



Letters of Intent: Avoiding an Unintentional Binding Contract

Purpose of Letters of Intent

A Letter of Intent (LOI) is often used by a party who is considering entering into a transaction with another party, but who does not yet want to be bound by any particular provisions. There are several reasons why a business contemplating a deal may wish to draft only an LOI in the early stages of negotiation: The business may want to get some idea of the terms which it will negotiate later; to lay the groundwork for the manner in which a contract will be drafted; to establish a timeline for drafting final agreements; to establish confidentiality terms; to prohibit negotiation with other parties for a certain period of time; or just to find out if the other party is serious about pursuing the transaction before both sides expend considerable time, effort, and money working out the details. Whatever the reason, the purpose of an LOI is not to create a binding contract between the parties. However, if an LOI is not drafted carefully, it can be viewed by one party as a binding agreement while the other party believes it is merely a framework for future negotiations, and can lead to litigation down the road if things go sour.

Legal Principles

A court may determine that an LOI is a binding contract if it contains (1) the necessary terms to form a contract and (2) a mutual manifestation of the parties' intent to be bound. If the LOI contains all the material terms of the transaction, a court may find it to be a valid and enforceable contract even though it lacks details that one of the parties intended to include in the "final agreement" that would come later.

In determining whether the parties intend to be bound, the courts generally examine the following factors:

- the actual words of the document;
- the context of the negotiations;
- whether either or both parties have partially performed their obligations;
- whether there are any issues left to negotiate; and
- whether the subject matter of the discussions concerns complex business matters that customarily involve definitive written agreements.

Courts have consistently stated that the most important factor in determining whether or which provisions in an LOI are binding is the language used by the parties in the document. The language of the LOI should, therefore, be definite and precise. Parties should also avoid situations and subsequent communications that have led some courts to find provisions of an LOI to be binding despite language seemingly to the contrary in the document. For example, loosely worded e-mails, oral communications, and other actions are often given a great deal of weight by courts in interpreting the intent of the parties. Oral statements such as “Looks like we have a deal!” or handshakes can indicate an intent to be bound.

Practical Suggestions

Below are some basic guidelines which can considerably mitigate the risk that a LOI will be viewed as a binding agreement:

- Do Not Call the LOI an “Agreement” or “Contract”. Make sure it is entitled as a “Letter of Intent” or even a “Non-Binding Letter of Intent” or “Term Sheet”.
- The LOI should contain an express non-binding provision that clearly and unambiguously states that the letter is not a binding contract and should not be interpreted to be a binding agreement. It should also clearly state what conditions must be met in order for the parties to be bound (e.g., formal execution of definitive agreements; written approval by the governing body of each entity). Make it clear that neither party intends to be bound, that the terms contained in the LOI are preliminary and not final, and that any binding agreement or obligation will be created only by new and additional documentation.
- Do not include all material terms of the agreement in the LOI. Leave out a few and clearly identify them (e.g., representations and warranties; transfer of real property lease; ancillary documents to be negotiated). The LOI should state clearly that the parties contemplate further negotiation of the terms of the transaction and the execution of complete, definitive documentation.
- Do not make an unintended agreement once the LOI is prepared and signed by taking any actions that may suggest you are performing obligations pursuant to an agreement.

Conclusion

Letters of Intent often fail to serve their intended purpose and can cause problems that neither party anticipates. Before drafting or agreeing to sign an LOI, taking the steps outlined above can help to avoid the unintended consequences of becoming legally bound to perform a contract you did not think you were making.

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