



Legal ALERT!

CORPORATE

James J. Canfield, Chair

315-425-2763

jjcanfield@hblaw.com

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In a Bind? Second Circuit Court of Appeals Considers Legal Effect of Letters of Intent

In M&A transactions involving privately-held targets, letters of intent ("LOI's") are often employed. For both buyers and sellers, they provide some comfort that the parties are "on the same page." Whether a LOI creates binding obligations or a preliminary non-binding understanding to be further negotiated in a more formal agreement was recently addressed by the United States Court of Appeals for the Second Circuit applying New York law in the case of *Vacold LLC v. Cerami*, 545 F.3d 114 (2nd Cir. 2008) (hereinafter "*Cerami*"). The decision in *Cerami* suggests that predicting whether a court will consider certain provisions of a LOI binding or non-binding, absent clear and concise language to the point, could prove difficult.

In *Cerami*, the court found that a preliminary agreement made in connection with the purchase and sale of securities was binding despite the parties' expressed intent to formalize their transaction in a subsequent more definitive written agreement. The Court found that the language of a preliminary letter agreement between the buyer and seller and negotiations between them indicated that the parties intended to be bound in that there were no open terms except for "boilerplate" to be added by counsel.

In issuing its holding, the Court reasoned that binding preliminary agreements fall into one of two categories: Type I preliminary agreements that are "fully binding" because the parties have agreed on all material points that require negotiation notwithstanding their agreement to memorialize their agreement in a more formal document; and Type II preliminary agreements that are binding as to certain terms (e.g. no-shop, confidentiality, etc.), but leave other terms open for future negotiation. In distinguishing between the two types of preliminary agreements, the court articulated and applied the following tests:

To determine if there is a Type I preliminary agreement, the court looked at the following factors:

1. Whether there is an express reservation of right not to be bound in the absence of further agreement;
2. Whether there has been partial performance;
3. Whether all the terms of the alleged contract have been agreed upon; and
4. Whether the agreement at issue is the type of contract that is usually committed to writing.

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For a Type II preliminary agreement, the court examined:

1. Whether the intent to be bound is revealed in the language of the agreement;
2. The context of the negotiations;
3. The existence of open terms;
4. Partial performance; and
5. The need to put the agreement into final form, as indicated by the customary form of such transactions.

In *Cerami*, the Court analyzed only those factors it saw as relevant to the preliminary agreement at issue. Based on the lack of any outstanding issues and open terms as requiring negotiation following the entry of the preliminary agreement, the limited contingencies and the parties characterization of their agreement as a "letter agreement" as compared to earlier drafts that had used the term "summary of discussions," among other considerations, the Court found that there was sufficient evidence of the parties' intent to be bound. The Court found that the parties' intention of enter into a more formal definitive agreement was mere "boiler-plate" that the parties foresaw no difficulty in negotiating. It further held that the need to negotiate and execute a formal agreement did not undercut the conclusion that the preliminary agreement at issue was a Type I preliminary agreement that bound the parties with respect to the purchase and sale of seller's shares.

Anyone who has negotiated an LOI might disagree with the Court's conclusion. In fact, the dissent in *Cerami* noted that there is a strong presumption against finding a Type I preliminary agreement when future preparation and execution of definitive contract documents is contemplated. Tellingly, the dissent pointed out that there was nothing in the majority's opinion that adequately explains why the preliminary agreement at issue is better viewed as a Type I rather than a Type II preliminary agreement. That is the challenge *Cerami* presents for M&A participants. Given the general and overlapping nature of the factors considered, absent express language on point, it may be difficult to predict with confidence which provisions of a LOI a court might find to be binding.

A buyer, for example, may want the exclusivity ("no-shop") and due diligence/access provisions of a LOI to be binding. At the same time, it views the "economic terms," such as price and payment terms, as non-binding and subject to due diligence and definitive documentation. But what if the buyer walks and seller attempts to enforce the LOI? Will a court honor the buyer's intent or will a *Cerami* analysis yield a Type I preliminary agreement?

The legal and factual backdrop of *Cerami* as a Section 10(b)/Rule 10b-5 case under the Securities Exchange Act of 1934 must be considered as well as the fact that the parties did subsequently enter into a definitive agreement and close the transaction. The seller brought the action only after it learned that the buyer had financed the purchase of the securities by striking a deal with a third party which imputed a far higher value to the securities than the buyer paid to the seller. The Court may have viewed the seller as suffering "seller's remorse" and crafted a decision aimed at denying it relief. Nonetheless, *Cerami* should cause the M&A community to revisit its letter of intent practices. ■

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