

WELCOME

Lecture Three

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Letters of intent

Letters of intent

Definition

“Letters of Intent,” or “LOIs,” are often used by parties during an exploratory phase of discussions. They express mutual intentions to move forward toward a contractual arrangement, but are, by their terms, nonbinding.



Here is a typical LOI introductory paragraph:

This letter of intent is for discussion purposes only and this letter of intent is not intended to be a binding agreement between the parties regarding the subject matter hereof. A binding agreement will not occur unless and until the parties have agreed upon the terms of the transaction and such terms are included in the appropriate definitive agreement that has been negotiated, approved, executed and delivered by each party hereto.

Letters of intent & oral contracts

Letters of intent & oral contracts

When done correctly, an LOI describes a mutual undertaking the parties are considering and further states that, in the event the parties are unable to negotiate an acceptable written contract, neither party is bound to take any further action. An LOI should include nothing that contradicts this except that each party might explicitly agree to protect and not misuse the other party's confidential information and one party might even agree to pay the other's pre-approved expenses.

Letters of intent & oral contracts

Letters of intent & oral contracts

Negotiating an LOI gives the parties an opportunity to sketch out a rough term sheet and provides each party with a document that can be shared with others in the organization, such as a Board of Directors, who need to understand what is being negotiated and why.

Misuse of LOIs

Often, unfortunately, once parties start writing an LOI, they get carried away and try to accomplish too much in it, describing the terms of a relationship in too much detail and often providing for one or both parties to begin performance while negotiations continue on a final agreement.

The misuse of LOIs can be a problem in organizations lacking policy and procedural checks and balances to regulate the impatience or naiveté of individual team members. Be quietly alert for the possibility that talk of an LOI is a red flag for a potentially troubled commercial relationship.

Misuse of LOIs

Variations on the following pattern sometimes play out around LOIs, especially in startups:

An LOI is used as a morale booster to portray a deal as all-but-certain;

Whether or not spelled out in the LOI, work begins on some aspect(s) of the project;

Signing of the LOI distracts attention from timely finalizing a real agreement;

Work on the project evolves beyond the LOI's terms and problems are encountered; and

One of the parties decides to terminate the project and disappointments and uncertainties abound.

Misuse of LOIs

However one gets there, reliance on an LOI to begin work, combined with the parties' later communications, acts of performance, and other "course of conduct," can set the stage for claims of damages, lost opportunities, compromised intellectual property, wasted resources, and other counterproductive outcomes.

LOI best practices

Because of the tendency to misunderstand and misuse LOIs, they should be discouraged if those managing the process are inexperienced. Where business dynamics make avoidance of an LOI impossible

The following conditions should be observed:

The LOI should be drafted narrowly and precisely, with the help of a lawyer if possible.

LOI best practices

The following conditions should be observed:

The LOI should be drafted narrowly and precisely, with the help of a lawyer if possible.

Performance by either party should be forbidden except, where critical, within very limited and explicitly described boundaries and with costs clearly allocated.

The LOI should be quickly followed by a comprehensive agreement that the parties can sign as soon as they have decided how to go forward.

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Oral contracts

Oral contracts

Oral agreements

Somewhat akin to LOIs, oral agreements between parties that are performable within a year and not for the purchase of real estate are generally valid and enforceable.

Despite their technical validity, it is best to avoid oral agreements. First, they are subject to obvious problems of proof. In the event of any type of dispute, how will the injured party present his or her case? Further, even the most casual arrangements can pose hidden or unforeseeable risks of non performance, inflated charges, and a range of potentially serious liabilities.

Oral Contracts

Oral Contracts

Oral agreements

For example, should the vendor that provides your office with coffee or bottled water do so without an agreement? What if one of the vendor's employees hurts himself with his own equipment on your property? What if the vendor's employee harasses or injures one of your employees or customers? A written document could compel the vendor to carry insurance and indemnify your company from all such losses and expenses – remedies a court might not award absent a written agreement.



Oral Contracts

Oral agreements

Similarly, a simple agreement with a company to provide cleaning services for your offices can and should include indemnification provisions as well as specific warranties and representations around licenses, worker background checks, insurance, and protection of confidential information.

Oral Contracts

Oral agreements

In summary, it is difficult to draw a line of materiality or significance below which oral agreements make sense, particularly since most responsible business persons have some form of standard agreement to offer as a starting point. In fact, resistance by any business person to a signed, written agreement should be a red flag prompting questions about insurance certificates, appropriate bonds or licenses, tax ID numbers, and other documentation.

