Letters of Intent and the Covenant of Good Faith and Fair Dealing

Elmon Bella Tanielian, Michael Best & Friedrich LLP – Salt Lake City, Utah

We as practitioners understand the purpose of a letter of intent (LOI) as a unique and useful instrument in conducting business transactions. Commonly used in proposed acquisitions, LOIs permit the parties to a transaction to document key points of an agreement and express their expectations before entering into a binding agreement. However, an LOI can also be an inherently contradictory exercise, particularly regarding whether the instrument or certain parts thereof are legally enforceable. If properly drafted, an LOI can effectively protect the interests of both parties and provides the opportunity to explore a potential business relationship while avoiding the binding obligations imposed by a formal contract. Alternatively, if an LOI is ambiguously construed, parties may find themselves on the wrong end of a lawsuit arising from a document they thought was unenforceable.

Fortunately, the risk of litigation can be significantly reduced through careful drafting. Paying attention to the language of an LOI is critical both in establishing the expectations of the parties and in avoiding liability in the event the contemplated transaction is never effectuated.

Binding vs. Non-Binding Provisions

An LOI should distinguish between formally binding obligations and communications merely intended to clarify the tentative points of a potential deal. Paradoxically, the more informally an LOI is drafted, the more likely it is to be completely binding. LOIs are usually written with less care than a definitive agreement, and accordingly courts are reluctant to put dispositive weight on language making the terms thereof subject to the parties reaching a formal agreement. Alternatively, a more formally drafted LOI that clearly identifies the intentions of the parties and distinguishes between binding and non-binding provisions is less likely to be interpreted as an enforceable contract.

The non-binding clauses of an LOI will generally include the subject of the transaction (e.g. the assets to be acquired), a proposed price, an approximate timeline, and any further expectations as to how negotiations may proceed. These portions ensure the parties have analogous impressions about the transaction as negotiations continue and due diligence begins. This outline of initial terms should indicate that, while the parties are under no obligation to enter into a formal contract, if they do it will conform to these provisions. Ideally, these portions of the agreement will be expressly labeled as non-binding to confirm that the parties intend them only to establish a framework for the transaction, and not as a binding commitment.

Additionally, an LOI will generally include binding provisions to protect both parties as negotiations move forward. For example, to conduct due diligence, a buyer will often need sensitive financial and organizational information. Accordingly, most LOIs will contain a confidentiality provision, which the parties should ensure is binding and will survive should negotiations break down. Similarly, LOIs often contain an exclusivity clause, precluding the selling party from soliciting or accepting offers from anyone else during a specified period. Exclusivity provisions should be expressly made binding to ensure the buyer doesn't invest time and money in due diligence only to be ousted from the deal by a third party. Similarly, parties may want to label clauses regarding governing law, due diligence, and legal effect of the agreement as binding, such that they may be enforced against a party who breaches such a provision, even if the contemplated acquisition is never formalized.

Covenant of Good Faith and Fair Dealing

While much litigation risk can be avoided by clearly distinguishing between binding and nonbinding provisions of an LOI, a less obvious danger comes from claims arising out of the implied covenant of good faith and fair dealing (the covenant). The covenant, inherent in all contracts, includes an implied duty that the parties to the contract will not take actions that will intentionally injure the other party's right to receive their benefit under the contract. This obligation exists whenever a contract is entered into and is imposed on the parties so long as it remains consistent with the agreed upon, common purpose of the contract. This doctrine speaks not to the content of the binding agreement, but rather to how the parties will execute and perform under the contract. A violation of the covenant amounts to a breach of contract, and can result in the same legal liabilities as breaching express contractual terms.

Due to the unique nature of LOIs as severable agreements, the way the covenant adheres can be complex. Ideally, a well-drafted LOI will precisely state which provisions are intended to be binding, and the covenant will attach to those provisions alone. The non-binding provisions would remain entirely unenforceable, and the covenant would not attach thereto. If an LOI effectively distinguishes between binding and nonbinding provisions, then only the binding portions must be executed in good faith. However, if the agreement is not clearly drafted and a court interprets the LOI as entirely binding on the parties, then the covenant would adhere to the agreement in its entirety, meaning any bad faith deviation from the terms of the LOI would constitute a breach of contract.

For example, in Utah, the covenant imposes a duty in which each party impliedly promises not to intentionally do anything which will harm the other party's right to receive the benefits of the contract. The doctrine doesn't speak to terms of the contract itself, but rather to how the parties ought to execute those terms. While good faith remains a nebulous legal concept, Utah courts have held that the covenant forbids any arbitrary action by one party that detriments the other. Accordingly, if a party arbitrarily decided to back out of a potential transaction under the assumption that an LOI between the parties was unenforceable, they could subject themselves to litigation resulting from breach of the covenant. Many jurisdictions similarly reprehend arbitrary or unreasonable conduct by a party as a violation of the covenant. Again, scenarios like this are why it is essential to clearly draft an LOI and distinguish between binding and non-binding clauses therein.

Our Recommendations

Overall, the greatest protection against unwanted litigation is a clearly drafted LOI. By clearly stating the intentions of the parties and properly distinguishing between binding and nonbinding provisions, drafters maximize the probability that courts will properly construe the agreement and will not enforce any nonbinding provisions, or good faith executions thereof.

Although the risk of litigation can never be eliminated, it can be mitigated by following a few simple recommendations:

- Know the Risks: Always consider the worst case scenario that a court will find the LOI binding. When drafting the instrument, be sure the terms are such that if your client was forced to comply with them, it would not be detrimental to their interests.

- Specificity is Key: Unambiguously state which provisions are legally binding and which are not. Clearly express that the non-binding clauses are not intended to be enforceable against either party.

- Comply with the Covenant: While the covenant should adhere only to the binding provisions of an LOI, it may apply to the LOI as a whole. Act reasonably and in good faith where possible. Avoid any actions that appear arbitrary, and never suggest that you are doing something "just because."

- Consider Separate Documents: By placing the binding provisions such as confidentiality and exclusivity in a document separate from an expressly non-binding LOI, the risk of being held liable under the LOI will be reduced.

- Don't Agree to Good Faith Negotiations: In many states, including Utah, a duty to negotiate in good faith is not implied in contract negotiations, and exists only if the parties decide to include it. An agreement to negotiate in good faith gives rise to legal liabilities that could ultimately result in breach even if negotiations fall through.

- Actions Matter: Once a non-binding agreement is executed, courts can conclude the parties actually intended a more binding effect than expressed in the LOI based on post-execution conduct. Don't treat the non-binding provisions as binding or threaten to sue for breaching of the non-binding provisions.

Elmon is a first year associate at Michael Best, focusing her transactional practice on mergers and acquisitions, real estate, venture capital, and corporate and finance law. For additional information on the article, contact Elmon at ebtanielian@michaelbest.com.

To coordinate legal work with Michael Best & Friedrich LLP, please contact Lyndon Ricks at llricks@michaelbest.com.