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The Letter of Intent-  
A Study from a Banking  
Perspective

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# Summary

Issuing a letter of intent often involves an initial step toward a contract, contemplating that a contract will be entered in the future. Agreements with the same meaning go under a variety of names. In the field of banking and finance a preliminary agreement is often referred to as a Commitment Letter. Traditionally, a letter of intent is a preliminary agreement without legal effects. However, some letters of intent do impose legal obligations. The difficulty is that there is no clear following regarding what legal effect a letter of intent can result in. To determine whether a letter of intent constitutes a binding and enforceable contract, its particular content and the surrounding circumstances must be examined. Courts focus on two parameters: whether the parties intended to be bound, and if so, whether the letter is sufficiently definite to be enforced. A fully binding contract does not have to contain all the terms of the deal, but those that the parties, according to the court, considered as essential. To determine the parties' intent, courts rely on the objective appearance. By examining party behavior courts, sometimes find letters of intent that are preliminary in form to be enforceable contracts. The mere labeling of the document as a preliminary agreement or making it subject to formal agreement or board approval, is not enough to prevent an agreement from becoming legally binding.

When, according to U.S. law, a complete contract is found, the parties are under a contractual obligation of good faith and need to perform according to the agreement. In case of breach of contract, the injured party would generally be awarded with expectation damages. Under current American law, the traditional rule assigns no precontractual liability, but the parties are free to back away from the deal. According to the culpa in contrahendo doctrine, which to some extent is accepted in Sweden, the parties may be under a duty to deal in good faith with each other during the negotiating stage. If they break this duty, they might face liability, often damages to the extent of the wronged party's reliance. Although not recognizing the culpa in contrahendo doctrine, American courts can impose an obligation to negotiate in good faith on the parties due to explicit or implicit provisions in the agreement. This means that, even though there is no complete contract, a court can then hold the parties bound by an obligation to negotiate in good faith to reach such. If the obligation of good faith is broken, damages, often measured by the reliance interest, can be awarded. It would also be possible, although unusual when dealing with letters of intent, to hold a party liable under various other doctrines.

What constitutes a breach of a good faith obligation is also a very unclear area of the law and must be considered from case to case. Backing out of an agreement just to cut a deal with somebody else or changing already agreed conditions are possible acts in bad faith.

# Abbreviations

A.2d	Atlantic Reporter Second Series (Collection of state supreme and appellate court cases)
All E.R	All England Reports
Am Jur	American Jurisprudence
App.	Appellate Court (State)
B.R.	Bankruptcy Reporter (Federal Cases)
Cir.	Circuit (Federal)
D.C	District Court
D.N.J.	Judicial District for New Jersey
E.D.Pa.	Eastern Judicial District for Pennsylvania
F.2d	Federal Reporter Second Series (Collection of U.S. Court of Appeals cases)
F. Supp.	Federal Supplement (Collection of published U.S. District Court Cases (Federal))
Id.	Ibidem
Md.	Maryland Reports
N.D.	North Dakota Reports
NJA	Nytt Juridiskt Arkiv ( Publication of Swedish Supreme Court Cases)
NJM	Nordiska juristmötet (Nordic Legal Meeting)
N.W.	Northwestern Reporter (Collection of state supreme and appellate court cases)
N.Y.S	New York Supplements Reporter (Collection of New York state court cases)
Prop.	Proposition (Bill from the Swedish Government)
SFS	Svensk författningssamling (Publication of Swedish Statutes)
S.D.	South Dakota Reports (State)
S.D.N.Y.	Southern Judicial District for New York (State)
S.W.	Southwestern Reporter (Collection of state supreme and appellate court cases)
UCC	Uniform Commercial Code

The U.S. Court of Appeals (the intermediate federal appellate court) is divided into 12 circuits and a special court. All published decisions are collected in the Federal Reporter. Below is a list of states in each of the circuits referred to in this thesis.

2 <sup>nd</sup> Circuit	New York, Vermont, Connecticut
5 <sup>th</sup> Circuit	Louisiana, Texas, Mississippi, Canal Zone
6 <sup>th</sup> Circuit	Michigan, Ohio, Kentucky, Tennessee

8<sup>th</sup> Circuit

Minnesota, Iowa, Missouri, Arkansas, Nebraska,  
South Dakota, North Dakota

# 1 Introduction

## 1.1 Presentation

That persons should behave in good faith is a minimal standard rather than a high ideal.<sup>1</sup> It is natural for two parties to assume that each will act in good faith toward the other throughout the course of their negotiations. Yet, bad faith is a continuing problem. Traditionally, under U.S. law, parties have been free to walk away from preliminary agreement without facing any sanctions at all. The longer the negotiation period and complexity of the contract, the greater the risk of wasted time and money if no contract eventually results. Therefore, in order to guard against this risk, parties draft letters of intent hoping to obtain some kind of guarantee that a contract will be concluded. Normally this does not mean that they intend to be legally bound by their agreement. Rather they want to achieve some kind of moral obligation, but be legally free. If the preliminary agreement is fulfilled according to the party's intention, there will be no problem. The same is true if the parties agree to cancel the negotiations. However, problems arise when one party wishes to withdraw while the other is arguing for performance. In most cases the parties try to work out the differences on their own. If they fail to do this, the dispute might be taken to court. Here, the letter of intent will be examined and analyzed. The parties should be aware that there is no clear authoritative answer on the legal interpretation of letters of intent. The letter of intent is a borderline instrument; lodged on the preliminary flank but known to, from time to time, visit the contractual side, resulting in liability for its drafters. A simple way to minimize the unpredictability regarding the side the letter of intent will end would be for the parties to clearly state their intentions in the writing and then behave according to the stated intent. Most people, however, don't think of divorce when getting engaged.

## 1.2 Scope and Limitation

This thesis sets out to deal with precontractual instruments generally referred to as Letters of Intent. I will examine the legal status of such writings and if and when they might impose liability on the parties. To narrow the scope I have chosen to angle the study from the perspective of banking and finance. By examining the facts of a number of cases related to these fields, my aim is to illustrate and deepen the discussion. To achieve the above purpose, I have chosen to focus on three questions. First, what meaning have courts given preliminary contracts? Can party language and conduct change the legal status? Second, is there an obligation of good faith in precontractual negotiations, and, if so, under what circumstances do courts impose such obligations. Finally, what different legal

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<sup>1</sup> Summers p. 195.

effects can a letter of intent result in? Can a letter of intent give rise to a claim for compensation?

U.S. law forms the basis for this thesis. The reason for this is that the legal interpretation of letters of intent has been given more attention by courts and scholars in the United States than in many other countries. In Sweden for example, case law on this topic is very limited. However, since this thesis is part of my legal education at a Swedish law school, I have included one chapter where I briefly discuss preliminary contracts in relation to Swedish law. My purpose has not been to compare these different legal systems, but rather to illustrate that the use of letters of intent is an international feature. The text in the other chapters, unless explicitly stated otherwise, refers to U.S. law.

This thesis will not discuss the institution of torts in any deeper context. I feel that the law of torts is too complex to fit into this study that primarily focuses on, at least in most cases, the intended contractual relationship between the parties.

Writings referred to as “letters of comfort” or “letters of awareness” will not be dealt with at all. Although sometimes called letters of intent, these writings are something very different. Often issued by a parent company, their function is to serve as a security for credits given to a subsidiary.<sup>2</sup>

In the following, I call preliminary writings "agreements" and contractual writings "contracts". Furthermore, I use the term “letter of intent” to generally refer to different kinds of preliminary agreements as, for example, commitment letters.