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Breach, Damages and Remedies

Breach, Damages and Remedies

Breach

Under contract law, a party can breach contractual obligations accidentally, intentionally, or even through no fault of its own due to circumstances beyond its control.

In this respect, breach of contract is somewhat similar to the concept of “strict liability” in tort law concerning dangerously defective goods.



Breach

For example, Under strict liability, if a baby stroller design includes a hidden defect that pinches off babies' fingers, liability cannot be avoided simply because the design defect was accidental or even difficult to have avoided. Similarly, a contract breach is a breach, regardless of intent or level of diligence.

Breach

And while showing “negligence,” a tort law concept, is not required to prove a breach of non-performance, negligence in performing contractual obligations can sometimes constitute its own breach for which damages are owed, particularly where professional or technical services are involved and a certain duty of care and level of skill customary within the profession is required to properly perform the services.

Breach, Damages and Remedies

Breach

Most contracts do not have a section captioned “Breach,” let alone a section captioned “Remedies.” This might be because many think the subject of possible performance failings is too negative to dwell on.

As a result, analyzing questions of breach and remedies after the fact is often an uncertain exercise. It usually involves harmonizing often-deficient Obligations and Termination language with conflicting provisions under Disclaimers of Warranties and Limitations of Liability.

Damages

In contract law, damages is the legal term for dollar amounts one owes in order to put the non-breaching party in the same economic position as if no breach had occurred. Unless specifically disclaimed or limited by contractual language, this generally means both losses sustained and gains prevented, minus losses or missed opportunities that could have been reasonably avoided or mitigated.

Damages

“Losses sustained” in this calculation could include things like expenses incurred by the non-breaching party to replace the product or service not timely or properly provided. They could also mean expenses incurred in reliance on and in preparation for the breaching party’s performance, including collateral expenses such as advertising the product or service that was dependent upon the breaching party’s performance.

Damages

“Gains prevented” could theoretically include lost profits, lost increases in company value, and the value of other missed opportunities caused by the breach.

In calculating losses sustained, courts have looked at whether expenses incurred by a non-breaching party were reasonable and whether or not they could have been “salvaged” for the same or another purpose.

Similarly, damages for “gains prevented” can be reduced by evidence of lack of “certainty” and by evidence that such damages were (or could have been) avoided or reduced through substitutions or other available efforts to reduce the damages, often referred to as “mitigation.” The potential for relatively open-ended damages under the case law is the reason that virtually all commercial agreements include Limitations of Liability clauses specifically disclaiming liability for indirect losses such as lost profits.

Remedies

Remedies is a broader term than damages. It covers a wide range of rights and obligations that can arise when a party breaches its contractual obligations, including claims for damages. Potential remedies can include, among other things:

Rights to compel performance or to provide substituted performance,

Rights to terminate for cause,

Rights to fee or price reductions or refunds,

Remedies

Remedies is a broader term than damages. It covers a wide range of rights and obligations that can arise when a party breaches its contractual obligations, including claims for damages. Potential remedies can include, among other things:

Rights to compensation for direct or indirect damages, and

Rights to “indemnification” for losses and expenses related to third party claims.

An interesting tenet of contract law is that, except as limited in writing, the damages to which a party will be entitled for another party’s breach are fairly broad and need not be detailed in an agreement.

Remedies

A related point is the general rule that all potential remedies - contractual, common law, statutory, or equitable - are “cumulative,” meaning that several different types of damages and other remedies can be awarded for the same facts.

If a parts supplier delivers defective parts to an auto manufacturer, and the manufacturer incorporates those parts into its vehicles before discovering the defects, the manufacturer could have multiple (cumulative) damage claims against the supplier, to the extent not limited under their agreement, including:

Remedies

To the extent not limited under their agreement, including:

(i) refunds of amounts paid for the parts,

(ii) all costs associated with recalling and fixing the vehicles with replacement parts,

(iii) costs and expenses relating to any customer lawsuits or regulatory actions stemming from the defective parts,

and (iv) any lost profits suffered by the manufacturer that can be attributed to the resulting bad publicity.

Remedies

Risk that Remedies Language May be Deemed Exclusive

Another point worth considering is the possibility that poorly drafted Remedies clauses might provide a non-breaching party less than what might have been available under the law, particularly if those stated remedies are later cast, fairly or unfairly, as “exclusive” remedies under the agreement.



