



Presentation Outline: "Agreements to agree, joint ventures and the duty to negotiate in good faith - A litigator's comments on virtual contracts"

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1. What is a Preliminary Agreement?

- a. A preliminary agreement is "any agreement, whether or not legally enforceable, that is made during negotiations in anticipation of some later agreement that will be the culmination of the negotiations." I E. ALLEN FARNSWORTH, FARNSWORTH ON CONTRACTS §3.8a (3d ed. 2004).
- b. It is more definite than an "agreement to agree." A contradiction in terms, an agreement to agree may result in no contract because there is no "meeting of the minds."
- c. A preliminary agreement is not intended to be the final form of the contract.
- d. Examples: commitment letters, binders, agreements in principle, term sheets, memoranda of understanding, letters of intent.
- e. Labels matter: they go to intent to be bound. *See Hill v. McGregor Mfg Corp.*, 178 N.W.2d 553 (Mich. App. 1970) (use of term "memorandum of understanding" rather than "contract" or "settlement agreement" evidencing intent not to be bound).
- f. Problems as to enforceability: not usually a question of "offer and acceptance," but: intent to be bound, indefiniteness, authority, statute of frauds, and interpretation of terms.

2. A Leading NY (federal) Case on Preliminary Agreements: *Teachers Ins. and Annuity Ass'n of Am v. Tribune Co.*, 670 F. Supp. 491 (S.D.N.Y.)

- a. Summary of Facts. Borrower ("Tribune") solicited loan in offering memo and term sheet. Lender ("TIAA") sent a commitment letter with a "Summary of Proposed Terms," which included material business terms and the following provisions:

Agreement would be "contingent upon the preparation, execution and delivery of documents ... in form and substance satisfactory to TIAA and TIAA's special counsel" and that transaction documents would include "usual and customary" business terms.

Invitation to Tribune to "evidence acceptance of the conditions of this letter by having it executed below by a duly authorized officer..."



Provided that: "Upon receipt by TIAA of an accepted counterpart of this letter, our agreement to issue sell and deliver to us... the captioned securities, *shall become a binding agreement between us.*"

Borrower (Tribune) countersigned TIAA's commitment letter, but indicated that its "acceptance and agreement would be subject to approval by the Company's Board of Directors and the preparation and execution of legal documentation satisfactory to the Company."

Interest rates fell dramatically and Tribune got a legal opinion that it might not get the favorable tax treatment it expected from the transaction (although it never made the tax issue a contingency for financing in the preliminary agreement). Tribune pulled out of the deal and TIAA sued for breach of contract.

- b. Court's Discussion. Court's analysis defined two forms of preliminary agreements:
- i. Type I: "Parties have reached complete agreement (including the agreement to be bound) on all issues perceived to require negotiation. Such an agreement is preliminary in form only in the sense that the parties desire a more elaborate formalization."
 1. Typical examples: insurance binders, earnest money agreements, mortgage commitment letters.
 2. Enforceability often depends on industry custom.
 3. Courts will supply missing terms or award damages for breach.
 - ii. Type II: "mutual commitment to a contract on agreed major term, while recognizing the existence of open terms that remain to be negotiated." The existence of "open terms" does not *necessarily* mean the parties intend not to be bound: parties can bind themselves to a "mutual commitment to negotiate together in good faith in an effort to reach final agreement with the scope that has been settled in the preliminary agreement."¹
- c. Holding: Court held that TIAA-Tribune agreement is a Type II Agreement. Court looked at multiple factors (intent, context of negotiation, open terms, partial performance, industry custom), but the *intent of the parties was most significant*.

¹ The Supreme Court of the State of Washington described three categories of preliminary agreements in *Keystone Land and Dev. Co. v. Xerox*, 152 Wash. 2d 171 (2004): (1) unenforceable agreement to agreement; (2) agreement with open terms that the court can provide, so long as the parties intended to be bound; and (3) an agreement to negotiate in good faith. Court did not decide whether type 3 is enforceable or what damages would be.



