

USING LETTERS OF INTENT: GOOD IDEA?

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Real estate players use letters of intent (LOIs) or term sheets all the time. Buyers and tenants present offers this way, often to see if a deal can be reached before incurring the costs of negotiating an agreement of sale or a lease (the Definitive Agreement). The key question is whether these agreements are binding or not. The legal principles are fairly easy to state: If the parties intend not to be bound to each other prior to the execution of a Definitive Agreement, the courts will give effect to that intent and the parties will not be bound until the agreement has been fully executed and delivered. This is true even if all issues in the negotiations have been resolved. Conversely, if the parties intend to be bound prior to the execution of a Definitive Agreement, the court will give effect to that intent, and the parties will be bound even though they contemplate replacing their earlier understanding with a later written agreement. 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 LOI itself.

Typically, parties draft LOIs to be partially binding. The LOI will contain provisions not intended to be binding and provisions expressly intended to be binding on the parties. The non-binding provisions consist primarily of the "deal points", such as a description of the key components of a proposed transaction and any important conditions. For an agreement of sale, these include the purchase price, deposit, due diligence period, deal contingencies (e.g. financing, licensing and land use approvals), time for closing and broker payment obligations. For a lease agreement, these include the rental rate, security deposit, tenant allowance, responsibility for repairs and replacements, use and exclusivity terms, brokers and any unique arrangements. The binding provisions focus on the negotiation time period, including access to information, confidentiality, a "no-shop" or exclusivity provision in which the seller or landlord agrees not to sell or lease the subject property to another for a specified period of time, broker representations and protection and non-disclosure (to third parties) obligations. There should be a termination provision and natural end date for the life of the LOI.

The main purpose of a typical LOI is for the parties to formulate deal points without committing to the actual transaction. LOIs provide counsel a blueprint for preparation of the Definitive Agreement, saving time and money. LOIs can keep the deal momentum moving forward while negotiating the details of a Definitive Agreement, especially when they contain milestones for delivering a draft and executing a final version. Moreover, an LOI may be necessary for a lender or investor to move to the next step of its process.

However, there are also potential risks in using LOIs. If inartfully drafted, or if the parties act as though

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they have reached a deal, the LOI may be deemed a binding contract, obligating the parties prematurely. Further, many courts have found that execution of an LOI creates an obligation for the parties to negotiate, in good faith, a reasonable agreement, which may be an unintended consequence of signing. Another possible disadvantage of using an LOI is that a party may share the letter with a competing bidder to shop the deal to see if they can get a better offer. Even worse, deal momentum may die while negotiating a trivial LOI provision for a simple transaction that could have gone straight to the Definitive Agreement.

Indeed it is often the case that conceptual agreement on the basic deal points will allow a buyer to prepare an agreement of sale, without the need to incur the time and expense of negotiating an LOI. But, for the complex commercial transaction, an LOI can provide a necessary level of comfort prior to expending significant resources on investigations, inspections, analysis and negotiation of a Definitive Agreement.

If you use LOIs, be clear and specifically describe the binding provisions, carefully distinguishing them from the non-binding provisions. If there are no special conditions or complicating factors, go straight to the Definitive Agreement instead of preparing an LOI to avoid unintended consequences, such as a forming a contract or creating an obligation to negotiate in good faith.

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