Remedies

Risk that Remedies Language May be Deemed Exclusive

As an example, a Remedies clause specifically providing for rights to:

(i) terminate for cause

and (ii) receive a refund of all fees paid, could be viewed restrictively by a court as being the exclusive remedies for breach, as negotiated by the parties.

Addressing this concern is relatively easy, assuming the other party goes along. Whenever remedies provisions are included in an agreement, the buyer should also add language to the effect that “the remedies described here are in addition to all other appropriate remedies under the Agreement or under law.”

Benefits of Strong Remedies Language

Despite such drafting risks and despite the default rule that damages are available to a non-breaching party, whether or not specifically provided for, the better approach in most cases is to think through the types of breaches the seller might commit, negotiate for the best possible remedies, and incorporate them into the agreement.

One of the most compelling reasons for doing so is the fact that litigating to enforce rights under almost any agreement is very expensive, time consuming, stressful, and often quite uncertain. Parties that have written provisions detailing performance obligations and meaningful remedies for breach are far less likely to have unexpected disagreements.

Benefits of Strong Remedies Language

Among other reasons for this, greater clarity on the costs of breach reduces the danger that a party will breach intentionally based on a miscalculation of the costs and benefits.

Additionally, in the event of a dispute, clarity in an agreement around performance obligations and remedies for breach will put the non-breaching party in a much better position to make its case to a court or arbitrator. A stronger case can mean reduced costs, fees and uncertainty, and potentially even a faster path to victory in the form of an earlier settlement or even a successful “Motion for Summary Judgement.”

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Common mistakes –part 1-

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While understanding contract law is certainly helpful in drafting and negotiating contracts, the most common and costly mistakes tend to involve simple errors in due diligence, judgment and drafting, and giving up too easily on important issues. The following mistakes are common sources of commercial disputes. Avoid them to prevent costly litigation, missed opportunities and wasted resources.

Performance before agreement

Whether based on mutually euphoric “good faith” or naive reliance on an LOI, one of the worst mistakes is having one or both parties begin performance before a final agreement is in place. Those who do this often see themselves as entrepreneurial risk takers.

The predictably bad outcomes often make such decisions seem impulsive and undisciplined in hindsight.

Performance before agreement

Here are some of the justifications you might use yourself or hear from others when pre-agreement performance is happening or being considered:

“The parties trust each other enough to move forward in good faith; the contract will come together in due time.”

“We’ll keep working on the contract, but the work has to start now to meet the project deadline.”

Performance before agreement

Here are some of the justifications you might use yourself or hear from others when pre-agreement performance is happening or being considered:

“The other party is a business partner, not a vendor. I’m not worried about the contract.” “Concern over the contract will show lack of trust and jeopardize the relationship.”

“An LOI will give us an opportunity to see how the other party performs before we sign.” “We’ll get a better deal once the other side feels committed.”

Performance before agreement

Starting performance prior to having an agreement often takes organizations backward from where they started, or at least sideways. This is because, by the time the mistake is realized, the organization may have to first dig out of a mess before it can start over.

Walking away from a failed relationship might involve more than just walking away from already incurred sunken costs and critically delayed opportunities - the other party may also have valid claims for additional compensation. Additionally, rights to any jointly created intellectual property may need to be sorted out between the parties, through amicable means or otherwise.

Performance before agreement

Managing Impatience



Impatience is the most common factor in proceeding without a final agreement. The decision to charge ahead before an agreement is in place often comes under tight deadlines, and sometimes when a difficult issue or two remain unresolved after two or more turns of a draft agreement.

Eventually, though, these very issues may bring about the relationship's undoing. Putting off difficult issues does not make them easier to resolve. Often, in fact, the opposite will be true. Once the relationship has started, the other party may have less incentive to compromise, particularly if you have already written checks or performed your part.

Performance before agreement

Managing Impatience



Prevent impatience from impacting contract negotiations in the first place by accepting and embracing the fact that it is quite common for sophisticated parties to exchange multiple drafts of important documents as they reach compromises and narrow their differences.

Failing to shop and compare

RFPs

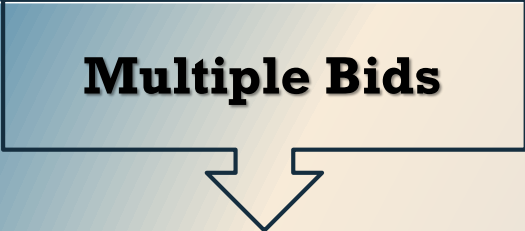


Depending on the size, importance and complexity of an expected relationship, it is generally wise to look at more than one option before entering into serious negotiations. At the conservative end of the spectrum, significant relationships are often preceded by a “Request for Proposals” or “RFP.”