### **1.3 Method and Material**

In this thesis the traditional legal dogmatic descriptive and analytical methods have been pursued in order to establish a theoretical basis for the research. Case law and legal doctrine have functioned as the main sources. Further, statutes such as the American Restatement of Contracts, Uniform Commercial Code and relevant Swedish legal acts have been reviewed. Case law has been selected and studied, not from a specific state perspective, but from a general viewpoint. In researching case law, cases from a diversity of state and federal courts of appeal and district courts have been studied. Nevertheless, a majority of cases referred to origins from New York. This is due to the fact that New York courts have been particularly active in their judgements regarding preliminary agreements. However, each state’s particular state law seems representative of the case law generally

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<sup>2</sup> Adlerceutz (2002) p. 115.



existing in other states. In the chapter referring to Swedish law, case law from the Swedish Supreme Court has been examined.

Legal writings in form of books and articles, mainly by law professors, have served a large role in my research. The current authority on U.S. contract law is Professor Farnsworth of Columbia Law School. His contract law treatises and article about precontractual liability provided a basis for my initial research. As the thesis developed, I consulted several other law professors' writings published in various American, and, in some instances, Swedish and English law reviews. Also, some practicing lawyers have given their thoughts on letters of intent. Their perspective is somewhat different, setting out to guide clients on making wise agreements. The only writing I found dealing with the topic from a banking angle was an article by Sue Murphy on how to structure loan commitments to avoid liability. Turning to books that deal solely with letters of intent, a publication by the Italian Law Professor Draetta and the American lawyer Lake must be mentioned. Their book *LETTER OF INTENT AND OTHER PRECONTRACTUAL DOCUMENTS* is set out to cover the international use of letters of intent. It examines the precontractual instrument rather broadly than deeply. A similar approach has two English and a Japanese author in *CONTRACT FORMATION AND LETTERS OF INTENT*, a work originally published in Japan. The publication *LETTER OF INTENT – VÄRT MER ÄN PAPPRET*, written as a thesis by two students at the University of Lund, deals with letters of intent from a Swedish perspective.

## **1.4 Outline**

The thesis is structured as follows: after the opening chapter, a brief introduction to relevant U.S. contract law will follow. This section is aimed for the reader not familiar with common law. The chapter thereafter will give a definition of a letter of intent and discuss when and why parties would chose to issue such writing. Chapter four will introduce the reader to the use of preliminary agreements and negotiations in the banking sector. Hereafter, the thesis will move on to deal with the question of the legal status of a preliminary agreement. Chapter six will discuss when parties to a letter of intent may be held liable for breach of a good faith obligation. The following chapter continues with a coverage of what behavior might be considered as bad faith. The examination of U.S. law will end with a chapter discussing what sort of remedies that can be imposed on the party in wrong. Thereafter, an overview is given of the legal status of letters of intent and precontractual liability in Sweden. The thesis is concluded by an analysis discussing when and why a letter of intent can result in a binding contract or in other ways impose liability on a party. An example of a commitment letter with an attached term sheet can be found in the appendix .

Throughout the examination, the thesis is illustrated with court cases. While reading these, the reader must remember that in most cases the parties actually do enter into a complete contract without any disputes. For this reason, the alleged

disagreement of intention present in most cases illustrated here, would not be typical. At least my hope is that most parties share the same intent whether or not to be legally bound.

## 2 Relevant Contract Law

The American Restatement of Contracts defines a contract as

a promise or set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes a duty.<sup>3</sup>

For the parties to be bound by a contract, preliminary or not, certain requirements must be met. Firstly, both parties must have assented to be bound. It is the external or objective appearance of the parties' intentions as manifested by their actions that matters when determining assent.<sup>4</sup> Intent might be found in a writing, or supplied by oral agreement or the conduct of the parties.<sup>5</sup> Under the principles of bargain and mutuality of obligation, both parties are free to withdraw from negotiations until the moment when both are bound. This happens first when the offeree accepts the offer. In most cases, consideration to show a serious intent to be bound must be given in exchange for a promise. Usually the consideration is a return promise, but it may also consist of some kind of payment or performance. Contracts where promises are made on both sides are usually referred to as bilateral. Contracts where a promise is given on only one side are called unilateral.<sup>6</sup>

Secondly, the agreement must be definite enough to be enforceable. This is because the promisee's expectation interest has to be protected. A court must, to be able to calculate the damages that will put the promisee in the position in which he or she would have been had the promise been performed, determine the scope of that promise with some precision.<sup>7</sup> According to the Restatement (Second) of Contracts, the terms of a contract must "provide a basis for determining the existence of breach and for giving an appropriate remedy".<sup>8</sup> The traditional concept of contract requires that a document is either wholly contractual or wholly noncontractual. This is referred to as the "all or nothing concept". As long as there is an essential term not yet agreed on, there is no contract.<sup>9</sup> Consequently, an enforceable preliminary agreement must specify all the essential and material terms to be embodied in the subsequent agreement. Whether a term is "essential" is a question of the intention of the parties, and matter for the court to interpret. American courts have found letters of intent with significant elements absent to be complete agreements.<sup>10</sup> The Uniform Commercial Code states that

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<sup>3</sup> Restatement (Second) of Contracts § 1 (1981).

<sup>4</sup> Farnsworth vol. I p. 168–169.

<sup>5</sup> Murphy p. 223.

<sup>6</sup> Farnsworth vol. I p. 164, 64-65.

<sup>7</sup> Farnsworth vol. I p. 161.

<sup>8</sup> Restatement (Second) of Contracts § 33 (2).

<sup>9</sup> Lake & Draetta p. 91; Corbin p. 131.

<sup>10</sup> Corbin § 2.8.

“even though one or more terms are left open a contract for sale does not fail for indefiniteness if the parties have intended to make a contract and there is a reasonably certain basis for giving an appropriate remedy”.<sup>11</sup>

If litigation arises in regards to a party’s intention to be bound by a contract, one party may seek to introduce evidence from earlier negotiations in an effort to show that the terms of the agreement are other than as shown in the writing. In doing this, the party will be met with the “parol evidence rule”, according to which extrinsic evidence of surrounding circumstances is not allowed to vary or contradict the terms of an unambiguously written agreement. However, while oral evidence modifying the terms of a written agreement is inadmissible, evidence of an oral agreement that an agreement does not exist at all is admissible. Further, the rule does not exclude evidence offered to help interpret the language of the writing.<sup>12</sup>

Under the doctrine of “promissory estoppel” the common law traditionally protects the promisee in a unilateral promise from negligent use of language. Under U.S. law, a party who has acted on a promise made during negotiations, and thereby been taken inequitable advantage of, can be compensated.<sup>13</sup> It should be mentioned that the doctrine is very different in English law where it only exists with respect to existing contracts.<sup>14</sup>

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<sup>11</sup> UCC 2-204(3).

<sup>12</sup> Farnsworth vol II p. 191-192, 210-211.

<sup>13</sup> Kessler & Fine p. 415; Restatement (Second) of Contracts § 90.

<sup>14</sup> Chitty §§ 183-191.

### 3 Definition and Use

The letter of intent may be described as a precontractual written instrument that reflects preliminary agreements or understandings of one or more parties to a future contract.<sup>15</sup> It is an outline of a not yet finalized agreement, a road map perhaps leading to a contract. Documents with the same meaning also appear under names such as “heads of agreement”, “commitment letter” “agreement in principle” and “memorandum of understanding”.<sup>16</sup> In this thesis, as said initially, “letter of intent” is used as a general term.