Tribune, therefore, breached duty to negotiate in good faith.² But Court did not address damages.

3. Damages for breach of Type II agreement (breach of the “duty to negotiate in good faith”): *Goodstein Constr. Corp. v. City of NY*, 80 N.Y.2d 366 (1992).

a. Facts

- i. Per two “letter agreements,” contractor won exclusive right to negotiate real estate development contract with the City.
- ii. City later “dedesignated” contractor.
- iii. Contractor sued for \$800 million: its projected profits on developments.

b. Holding: contractor is limited to “out of pocket” expenses for breach of City’s duty to “act in good faith” in negotiating contracts; no lost profits. Court reasoning: the city’s contractual promise was to negotiate in good faith, so damages must flow from that. City did not enter into substantive development contract (from which lost profit damages might flow). Court also said that lost profit damages were not reasonably foreseeable to City at time of contract (citing English case on consequential damages: *Hadley v. Baxendale*, 9 Exch. 341 (1854)).

4. *Teachers Ins. approved by Court of Appeals, Second Circuit: Aracadian Phosphates, Inc. v. Aracadian Corp.*, 884 F.2d 69 (2d Cir. 1989).

a. Facts: Seller of fertilizer business claimed: “agreement to agree”; buyer of business claimed “memorandum” was Type I binding contract.

- i. Preliminary Agreement termed an “Agreement.”
- ii. Subject to approval of boards of buyer and seller.
- iii. “Agreement” stated compensation for failed negotiations of final contract.
- iv. Parties agreed “to cooperate fully and work judiciously in order to expedite the closing date and consummate the sale of the business.”

Seller and buyer took numerous affirmative steps in contemplation of closing of final agreement: board approval, payment of deposits, many statements by parties referring to agreement. But because of a major change in the price of phosphates, seller broke negotiations on pretext (control over joint venture entity, which had already been negotiated).

² New York state law also recognizes an agreement to negotiate in good faith as enforceable. *ABC v. Wolf*, 52 N.Y.2d 394 (1981) (sportscaster signed with competitor during contractual period requiring good faith, exclusive negotiations; but court denied injunction denied because personal services contract; damages were not sought – example of a right, but no remedy).

- b. Holding: Court held: “agreement” was not a Type I because it referenced the “possibility that negotiations might fail” and provided for “a binding sales agreement” to be concluded in future. Court found, however, that seller may be liable for “promissory estoppel”

5. Is *Teachers Ins.* still good law?

- a. Utility of Type I and Type II Agreements criticized in *IDT Corp. v. Tyco Group, S.A.R.L.*, 13 N.Y.3d 209 (NY 2009). Dispute involved implementation of a settlement agreement. Footnote 2 criticizes *Teachers Ins.*: “The parties debate whether the settlement agreement is a Type I or Type II preliminary agreement While we do not disagree with the reasoning in federal cases, we do not find the rigid classifications into “Types” useful.

- i. New Mode of Analysis? Lower court in *IDT* found that the settlement agreement was a Type I. Court of Appeals said test is: (1) *did the agreement contemplate negotiation of later agreements and (2) is the later agreement “a precondition to a party’s performance?”*
- ii. Summary of Facts in IDT: parties entered into a settlement of a lawsuit over a MOU regarding joint venture to create fiber optic network. Settlement required Tyco to provide IDT with an indefeasible right of use (IRU) of fiber optic capacity free for a 15 year period. Network was not then constructed, so performance would be in future. Settlement provided that “the IRU shall be documented pursuant to definitive agreements to be mutually agreed upon and, in any event, containing the terms and conditions consistent with [the settlement]” and consistent with “Tyco’s standard agreements with similarly situated customers.” The “standard agreement” was also not the in existence.