This is a document sent to prospective providers of a needed good or service that describes in detail the requested good or service, specifying exactly how interested parties are to respond and by when.

Failing to shop and compare

Multiple Bids



If a full RFP is too burdensome, it is still wise to follow the traditional rule of getting two or three bids for any commercial procurement of goods or services. At a minimum, going through either process will help an organization assess its objectives and expectations and prepare it for incorporating those in a final agreement.

Failing to shop and compare

RFP Follow-up



Answers to RFPs are often carefully written. They should be carefully studied and follow-up information should be requested where answers seem incomplete, evasive or otherwise miss the mark. Depending on the nature of the proposed arrangement and your level of certainty or uncertainty about the abilities, facilities and reputation of the parties involved, you may want to perform additional due diligence by visiting and inspecting facilities, talking with customer and creditor references, and pulling reports on financial condition, judgments and the like.

Failing to shop and compare

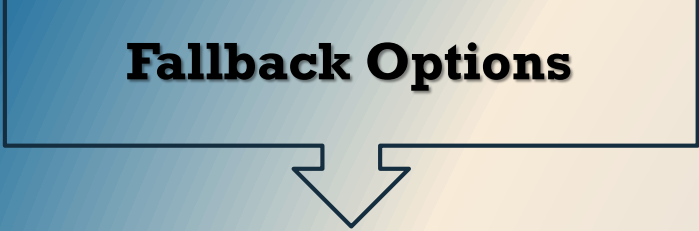
**Incorporate RFP into
Final Agreement**



Lastly, consider adding a party's finalized RFP response as an exhibit to any agreement entered into with them, along with language in the agreement making the RFP response part of the agreement.

Failing to shop and compare

Fallback Options



An added benefit of scrutinizing and engaging with more than one prospect is that, if contract negotiations do not go well, you may have a viable fallback option. Even if you do not resort to that option, the knowledge that you have an option will make you a better negotiator.

Inadequate Descriptions of Performance Obligations

Detailed Performance Obligations



Performance shortcomings are surprisingly common in business. Sellers of goods and services can disappoint for any number of reasons, including over-promising, corner-cutting, staffing problems, phasing out a product line or service, selling a product line or service to another company, and simple incompetence or lack of diligence.

As a result, performance concerns are possibly the top source of commercial disputes. Every contract should clearly and completely describe each party's performance obligations.

Inadequate Descriptions of Performance Obligations

Detailed Performance Obligations



These descriptions should include all of the details that the parties have discussed, and particularly all of the representations the other party has made, either directly or indirectly through representations of their staff members or through their advertising or marketing materials.

As noted above, if the other party provided a written RFP response, consider attaching it to the agreement if it contains the best description of the other party's obligations and possibly also specific representations and warranties.

Inadequate Descriptions of Performance Obligations

Get in writing



It is much easier to make another party perform as you expect if those expectations have been clearly written into the contract. In the end, it does not matter what the sales or “business development” person told you if it is not in the agreement. As discussed in Chapter Five, Common Contract Terms, most contracts contain a clause captioned along the lines of Entire Agreement that specifically disclaims the enforceability of any written or oral promises or representations made but not incorporated into the agreement.

In the face of resistance to detailing performance obligations, sometimes it helps to tell the sales person or other negotiator that, while you believe and trust them, others in their organization and in your organization will also be required to understand and administer the agreement in the future, so the details need to be in writing.

Inadequate Descriptions of Performance Obligations

**Aversion to Detail is a
Red Flag**



Another party's refusal to add detailed performance obligations to an agreement is always a red flag. Take it as a clue that the other party does not intend to perform as you are hoping or expecting. Rarely does a party's performance exceed their written commitments. Many get burned by assuming others will perform at a high level for reputational reasons. Reputational concerns, unfortunately, are not always the driving force one would expect.

Inadequate Descriptions of Performance Obligations

Bad Outcomes



The mistake of failing to detail performance obligations causes some of the worst contractual nightmares. If proper performance is not clearly defined, poor performance likely will not constitute a breach of the agreement, making remedies such as offsets, price reductions or termination unavailable. Paying full price for the wrong product or service is a bad outcome. If the agreement is for an extended term, the only recourse may be to negotiate a large termination fee just so you can walk away and pay a new provider all over.

thank
you!