The term “letter of intent” was originally used on the United States stock market. In order to raise money to file an application to make a public offering of its share, a corporation needs a guarantee from a stock company to underwrite the issue. The underwriter will wish to delay its commitment until the application filing is completed. Therefore, both parties execute a document saying they agree that an underwriting agreement will be made when the filing process is completed. The document further states that the initial agreement is a “gentlemen’s agreement” which is not legally binding.<sup>17</sup>

Important negotiations often involve a gradual process in which agreements are reached gradually, step by step. A court has explained that “a complex business transaction requires a significant amount of time, effort, research and finances simply to arrive at its terms”. Together, all these costs may consume a significant amount of the benefit the parties hope to gain. This cost may be too high to bear with no assurance that it will culminate in a transaction. If potential buyers are forced to undertake duplicative research and preliminary commitments with only one among many to close a deal, each will spend less time on research and the bids will generally be lower. Thus, when a deal is preceded by costly groundwork, a letter of intent may benefit both the purchaser and the seller. “Neither party has committed himself to the exchange. Both have agreed to work toward it. While success is not certain, it is more likely and the fear of wasted or duplicative effort is reduced.”<sup>18</sup>

Letters of intent can be designed in different ways and may have various purposes. There are as many types as there are prospective transactions. Usually the parties expect that a record of the understandings that they have reached at a particular stage will smoothen the progress of further negotiations. Such record may prevent misunderstandings, suggest formulas for reaching further agreements, and provide a basis for drafting a definitive text. The preliminary document may also be useful as a device to inform others of the progress of the negotiations. It

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<sup>15</sup> Lake & Draetta p. 5.

<sup>16</sup> Farnsworth (1987) p. 250.

<sup>17</sup> Furmston, Norisada & Poole p. 143.

<sup>18</sup> Feldman v. Allegheny International, Inc, 850 F2d 1217 at 1221 (7<sup>th</sup> Cir 1988).

might be shown to third parties, such as board of directors and prospective lenders and investors, whose cooperation is sought for the deal to be done.<sup>19</sup> Once the letter of intent is executed, there is a clear understanding that negotiations have progressed beyond the mere discussion stage.<sup>20</sup> Each party, although realizing that the transaction might not close, can be relatively certain that the other has a good-faith desire to continue negotiations to achieve goals stated in the letter.<sup>21</sup> Once the preliminary agreement has been issued it is harder to withdraw concessions, and more disadvantageous to allow the negotiations to fail, especially if the anticipated agreement has been made public.<sup>22</sup>

Depending on the circumstances, the parties may or may not intend the terms in the letter of intent to be binding. Businesspeople often insist on receiving letters of intent which deny any legally binding effect because they expect that, regardless of legal force, such document obliges the other party to abide by what he has promised. In many instances businesspeople wish to obtain the other party's acceptance before binding themselves to conclude the contract. They seek to achieve this by inserting a clause saying that the offer is subject to approval by the board of directors, or similar. Letters of intent can therefore seek to bind one party while leaving the other one free.<sup>23</sup> A British judge once held that "A gentlemen's agreement is an agreement which is not an agreement, made between two persons, neither of whom is a gentleman, whereby each expects the other to be strictly bound without himself being bound at all."<sup>24</sup>

When a dispute arises one party often argues that his or her intent was completely different from what the other party is arguing. Frequently one party asserts that there was an agreement while the other holds that there was no agreement. This is when the difficulty arises. The offer and acceptance paradigm was not created to deal with complex business matchmaking where several writings and letters of intent exist.<sup>25</sup> The question of the legal effect of letters of intent is a developing area of the law where the use has outpaced the development of the jurisprudence.<sup>26</sup> Professor Farnsworth has expressed that "It would be difficult to find a less predictable area of contract law".<sup>27</sup> This is partially attributed to the fact that letters of intent are seldom drafted by lawyers, but at a stage of negotiating when the parties believe that legal participation is unnecessary.<sup>28</sup> Negotiating parties are often so eager and focused on closing the deal that they will wrap up a letter of intent, just because it is standard practice, without any

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<sup>19</sup> Farnsworth (1987) p. 257-258.

<sup>20</sup> Temkin p. 130, 141.

<sup>21</sup> Corbin p. 46.

<sup>22</sup> Farnsworth (1987) p. 258.

<sup>23</sup> Furmston, Norisada & Poole p. 14.

<sup>24</sup> Bloom v. Kinder (1958) T.R. 91.

<sup>25</sup> Johnston p. 466.

<sup>26</sup> Lake & Draetta p. 18.

<sup>27</sup> Farnsworth (1987) p. 259-260.

<sup>28</sup> Lake & Draetta p. 11.

thought of the possibility that the deal might not close. Because of their ambiguity, obscurity and susceptibility to unexpected interpretations, the letter of intent has even been characterized as an “invention by the devil” that “should be avoided at all costs”.<sup>29</sup> As different examples indicate, courts seem to be inconsistent in their treatment of letters of intent. This has made it hard for negotiators and issuer of letters of intent to know what they can do without facing liability. This unpredictability has made several lawyers to dissuade clients from the use of letters of intent if they intend not to be bound.<sup>30</sup> One attorney expressed:

I don't like LOIs because I see a document that has the potential to haunt my client in a courtroom if the parties never agree to the "definitive agreement." Therefore, I usually recommend an LOI that's for the most part not binding as clearly stated in the LOI. Of course, this brings us full-circle yet again. Why did we bother with an LOI?<sup>31</sup>

According to another attorney, “Intended to facilitate business transactions, letters of intent (...) may instead assure litigation”.<sup>32</sup>

However, despite their uncertain legal status, letters of intent are useful devices in structuring not yet completed business transactions, and can play a legitimate role in the negotiation.<sup>33</sup> Preliminary agreements are usually complied with for economic, practical, psychological, and sometimes moral reasons. Businesspeople are generally more sensitive than lawyers to the morally binding character of commercial agreements. The explanation is that they often fear business sanctions rather than legal sanctions. Because of this, resort to judicial systems to resolve disputes regarding letter of intents is less frequent than their uncertain status and frequency of use might imply.<sup>34</sup> According to the sociologist Steward Macaulay it is better to uphold good business contacts than insisting on ones legal rights.<sup>35</sup> Law provisions assume that each business deal is an isolated transaction, while in reality the deal is included in a sequence of related transactions.<sup>36</sup>

Thus, if letters of intent are interpreted as binding by courts, lawyers and parties will shy away from using it, and a practical tool for planning friendly transactions will be lost.<sup>37</sup>

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<sup>29</sup> Expressed by New York attorney Stephen R. Volk after discussing developments in the Texaco-Pennzoil situation. Volk p. 145.

<sup>30</sup> Ominsky p 39; Volk p. 145.

<sup>31</sup> Grossman & Chulock.

<sup>32</sup> Ominsky p. 25.

<sup>33</sup> Corbin p. 46.

<sup>34</sup> Lake & Draetta p. 12; Furmston, Norisada & Poole p. 14.

<sup>35</sup> Macaulay p. 64.

<sup>36</sup> Hellner p. 10

<sup>37</sup> Klein p. 143.