Parties attempted to negotiate IRU for three years, but talks broke down, resulting in second lawsuit. IDT claimed that Tyco breached settlement agreement by proposing terms inconsistent with the settlement agreement, including a provision that allowed Tyco to decommission the network in five years (settlement required 15 years of use) and assess fees for shutdown of the network (settlement required IRU to be free).

- iii. Holding. Court held that settlement was a binding agreement. Definitive written agreement on IRU was a condition precedent to Tyco’s future performance. Tyco did not breach duty to negotiate in good faith merely by proposing terms that were inconsistent. Settlement saved from indefiniteness because parties had a mechanism for resolving dispute over terms in IRU: Tyco’s standard agreement with customers controlled.
- b. *Teachers Ins.* questioned again in *Amcan Holdings, Inc. v. CIBC*, 70 A.D.3d 423 (NY App. Div. 2010). Appellate Division cited *IDT*’s rejection of the mode of analysis in *Teacher’s Ins.*

- i. Facts: borrower sued bank for breach of August 31, 2001 Summary of Terms and Conditions (the "Summary") for credit facility and term loan. Summary contained following disclaimer:

This summary represents an outline of the basis on which CIBC will provide its commitment under the Credit Facilities. The Credit Facilities will only be established upon completion of definitive loan documentation including a credit agreement (the "Credit Agreement") which will contain the terms and conditions set out in this Summary in addition to such other representations, warranties, covenants, indemnities, defaults, and other terms and conditions (including increased costs, reserve tax, capital adequacy, currency of payment and other provisions) as CIBC may reasonably require.

Borrower partially performed, paying two of three installments of loan commitment fees (\$50K on acceptance of draft summary (which preceded the "summary," and \$150K on "acceptance of committed offer" to loan). Borrower did not pay \$300K balance of commitment fee on closing of loan.

Bank discovered alleged non-disclosure by borrower, broke off negotiations, and returned deposits. Deal never closed.

- ii. Lower Court's Decision: Lower court denied lender's motion to dismiss, finding that there was an issue of fact as to whether contract was a binding agreement or merely an agreement to agree. Court noted the detail in the Summary, the fact that borrower signed it, and the payment of \$150K as "acceptance of committed offer."
- iii. Appellate Court's Holding: citing *IDT*, Appellate Division held that the bank's performance was contingent on final agreement. Appellate Court also found that "at no point did the parties explicitly state that they intended to be bound by the Summary pending the final Credit Agreement, nor did they waive the finalization of such agreement." Since there was no final agreement, there was no contract—complaint dismissed. Appellate Court did not discuss duty to negotiate in good faith.³

6. The Problem of Indefiniteness – Necessity of a Fall Back Standard

- a. Not every ambiguity will render a contract unenforceable. "Indefiniteness must reach the point where construction becomes futile." *Heyman Cohen & Sons v.*

³ See also *Jordan Panel Sys., Corp. v. Turner Constr. Co.*, 45 A.D.3d 165 (N.Y. App. Div. 2007): a corollary to "freedom of contract" is the freedom not to contract. In a bad sign for plaintiff, the Court opened its analysis by stating: "It is well settled that, if the parties to an agreement do not intend it to be binding upon them until it is reduced to writing and signed by both of them, they are not bound and may not be held liable until it has been written out and signed." Subcontractor lost where general contractor gave oral award of subcontract (and actually allowed subcontractor to start working) but "preliminary term sheet" clearly stated no binding contract until signed by both parties and specifically contemplated GC's right to not award contract even after subcontractor started work. The court emphasized that freedom of contract includes "freedom to avoid oral agreements."

Lurie Woolen Co., 232 N.Y. 112, 114 (1921). But there must be an agreement on the material terms.

- b. Even where the parties writing shows intention to be bound, contract can still fail based on indefiniteness. *See Joseph Martin, Jr. Delicatessen, Inc. v. Schumacher*, 52 N.Y.2d 105 (1981) (lease renewal option providing that “the Tenant may renew this lease for an additional period of five years at annual rentals to be agreed upon” unenforceable because no external reference or standard for resolving amount of rent); *but see* U.C.C. § 2-305 (open price term will be established with reference to market price).

