## CONTRACT LAW

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### The Trouble With Preliminary Agreements

Those 'nonbinding' preliminary agreements may be more binding than you think

Many complex transactions are preceded by some form of a "preliminary agreement," such as term sheets, letters of intent, agreements in principle or memoranda of understanding. Many assume these agreements merely express a party's nonbinding intention to enter into an agreement — because "the financial community does not regard [them] as a binding agreement, but rather, an expression of tentative intentions of the parties." *Dunhill Securities Corp. v. Microthermal Applications, Inc.*, 308 F. Supp. 195, 198 (S.D.N.Y. 1969). This assumption may be overly simplistic, and parties should not make the mistake of waiting until *after* the preliminary agreement is signed to get their lawyers involved. All of the careful lawyering in the world *after* signing a preliminary may be fruitless — as it is possible to be contractually bound by the preliminary agreement itself. Counsel should be involved even in the drafting of a preliminary term sheet — either to make the term sheet binding or to protect against this.

Consider this real world example.

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After a year-long search, a Fortune 500 company found the perfect building for its new headquarters. The building was under a long-term lease by another company that no longer needed the building. The parties signed a document entitled "Principle Business Terms" for a sublease containing detailed sublease provisions, but which contained the following statement:

This Term Sheet is not intended to be contractual in nature, but only an expression of the basis upon which the parties would consider entering into a sublease at the subject property. Neither party shall have an obligation to sublease the subject property unless and until a written sublease in form and substance satisfactory to both parties has been prepared and executed.

The Term Sheet also provided that:

For a period of two months (the 'Exclusivity Period'), so long as both parties are engaged in good faith negotiations to execute a sublease substantially on the terms of this Term Sheet,

neither party shall enter into

any negotiations or agreement with a third party that would prevent either party from subleasing the Premises under the terms as outlined in this Term Sheet.

Knowing that its tenant no longer wanted the building, the landlord had negotiated a letter of intent for a lease with another company to take over the building. The landlord then negotiated a lease termination agreement with its tenant, at which time the landlord became aware of the Term Sheet for the sublease. The parties nevertheless proceeded with the lease termination, relying on the language that the Term Sheet was "not intended to be contractual in nature;" was just "an expression of the basis upon which the parties would consider entering into a sublease;" and was not binding "unless and until a written sublease in form and substance satisfactory to both parties has been prepared and executed." Imagine the landlord's surprise when it then received a letter from the Fortune 500 company demanding possession of the property under the provisions of the Term Sheet. Then imagine the landlord's surprise when the Fortune 500 company obtained an injunction that prevented it from leasing its building to anyone else. How and why did this happen? How can

a party protect its expectations and get the deal it bargained for?

If the parties *intend* to be bound by their preliminary agreement (whether oral or written), they are bound at the time they enter into their preliminary agreement — even if they contemplate signing a formal contract, and even if a formal contract is never prepared or signed, or could not be agreed upon. The case law has been more developed in the Second Circuit, under New York law. In one of the seminal cases in this area, *Teachers Ins. & Annuity Ass'n of Am. v. Tribune Co.*, 670 F. Supp. 491 (S.D.N.Y. 1987), the court observed that a *binding* preliminary agreement occurs when the parties have reached complete agreement on all negotiable issues and intend to be bound. Whether a binding agreement exists is determined by the objective words and deeds of the parties, rather than subjective evidence of intent. *Adjustrite Systems, Inc. v. GAB Business Services, Inc.*, 145 F.3d 543, 547 (2d Cir. 1998). Four primary factors are used to determine whether the parties to a preliminary agreement intended a fully binding and enforceable agreement:

1) Whether there has been an express reservation of the right not to be bound in the absence of a formal contract. This is the most important factor, particularly when express reservation exists. However, the fact that an agreement contains no express reservation of the right not to be bound is not dispositive.