## 4 Preliminary Agreements in the Banking Sector

In the banking sector a preliminary contract issued before the loan agreement is executed usually appears as a “commitment letter” binding the lender to make the loan on specific terms.<sup>38</sup> A borrower will enjoy a commitment letter with definite terms and conditions to be assured of a closing pursuant to specific terms. The borrower may also need to show a third party that it has adequate financing to proceed with a transaction. A lender might want the borrower to commit to insure that its time and expenses will ultimately result in a closed transaction or perhaps secure fees to cover its expenses if the transaction would not close.<sup>39</sup>

The loan transaction normally originates with the borrower filling out an application on a form provided by the lender. In more complex transaction a lender usually produces a “term sheet” document identifying basic terms of the transaction which have been agreed upon or which the lender will require. A term sheet is not a binding document. It provides a basis for discussion and ordinarily is not signed by either party. No fee should be charged for preparation of such a document, since it then may be understood as a commitment.<sup>40</sup>

The application, summarizing the terms of the loan, is, when filled out and returned by the borrower, generally understood as an offer. The lender then responds with a commitment letter that also summarizes the terms of the loan agreement but usually varies them in some way, making it a counter-offer. The borrower accepts this counter-offer by noting acceptance on the commitment letter.<sup>41</sup> During the period of the negotiations the bank undertakes to hold the amount of the loan ready, and to make the loan when and if it closes. In exchange for this undertaking the prospective borrower is to pay a commitment fee. Sometimes the parties’ relations regarding this subject are governed in a separate fee letter. The commitment fee normally has both a fixed and a variable component. The fixed component is called the non-refundable fee and will be kept by the lender in payment for its commitment. The variable fee will depend on how quickly the loan is executed. If the loan closes promptly, the total commitment fee payable is low. If the loan is delayed, the fee is higher. The longer the delay, the bigger the fee. If the loan falls through, a termination fee clicks in. If the loan closes, the borrower is to pay the much larger closing fee. The fees are compensation for the costs incurred by the bank in considering whether to grant the proposed loan, in preparing the loan documents, in selling participations in the loan to other banks to spread risk and overcoming regulatory lending limits, and in forgoing other lending

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<sup>38</sup> Furmston, Norisada & Poole p. 143.

<sup>39</sup> Murphy p. 214-215.

<sup>40</sup> Murphy p. 217-218.

<sup>41</sup> Farnsworth (1987) p. 290.



opportunities as a consequence of having to hold the money for the loan in readiness during the period of negotiations. Banking regulations limit the volume of commitments that a bank may take, so committing to one prospective borrower might cause the bank to turn down another potentially profitable commitment.<sup>42</sup>

At the closing, when the lender makes the loan, the borrower executes a loan agreement and other documents. These other documents have been prepared in conformity with the commitment letter by the lender's lawyer, who often becomes involved only after the commitment letter has been accepted.<sup>43</sup>

The terms in the commitment letters normally provide that the bank is not obliged to lend unless certain conditions, the "conditions precedent", are satisfied. These conditions are to ensure that all legal matters are in order and that the security is in place. They may stipulate that the bank is not obliged to make any loans until the bank has received documents showing, for example, guarantees for the loan, approval of the board, consent of the authorities and legal opinions. If the loan is secured, the conditions precedent may also include documents representing the collateral. The conditions must be satisfied for the loan to be made. It is sometimes stated that fulfillment of the conditions precedent is to be "satisfactory" to the bank.<sup>44</sup>

In constructing financing, long-term mortgages are generally available only after a building project is finished. To get funding for the construction, the developer usually obtains a short-term mortgage from a construction lender. When construction is completed, a permanent lender "takes-out" the construction lender by making a permanent loan to the developer. With these funds, the developer can pay off the construction loan. However, the construction lender will not advance money for construction without the assurance by a permanent letter that a permanent loan will be taking out the construction lender when the project is completed. This assurance is given in a commitment letter from the permanent lender to the developer as borrower. Furthermore, to strengthen the construction lender's position against the permanent lender, it is arranged that the permanent lender will buy the construction loan from the construction lender and convert it to a permanent loan. Thus, under a buy-sell agreement, the permanent lender agrees to buy the construction loan, the construction lender agrees to sell it and the developer agrees to accept the permanent loan.<sup>45</sup>

As the following chapters will show, commitment letters, like other letter of intents, can appear in many different forms and varieties. They may appear both as unilateral and bilateral agreements. They can include intent to be bound, or not to be bound. They can be complete contracts covering all essential terms of the

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<sup>42</sup> First National Bank v. Atlantic Tele-Network, 946 F.2 516 at p. 519-520.

<sup>43</sup> Farnsworth (1987) p. 290.

<sup>44</sup> Wood p. 16-18.

<sup>45</sup> Farnsworth vol. I p. 196.

deal but can also be very preliminary in form. The legal status of a particular commitment letter may become relevant where a borrower refuses to pay, or a bank refuses to repay, a fee referred to in the document. Further, the question of legal nature arises when one of parties refuses to complete the formal documentation referred to in the writing.

When the commitment letter is considered a complete contract, the parties are bound by it as soon as it is signed. However, the bank does not need to make the funds available until the conditions precedent are fulfilled.<sup>46</sup>

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<sup>46</sup> Cranston p. 339.

# 5 Enforceability

## 5.1 Agreements Preliminary in Form

The traditional rule in common law is that an agreement to agree is not enforceable. The most famous statement of this rule was that of Lord Wesleydale in 1857:

An agreement to be finally settled must comprise all the terms of which the parties intend to introduce into the agreement. An agreement to enter into an agreement upon terms to be afterwards settled between the parties is a contradiction in terms. It is absurd to say that a man enters into an agreement till the terms of that agreement are settled. Until those terms are settled he is perfectly at liberty to retire from the bargain.<sup>47</sup>

This view is still, to a large extent, upheld by English law.<sup>48</sup> The reluctance to enforce preliminary agreements rests on the so-called “general principle of contract” that the law does not recognize a contract to enter into a contract since it is not definite enough.<sup>49</sup> The unwillingness to enforce preliminary agreements applies even if the agreements manifest intent to be bound. Courts do not like to make up terms that have not been agreed on and impose them on the parties. Moreover, enforcing the agreement might not be what one or both of the parties had intended.<sup>50</sup>

Today, as this chapter will show, American courts seem less concerned about missing terms and are far more willing to enforce an agreement. Generally, the intent of the parties at the time of the execution of the precontractual agreement is controlling. Legal effects, such as obligations to negotiate in good faith, might still be imposed even if the agreement otherwise is not complete enough to be a valid contract.

### 5.1.1 Cases Not Definite Enough to Enforce

In *Freeman Horn, Inc. v. Trustmark National Bank*,<sup>51</sup> a bankruptcy court had to decide whether a document prepared by the lender was a binding letter of commitment to make a \$750,000 loan. The borrower argued that the letter was binding. By refusing to honor its commitment the bank had breached its duty of good faith and fair dealing, forcing the borrower into bankruptcy. According to the lender, the letter had been provided at the borrower’s request to satisfy a

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<sup>47</sup> Lord Wensleydale in *Ridgeway v. Wharton*, (1857) 6 Clark’s HL Cases 238 at p. 305-306.

<sup>48</sup> Lake & Draetta p. 171.

<sup>49</sup> Dugdale & Lowe p. 31.

<sup>50</sup> Barnett p. 101.