7. The Problem of the Signature

- a. On the one hand, if parties do not intend to be bound to an agreement until it is reduced to writing and signed by both parties, then there is no contract until that event occurs. *Scheck v. Francis*, 26 N.Y.2d 466 (1970) (defendant’s attorney sent contract to plaintiff with instructions for both principals to sign; only plaintiff signed; absence of defendant’s signature fatal to contract). *See also Reprosystem, B.V. v. SCM Corp*, 727 F.2d 257 (2d Cir. 1984) (letter provided for sale of business for \$9MM subject to (1) “satisfactory audit by accountants” and (2) “execution of a formal agreement” satisfactory to seller and buyer. After months of negotiations, parties entered into “agreement in principle,” *still subject to definitive agreements*. Parties negotiated “final drafts,” described as such, but never executed. Seller then terminated negotiations. Lower court found that the parties intended to be bound by final drafts, but Court of Appeals reversed because the agreements contemplated execution of definitive agreements. Court also rejected claim of breach of duty to negotiate in good faith, citing indefiniteness of agreement). One commentator has suggested that after *Goodstein Constr.*, a plaintiff could now recover out of pocket damages for breach of duty to negotiate in good faith. Vol. I JOSEPH M. PERILLO, CORBIN ON CONTRACTS § 2.8 n. 19 (Rev. ed. 1993).
- b. On the other hand, if there is no understanding that a signed writing is necessary before the parties will be bound, and the parties have agreed upon all substantial terms, then an informal agreement can be binding, even though the parties contemplate evidencing their agreement in a formal document later. *Municipal Consultants & Publishers, Inc. v. Town of Ramapo*, 47 N.Y.2d 144 (1979).

8. Other Inchoate or “Virtual” Contracts

- a. Implied in fact agreement
- b. Promissory Estoppel: *Aracadian Phosphates, Inc. Revisited*
 - i. Elements of Promissory Estoppel. NY law requires: “a clear and unambiguous promise; a reasonable and foreseeable reliance by the party to whom the promise is made; and an injury sustained by the party asserting the estoppel by reason of his reliance.”



- ii. Holding: Trial would be needed to see whether Seller made “unambiguous promise to negotiate in good faith” reliance, and damages. Damages would be limited to out of pocket expense.
- iii. But note: Promissory estoppel is difficult claim to establish under New York law. *See Prospect St. Ventures I, LLC v Eclipsys Solutions Corp.*, 23 AD3d 213 (N.Y. App. Div. 2005) (“The legal insufficiency of the contract cause of action requires the dismissal of the promissory estoppel claim as well, since the inclusion of the condition [to execute final documents] precluded the element of detrimental reliance The expenditure of time and \$25,000 for due diligence is not detrimental reliance under the circumstances.”) “Promissory estoppel” requires not just an “injury” but an “unconscionable injury,” which is a difficult standard. *Philo Smith & Co. Inc. v. U.S. Life Corp.*, 554 F.2d 34 (2d Cir. 1977).

c. Joint Ventures/Partnerships at Will

9. Prophylactic Advice

- a. Easiest way to avoid being ambushed is to state clearly that the parties are not legally bound. *See Dunhill Sec. Corp. v. Microthermal Applications*, 308 F. Supp. 195 (S.D.N.Y. 1969).
- b. If parties want consequences for the failure to reach a definitive agreement, preliminary agreement should set forth exactly what those consequences are.
- c. Preliminary Agreements are useful: manifesting agreement on major business points (leaving details to lawyers), setting ground rules for negotiations and due diligence, and establishing consequences of “no deal.” But other times, best advice is to go straight to contracts.
- d. Courts will be practical: complex deals and sophisticated parties will face strict construction. Usage of trade will affect enforceability.

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