2) Whether there has been partial performance of the preliminary agreement. This factor looks to whether actual performance of agreement has occurred, as opposed to a party merely preparing to perform or taking action in purported reliance on the agreement.

3) Whether all of the material terms of the transaction have been agreed upon. Frequently, it becomes apparent that not all of the material terms have been addressed when the parties thereafter negotiate a formal contract. However, when nothing suggests that the contested preliminary agreement contained open terms, it will suggest the parties' intention to create a "binding" agreement.

4) Whether the agreement at issue is the type of contract that is usually committed to formal writing. This factor

depends on the specific industry the preliminary agreement covers. If, in the relevant business community at issue, agreements are ordinarily committed to sophisticated, formalized contracts complete with the standard, then the enforceability of a preliminary agreement comes into question. If, however, it is common business practice that for agreements to be reached quickly and before every minute detail is hammered out between the parties, then parties could be contractually bound by a preliminary agreement.

Cases distinguish binding preliminary agreements from nonbinding agreements or commitments. Although open terms can indicate that parties do not have the intent to be bound to the ultimate transaction, the court in *Teachers* said parties can nevertheless "bind themselves in the sense that they accept a mutual commitment to negotiate together in good faith in an effort to reach final agreement within the scope that has been settled in the preliminary agreement." Such a nonbinding commitment "does not commit the parties to their ultimate contractual objective, but, rather, to the obligation to negotiate the open issues in good faith in an attempt to reach the...objective within the agreement framework."

The *Teachers* case, and numerous subsequent decisions, discuss a party's obligation to negotiate in good faith after entering into a nonbinding preliminary agreement, such as a term sheet or letter of intent. The New York cases hold that the obligation to negotiate in good faith bars a party from renouncing the deal or abandoning the negotiations.

By holding that the improper abandonment of negotiations — for example, to pursue a better deal with someone else — is "bad faith," such cases suggest that it is "bad faith" to refuse to execute a finalized formal contract for improper reasons (e.g., a better deal, or changed market conditions), particularly when all the terms have been agreed to and accurately incorporate the terms of the preliminary term sheet. Thus, the reasons for abandoning the negotiations may be relevant — whether they were abandoned because the parties just could not agree on the final terms, or whether one party reversed course to take advantage of a better deal or changing conditions.

For example, in *Channel Home Centers v. Grossman*, 795 F.2d 291, 299 (3d Cir. 1986), the court held that a non-binding letter of intent created an obligation to negotiate in good faith if "the totality of the agreement and the relevant circumstances" show that the parties so intended. In *Channel*, the parties executed a letter of intent detailing the essential terms of a lease, which specifically said it was *not binding* unless and until there was a signed final lease. The landlord then abruptly terminated the negotiations to lease the property to another party on more favorable terms. While there was no specific language in the letter of intent requiring good faith negotiations, the court relied on a statement in the letter of intent that the landlord would "withdraw the Store from the rental market, and only negotiate the above-described leasing transaction to completion."

It has long been the law that one who interferes with the prospective business affairs of another is liable in tort for the injury he has caused. Such a cause of action is separate and distinct from the cause of action for tortious interference with a contract. The elements of a claim are: (1) a reasonable expectation of economic advantage; (2) interference committed intentionally and without justification or excuse; (3) a reasonable probability that the plaintiff would have received the anticipated economic benefits, but for defendant's interference; and (4) resulting harm. Even a stranger to the preliminary agreement can find itself bound by a *nonbinding* preliminary agreement between two other parties, where the third party is aware of the preliminary agreement and interferes with one party's obligation to negotiate in good faith or induces that party to abandon the negotiations.

Parties and their counsel need to be careful when negotiating and entering into a preliminary agreement. Express *reservations* may prevent the preliminary agreement itself from being a binding contract on the ultimate, underlying transaction. However, this may not eliminate a party's enforceable obligation to negotiate a final contract in good faith — an obligation not to abandon the transaction for "greener pastures." ■