<sup>51</sup> 245 B.R 820 (S.D. Miss. 1999).

bonding company. Such letters had also been provided for the borrower in the past. Their task was simply to inform the bonding company of the nature of the borrower's current banking relationship. No offers were made in these letters. Agreeing with the lender, the court held that the letter was not a commitment letter or a contract, but a standard bonding company letter. A banking expert testified that a commitment letter would have been considerably longer and would have included information regarding interest rate, closing fees, terms of repayment, collateral conditions for funding, a signature line and an expiration date. These features were not present in the relevant letter. Thus the court found that the letter did not constitute a commitment letter and rejected the borrower's claim.<sup>52</sup> A Mississippi district court affirmed the bankruptcy court's finding. This court reviewed the analysis and added that there had been no suggestion that the letter was a commitment letter until after the bank held that the borrower's security would not be sufficient for a new loan.<sup>53</sup> The court concluded that the purpose of the letter was to provide proof of a banking relationship to the borrower's bonding company. The letter did not attempt to create any new lending commitments. "The letter simply does not bear the character of a binding letter of agreement". Further, the court held that if the letter is anything other than a notice to a bonding company of a banking relationship, it is more in the nature of a term sheet than a commitment letter. Pointing to this conclusion was the fact that the letter left terms of interest rate and acceptable collateral open. Also, the borrower had not signed the letter, which would indicate that there was no acceptance of an offer.<sup>54</sup>

In *Clardy Manufacturing Company v. Marine Midland Business Loans Inc.*,<sup>55</sup> the question was whether a letter agreement was in fact a satisfactory contract or merely an agreement to undertake due diligence. The Court of Appeals for the Fifth Circuit found the wording in the letter agreement to be unambiguous and held that it served to set out the terms and conditions of the credit or loan. Beyond this, it also contained an undertaking for the lender to conduct due diligence to determine whether the client satisfied the credit criteria. The letter agreement's silence on the lender's undertakings once the internal credit approval process had been satisfied did not make the language in the letter any less clear or unambiguous. There was nothing in the letter agreement which suggested that the lender was binding itself to issue a commitment letter, obligating itself to make a loan, upon the successful completion of the due diligence outlined in the letter. Instead, the lender was entitled to make a subjective decision before taking further steps entering into the final stage of the loan approval process. Consequently, the letter agreement did not constitute a satisfaction contract. Thus, the court held there could not be damages for breach of contract.<sup>56</sup>

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<sup>52</sup> Id. p. 824-825.

<sup>53</sup> Id. p. 827.

<sup>54</sup> Id. p. 828.

<sup>55</sup> 88 F.3d 347 (5<sup>th</sup> Cir. 1996).

<sup>56</sup> Id. p. 354.

In *Pueblo Chemical, Inc. v. 111 Enterprises Inc.*,<sup>57</sup> the two companies Pueblo and Enterprises were involved in negotiations for an agreement in which Pueblo agreed to grant Enterprises a \$4.7 million loan which Enterprises needed to settle tax liabilities and bank debts. The terms were reduced to writing in a two-page loan term sheet signed by both parties. The parties encountered difficulties in their negotiations and were unable to resolve all the open issues and finalize the document. Later, Enterprises filed a bankruptcy petition. Pueblo alleged that Enterprises had done this solely to avoid honoring the alleged loan agreement and that Enterprise was acting in bad faith.

The bankruptcy court concluded that the loan term sheet consisted of only a two-page, sparsely detailed document. It included several provisions that appeared to be complete and acceptable, such as the loan amount, loan term option, annual interest rate, and pre-payment terms. However, the document lacked other material provisions, such as terms covering repayment, default, representation, collateral, bank consent and guarantee. Viewed as a whole, the court found that the document lacked material terms and demonstrated only an intention to negotiate toward a possible final contract, rather than signifying a binding agreement. The court pointed out that a contract comes into existence if a reasonable person would conclude, based on the objective manifestations of intent and the surrounding circumstances, that the parties intended to be bound to their agreement on all essential terms.<sup>58</sup> Not only was the document lacking, or at least unclear, concerning essential terms, but the totality of the circumstances strongly suggested that the parties did not intend to be bound by the loan term sheet. The mere fact that the loan term sheet was in writing and signed by both parties did not prove that the parties intended to be bound by writing. Further, the loan term sheet specifically noted that further documentation and administrative matters remained to be completed. All these fact illustrated that the parties were far from reaching a final agreement. The court held that it would be unwise to create terms for the parties. Thus, there was no binding contract. Further, the court held that it could only enforce intent of contracting parties.<sup>59</sup> Here, the court applied the “all or nothing” approach which will be discussed in chapter six.

## 5.2 Agreements Contractual in Form

I will now turn to agreements that contain all, or at least the essential, elements of a final contract. Whether such document is an enforceable contract depends on the intent of the parties at the time the precontractual document was executed.<sup>60</sup>

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<sup>57</sup> 169 B.R 551 ( E.D. Pa. 1994).

<sup>58</sup> Id p. 554.

<sup>59</sup> Id. p. 554-555.

<sup>60</sup> Corbin p. 144.

In *Jerry Harmon Motors, Inc. v. First National Bank & Trust Co.*,<sup>61</sup> the issue arose whether a bank was bound by a credit agreement that had an unsigned line for a signature of a bank officer. The North Dakota Supreme Court found that the lack of a signature created an ambiguity since the language in the agreement could be read to exclude the need for the bank's signature. The court held that the mere fact that blanks are left open in written agreement does not automatically render it invalid. Instead, it raises questions regarding the parties' intent of a complete document.<sup>62</sup>

If an agreement is found to be an enforceable contract, the parties are not only bound by their commitment but are also under a contractual obligation to behave in good faith. The *Sterling* and *Murphy* cases below confirm that once a unilateral commitment has been made, both the lender and the borrower must negotiate in good faith consistent with the terms of the commitment.

### 5.2.1 Agreement to Engage in Transaction

A preliminary contract that commits one or both parties to do something in the future, leaving no terms open for future negotiations, is referred to as an **agreement to engage in a transaction**. It has the advantage of binding one or both parties to carry through the transaction while postponing preparation and execution of the necessary documents. Like an ultimate contract the agreement to engage in a transaction is definitive, leaving none of the terms of the prospective loan open for further negotiations.<sup>63</sup> A complete commitment letter would fit into this category.

In *Sterling Faucet Company v. First Municipal Leasing Corporation*,<sup>64</sup> a letter, which the lender claimed to be a mere proposal, was held to be a binding commitment. The Court of Appeals for the Eight Circuit found that the proposal letter contained all the elements of a contract and that the parties intended to be bound by it. The letter was very detailed, containing the amount to be loaned, term and interest rate, and stated conditions precedent. The letter, which had been sent by the lender's agent, was signed and accepted by the borrower. The lender received a copy of the signed letter, but did not try to modify it or disavow it as a commitment. Later, the lender refused to provide financing. The court held that the borrower had complied with the conditions precedent and an enforceable contract existed. Thus, the lender was obliged to evaluate the loan documentation in good faith consistent with the terms of the commitment letter.

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<sup>61</sup> 472 N.W.2d 748 (N.D. 1991).

<sup>62</sup> Id. p. 753.

<sup>63</sup> Farnsworth (1987) p. 251.

<sup>64</sup> 716 F.2d 543 (8<sup>th</sup> Cir. 1983).

One of the less usual cases where it is the borrower who allegedly had breached the agreement is *Murphy v. Empire of America*.<sup>65</sup> Here, a couple had applied for a second mortgage on their home. The bank issued a commitment letter for a \$27 000 loan. The couple executed the commitment letter and returned it with the commitment fee. Later, the couple changed their mind and, claiming that the transaction had not yet taken place since the note and mortgage were not executed, cancelled the transaction. The Court of Appeals for the Second Circuit held that the borrowers had confused the term "consummation" with the "performance" of the obligation. It explained that the transaction is consummated when the lender and borrower sign a contract obligating them, respectively, to lend and to borrow. Thereafter, the lender is bound to lend the funds and the borrower is bound to borrow the money. If the lender refuses to provide the loan, it can be held liable to the borrower for damages. Equally, if the borrower decides not to use the credit, he or she can be liable to the lender for the interest on the loan. Consequently, the court stated that by executing and returning the commitment letter to the lender, the borrowers obligated themselves to accept the loan and conform to the terms of the commitment letter.<sup>66</sup>

### 5.2.2 Agreement with Open Terms

A preliminary **agreement with open terms** sets out most of the terms of the deal but leave some open. The parties agree to be bound by the set terms, and undertake to continue negotiating to reach agreement on the open ones. However, the requirement of definiteness limits the extent to which terms can be left open. For the parties to be bound, the terms left open must not be essential to the deal. If, despite continued negotiating by both parties, no agreement is reached on the open terms, the parties are bound by their original agreement. The matters left open will be supplied by the court, provided that they are nonessential.<sup>67</sup> Consequently, given that there is a shown party intention for a binding contract and that the terms left open are not essential, a deal governed by an agreement with open terms will be carried out, even if the parties are unable to reach an ultimate agreement. Since an agreement with open terms is a contract, it imposes a general obligation of fair dealing in the negotiation of the open terms.

In *Lincoln National Life Insurance Company v. NCR Corporation*,<sup>68</sup> the District Court for Indiana, in deciding if a mortgage loan agreement was an enforceable contract, had to determine if the commitment letter was unilateral or bilateral. In this case too, it was the borrower who allegedly had breached the agreement. The lenders sought damages since no commitment fee secured the agreement. To start with, the court pointed out that commitment letters are either

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<sup>65</sup> 746 F.2d 931 (2d Cir. 1984).

<sup>66</sup> Id p. 934.

<sup>67</sup> Farnsworth (1987) p. 250; Lake & Draetta p. 62.

<sup>68</sup> 603 F. Supp. 1393 (D.C Ind. 1984).

unilateral, binding only one party, or bilateral, binding both. The lender argued that the commitment letter was bilateral, conferring a mutuality of obligations so that the lenders were committed to lend and the borrower required to borrow. The borrower, of course, was of the opinion that the commitment letter was a unilateral contract, which only committed the plaintiffs to lend. In determining whether the commitment letter was unilateral or bilateral the court had to explore the parties' intention. It pointed out that it is the objective, not subjective, intent of the parties which controls. The strongest external sign of agreement between contracting parties is the words they use in their written contract. The agreement between the present parties did not explicitly state that "borrower is required to borrow". The court was to determine if that requirement was implicit within the context of the entire agreement. It found the language to be ambiguous and explained that "as a general proposition, the parol evidence rule bars admission of extrinsic evidence to vary or contradict the terms of an unambiguously written agreement. Where, as here, the written agreement is ambiguous, the parol evidence rule is inapplicable and extrinsic evidence of surrounding circumstances may be admitted to explain an ambiguity."<sup>69</sup> Evidence extrinsic to the commitment letter indicated that the parties had sought to and entered into a bilateral and thus enforceable contract. However, the fact that the commitment letter did not contain a commitment fee suggested that the parties viewed the contract as unilateral. Also, the lender had not specifically included language requiring the borrower to borrow. These arguments were not considered fatal and did not detract from the conclusion that the parties had entered into an enforceable contract. Thus, liability was found in favor of the lender. However, since the lenders had not proven that the borrower's breach had any effect on their investment opportunities they were not entitled to damages for their expectation interest.<sup>70</sup>

### 5.2.3 Agreements with Reservations and Conditions

#### 5.2.3.1 Nonbinding Provision

A **nonbinding** letter of intent sets out the terms of the proposed agreement, but clearly pronounces that no liability or obligation is to be created between the parties. In connection with mergers and acquisitions parties often use letters of intents to turn otherwise enforceable agreements into unenforceable ones. These so called "gentlemen's agreement" are intended to be only morally binding. Courts have generally accepted provisions that clearly state that the agreement is not legally binding. Most of the letters of intent involved in litigation are however silent as to their binding character and courts have split on whether the parties are bound by terms in such letters.<sup>71</sup> The mere labeling of a preliminary agreement as a "letter of intent" or "letter of comfort" is not enough for courts to deprive it of

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<sup>69</sup> Id. p. 1402.

<sup>70</sup> Id. p. 1403-1410.

<sup>71</sup> Farnsworth (1987) p. 294, 257, 289.



binding effect, although it might be an indicator of the parties' intentions. For example, an "offer document" would seem to suggest less of an intention to be bound than a "commitment letter".<sup>72</sup>

In *Chrysler Corporation v. Southeast Hotel Properties*,<sup>73</sup> the lender had sent a proposal to the borrower setting forth the loan amount, term, interest rate, terms of the commitment fee, and various other essential terms of the contract. However, included was also language that the letter did not represent a commitment, but was a proposal outlining the terms and conditions which would form the basis for a commitment. When the lender sent a final commitment letter to the borrower, the borrower refused to sign and obtained financing elsewhere. The district court found that the lender had expressly reserved the right not to be bound absent a signed writing. Consequently, the lender was not entitled to recover damages.

### 5.2.3.2 Subject Provisions

Related to expressed contractual negotiations are precontractual documents where the parties have agreed that the contract is not to be effective or binding until certain conditions are performed or occur, for example by using "subject to" clauses. The parties might have agreed that the details of a proposed agreement is not binding until embodied in a formal written document that has been approved and executed by the parties. The premise is that no binding contract will arise until the conditions specified have occurred or been performed.<sup>74</sup> However, language such as "subject to formal contract" is, according to American courts, not sufficient to prevent a preliminary contract from being enforceable.<sup>75</sup> If the subsequent agreement is merely a formality, and the precontractual document covers all the essential terms and is complete in all material respects, the document is considered a binding agreement.<sup>76</sup> English courts however have given effect to such language.<sup>77</sup> Thus, American courts tend to inquire into party intentions despite the language, where English courts would have accepted the expression without investigating the intention.<sup>78</sup>

In *US West Financial Services Inc. v. Tollman*,<sup>79</sup> a federal New York district court held that if the parties have clearly expressed intention not to be bound until preliminary negotiations have culminated in the execution of a formal contract,

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<sup>72</sup> APCO Amusement Co. Inc. v. Wilkins Family Restaurants of America Inc., 673 S.W. 2d 523 (Tenn. App. 1984); Teachers' Insurance and Annuity Association v. Tribune Co., 670 F. Supp. 491 (S.D.N.Y. 1987); Cranston p. 328.

<sup>73</sup> 697 F. Supp. 794 (S.D.N.Y. 1988).

<sup>74</sup> 17A Am Jur 2d p. 62.

<sup>75</sup> Arnold Palmer Golf Co. v. Fuqua Indus, 541 F.2d 584 (6<sup>th</sup> Cir. 1976).

<sup>76</sup> Lake & Draetta p. 73.

<sup>77</sup> Farnsworth (1987) p. 259.

<sup>78</sup> Furmston, Norisada & Poole p. 193.

<sup>79</sup> 786 F. Supp. 333 (S.D.N.Y. 1992).

parties cannot be bound until then because the necessary determination of assent is missing. Here, the letter agreement stated that assent to finance would be manifested in a formal commitment letter. Since no such letter was provided, the court found that the creditors had not assented to financing.<sup>80</sup>

In *Runnemedede Owners v. Crest Mortgage Corporation*,<sup>81</sup> a borrower was looking to get a loan in order to finance a hotel purchase. A mortgage company had agreed to make a loan subject to a number of conditions stated in a letter labeled as a commitment letter. The mortgage company expressly refused to enter a binding obligation to fund the loan until it had completed its pre-closing investigation. In the eleventh hour, after going over financial data, the mortgage company decided not to make the loan. The borrower then sued the company, alleging that the mortgage company had breached a written contract binding the company to loan the borrower 5.5 million dollars. The Court of Appeals for the Second Circuit held that the commitment letter was nothing more than an agreement to consider extending a loan. It was not a promise that such consideration would yield the borrower financial help. Further, the court stated the parties may agree that further consideration will be necessary to create binding relations. Because of the commitment letter's clear language, the court found that no binding contract to make the loan had arisen. To hold that the mortgage company had agreed unconditionally to make the loan would run contrary to the intent of the parties expressed in the conditional written commitment letter.<sup>82</sup>

Although most "subject to" provisions have legitimate purposes, there are considerable possibilities of taking advantage of them in a disloyal manner. Subject to provisions can be included in preliminary contracts to keep an "emergency exit" open in case the party would want to get out of the deal at a late stage. By referring to a "**Subject to board approval**" provision, a party can get out of the deal by holding that the board did not grant the deal, when in fact the board was told not to pass the deal.<sup>83</sup> Professor Gorton has held, although not discussing U.S. law in particular, that a party is not permitted to invoke a "subject to" provision unless there is some substance to the claim. Nevertheless, the party in wrong will have good chances to get away from the agreement considering the difficulty in establishing evidence and the fact that the other party has accepted such wide provision as "subject board's approval".<sup>84</sup>

In *Zelazny v. Pilgrim Funding Corporation*,<sup>85</sup> the issue was once again whether the commitment letter was a firm contract to lend money and if so, had the lenders breached this contract. The plaintiff, the Zelazny couple, had entered a

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<sup>80</sup> Id. p. 342.

<sup>81</sup> 861 F.2d 1053 (2d Cir. 1984).

<sup>82</sup> Id. p. 1054-1057.

<sup>83</sup> Holmgren & Lundquist p. 45, p. 48; Adlercreutz (1987) p. 506.

<sup>84</sup> Gorton p. 45, 49.

<sup>85</sup> 244 N.Y.S 2d 810 (N.Y. Dist. Ct. 1963).

contract to purchase a family house. The contract provided that it was subject to the purchaser obtaining a commitment for a mortgage. After applying for a mortgage loan, the Zelaznys received a commitment letter from the bank, which stated an interest rate at 5.5 percent. The Zelaznys signed the commitment letter and mailed it back to the bank with a check. Just prior to the time of closing, Mr. Zelazny received a letter stating that due to a possible lay off at the company where he was employed, the bank was obliged to raise the commitment to a 5.75 % interest rate. The Zelaznys argued that the commitment letter was a firm contract to lend money and that the lender had breached the contract. The bank claimed that the commitment letter was a conditional commitment and not a firm and binding contract since it contained the following sentence: “Subject to compliance with law, rules, regulations and/or directives of government body affecting this transaction and amended rule by our attorneys of all closing papers”. According to the bank, this would make the agreement subject to an approval by another lending institution.<sup>86</sup> The state district court initially held that a commitment letter to a prospective borrower constitutes a contract and one who has suffered damage as a result of a breach of such contract may recover damages for breach. Thus, the court found that a contract was entered into between the Zelaznys and the bank that entitled the bank to make the loan to the Zelaznys. The court did not agree with the bank’s contention that the contract was subject to approval by some other lending institution since the commitment letter did not refer to any other lending institution, but purported to be a contract between the bank and the Zelaznys. The court continued by stating that the commitment letter contained no clause making a change of employment, income, financial status or credit rating a condition of the granting, rejecting or modifying of the loan. Thus, the bank had no right to change the conditions of the loan for such a reason. Further, the condition that the loan was subject to “approval by our attorneys of all closing papers” referred the contract of sale and not to the credit. If this would have been the intention, the bank could have provided such a provision. Thus, the court found that by changing the interest rate, the bank was in breach of the contract to make the loan.<sup>87</sup>

### 5.3 Determining Intent

New York courts have set out a **multi-factor test** for determining whether it was the parties’ intention to become bound prior to the final closing. According to the original version of the test, the court will look to four major factors: 1) the explicit language of the parties’ writings; 2) whether substantial partial performance occurred; 3) the existence of open terms; and 4) business norms regarding the need for a written contract, given the complexity of the deal. No single factor is decisive, but each provides significant guidance.<sup>88</sup>

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<sup>86</sup> Id. p. 812-815.

<sup>87</sup> Id. p. 818.

<sup>88</sup> R.G. Group, Inc. v. Horn & Hardart Co., 751 F.2d at 75-77 (2Cir. 1984).

The four factors were considered in the infamous *Texaco v. Pennzoil* case,<sup>89</sup> where an “agreement in principle” was considered binding although no definite agreement had been reached and although the parties, Pennzoil and Getty Oil, contemplated negotiating and entering into such agreement by using “subject to” language. The agreement did not contain a disclaimer. The Court of Appeals for Houston held that whether there was an intention to be bound was a question of fact to be determined by the jury in the light of all circumstances of the case. The jury found that the essential terms were agreed upon and that the parties intended to be bound. Texaco, which had interfered with the contractual relationship, inducing Getty Oil to break off negotiations with Pennzoil and deal with Texaco instead, was subject to a multibillion-dollar liability judgment.<sup>90</sup>

In determining intent, courts often, as in the *Texaco* case, ignore the special commercial setting in which the document was set up and the parties' apparent understanding that preliminary agreements are not binding. Instead, the agreement is examined from a traditional contract perspective. Considering this, it might be fair to say that “while litigators might be confused, corporate directors and merger lawyers should be frightened”.<sup>91</sup>

The *Texaco* verdict serves as a warning against loose drafting of letters of intent, not expressing intentions in sufficiently clear terms. In addition, the parties must take care that their actions are consistent with that intent. The *Sterling* case above is also an illustration of this. Until the *Texaco* ruling, it was widely understood that an agreement in principle was not a final binding agreement. Instead, it was a commitment that the deal would proceed on the announced terms if the terms still to negotiate were satisfactorily resolved.<sup>92</sup> Disclaimer clauses were not used since they were considered pessimistic statements. After the *Texaco* judgement, it has more or less become standard practice to include a disclaimer of intent to be bound in every pre-closing document.<sup>93</sup>

Thus, maybe as a reaction on the *Texaco* ruling, some recent cases show that courts put rather less weight on such explicit clauses in determining the intent to be bound. In *Shearson Lehman CMO Inc v. TCF Banking and Savings*<sup>94</sup> a brokerage house (Shearson Lehman's Collateralized Mortgage Obligation entity or "CMO") brought action for breach of contracts and promissory estoppel against a savings and loan institution (TCF). The directors of the two companies had agreed orally that TCF would purchase residuals in a CMO mortgage trust. Shortly thereafter, CMO sent a document, commonly called a tombstone,

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<sup>89</sup> 729 S.W.2d 768 (Tex. Appl. Houston 1987).

<sup>90</sup> Id. p. 790.

<sup>91</sup> Klein p. 144, 148.

<sup>92</sup> Johnston p. 403, 460.

<sup>93</sup> Johnston p. 404.

<sup>94</sup> 710 F. Supp. 67 (S.D.N.Y. 1989).

describing the purchase to TCF. The document was returned with about three words changed. Later, when realizing that if the purchase would go through it would face previously unforeseen tax and accounting problems, TCF refused to buy the residuals. CMO brought suit for breach of contracts, alleging that there was a valid oral agreement.<sup>95</sup>

In order to determine if the parties had intended to be bound by an oral contract or a written agreement, the four-factor test described above was used. First, discussing the explicit language in the agreement, the New York district court expressed that mutual intent not to be bound by anything other than a writing is conclusively established when neither party objects to provisions in the preliminary agreement that state that the agreement shall be binding when executed and delivered. Thus, since neither had protested a clause in the tombstone draft saying “if you are in agreement with the forgoing, please sign a counterpart hereof and return the same... whereupon this agreement shall become a binding agreement” the parties had expressed intention to be bound only by written agreement.<sup>96</sup> Secondly, as to whether substantial partial performance had occurred, the court held that actions of CMO were mere preparatory and did not constitute partial performance. Turning to the factor regarding open terms, the court held that an agreement does not become binding until all terms that the agreement anticipated are settled. In this case, there was no agreement since terms that both sides understood as crucial were still being negotiated. The fact that essential factors such as price and interest had been settled did not change the result. Finally, discussing business norms, the court pointed out that while it is possible that some transactions in the security industry are done orally, trading in CMO residuals represents a very high degree of complexity and transactions would be done in writing.<sup>97</sup>

After analyzing these four factors, the court found that the evidence showed that the parties did not intend a contractual obligation to exist before a signed writing existed. Therefore, no contract had come into existence. Further, there was no promissory estoppel since there was not the clear and unambiguous promise that New York law requires.<sup>98</sup>

In *Frutico S.A de C.V v. Bankers Trust Co*,<sup>99</sup> the question was whether a breach existed of an alleged agreement in which the bank was to make a loan to the prospective borrower. The New York district court pointed out that it is a fundamental principle of contract law that no contract can be formed unless the parties intended to be bound. Also under New York law, when parties do not intend to be bound by an agreement until it is in writing, there is no contract until

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<sup>95</sup> Id. p. 68-69.

<sup>96</sup> Id. p. 70-71.

<sup>97</sup> Id. p.70-72.

<sup>98</sup> Id. p. 72-74.

<sup>99</sup> 833 F. Supp. 288 (S.D.N.Y. 1993).

that event occurs. In determining whether the parties intended to be bound, the court applied the four-factor test. Discussing the first factor, the court held that the preliminary agreement expressly stated that the parties did not intend to be bound to an enforceable agreement prior to execution and delivery of the documents. Turning to the second factor, the court found that there had been no partial performance. Thirdly, the court held that the existence of various open terms indicated that the parties did not intend to be bound absent a written agreement. Lastly, in regard to relevant business norms, the court stated that “given the complexities of the proposed transactions and the significant sums of money they were to involve, the Alleged Agreement was one to which its parties would not intend to be bound until all the relevant documents had been properly executed”. This was also supported by the prior dealings between the parties.<sup>100</sup>

After addressing the four factors, the court found that “the intentions of the parties to the Alleged Agreement had not ripened to the point where they intended to be bound by any draft agreement”. Thus, there was no enforceable contract that the bank could have breached. Neither was there a claim under promissory estoppel since there had been no “clear and unambiguous promise” by the bank to the borrower. The plaintiffs had also asserted that the bank had breached a duty of good faith and fair dealing. The court pointed out that since there was no contract and since the parties had not agreed to negotiate in good faith this duty could not be enforced.<sup>101</sup>

Just as case law seemed to, despite the *Texaco* ruling, establish a default presumption that there was no agreement until execution of the final agreement, a new setback came: The *Consarc* case!

In *Consarc Corp. v. Marine Midland Bank*,<sup>102</sup> the parties had exchanged several letter agreements but no formal writing had been executed. The question raised was whether a contract existed between the parties in the absence of a formal writing. The Court of Appeals for the Second Circuit held that the default rule is that mutual assent, even oral or informal, will establish a binding contract unless one of the parties expresses an intention not to be bound until a writing is executed. The court continued by pointing out that the failure of the writings to contain a disavowal is one factor courts consider in deciding whether several writings together form a contract between the parties. The court also held that simply because the parties contemplate memorializing their agreement in a formal document, it does not prevent their agreement from coming into effect. If the parties have settled on the substantial terms, a binding contract will have been created, even though the parties also intended to memorialize it in a formal writing.<sup>103</sup> Further, the court introduced a test with 16 factors that courts rely on

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<sup>100</sup> Id. p. 297-298.

<sup>101</sup> Id. p. 299-301.

<sup>102</sup> 996 F.2d 568 (2d Cir. 1993).

<sup>103</sup> Id. p. 570, 573-574.

in determining whether parties intended to be bound absent a writing.<sup>104</sup> In conclusion, since the letter agreements contained no expression from either party of any intent not to be bound, and since the defendant had failed to show any oral intent not to be bound, the court found that a contract had been reached.<sup>105</sup>

Professor Johnston of Pennsylvania Law School is of the opinion that the *Consarc* court moved the law backwards. He holds that prior to *Consarc*, the presumption was that parties to complex business dealing generally did not intend to be bound until the execution of the formal written agreement. Thus an explicit disclaimer was not required to avoid liability. Rather it was recognized as conclusive evidence of intent not to be bound. Professor Johnston is in favor of a default rule that says that in complex business negotiations, the parties do not incur legal liability for failure to trade unless and until they execute a final written agreement.<sup>106</sup>

A case where an explicit disclaimer of intent was honored is *Philips Credit Corporation v. Regent Health Group*.<sup>107</sup> Here a commercial lender was seeking determination that it had no obligation to make a loan to a borrower based on alleged oral statements made in loan negotiations. The borrower, who asserted that a binding preliminary agreement existed, counter-claimed for damages for inability to go forward with the project. Initially, the New York district court found that a binding preliminary agreement to finance the borrower's project did not exist. It then turned to the question of whether a contract existed absent a signed writing. It was noted that under New York law, there is no contract if the parties did not intend to be bound by an agreement until it is in writing and signed. This is true even if the parties have orally agreed upon all the terms of the proposed contract.<sup>108</sup> By applying the 16 factors introduced in *Consarc*, and addressing the different elements, the court found that there was no intent to be bound absent a signed writing. For example, the language in the commitment letters contained an express reservation by the lender of its right to be bound only if the commitment letter was duly executed and accepted. In addition, the terms left open were numerous, complex and "cut right to the heart of the deal".

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<sup>104</sup> (1) Number of terms agreed upon compared with the total number to be included, (2) relationship of the parties, (3) degree of formality attending similar contracts, (4) acts of partial performance by one party accepted by the other, (5) usage and customs of the industry, (5) subsequent conduct and interpretation by the parties themselves, (6) whether writing is contemplated merely as "memorial", (7) whether contracts need a formal writing for its full expression, (9) whether any terms remain to be negotiated, (10) whether contract has few or many details, (11) whether amount involved is large or small, (12) whether a standard form is widely used in similar transactions or whether this is an unusual type of contract, (13) the speed which the transaction must be concluded, (14) the simplicity or complexity of the transaction, (15) the availability of information necessary to decide whether to enter into a contract, and (16) the time when the contract was entered into. *Id.* p. 575-576.

<sup>105</sup> *Id.* p. 577.

<sup>106</sup> Johnston p. 474, 479.

<sup>107</sup> 953 F. Supp. 482 (S.D.N.Y. 1997).

<sup>108</sup> *Id.* p. 509.

Further, there had been no partial performance, the parties had no prior relationship, the alleged oral agreement was the type of large and sophisticated transaction that is typically made in a signed, formal writing, and the defendant had been negotiating with other lenders.<sup>109</sup>

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<sup>109</sup> Id. p. 511-514.



# 6 Precontractual Liability and Good-Faith Obligations

Most law systems impose a duty of good faith in the performance or enforcement of an existing contract. In England, the doctrine has not been formally adopted although case law encourages that contracts are performed in good faith by applying concrete solutions.<sup>110</sup> U.S. law imposes a duty to perform existing contracts in good faith by provisions in The Restatement (Second) of Contracts and the Uniform Commercial Code. The restatement holds that “Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement”.<sup>111</sup> The relevant question in this thesis is whether a duty of good faith and fair dealing applies to a precontractual relationship. Neither the Restatement nor UCC deal with good-faith obligations in this stage. It can be mentioned that the UNIDROIT Principles holds that the parties must conform to good faith and fair dealing throughout the life of the contract, including the negotiation process. Liability may be imposed for negotiations conducting in bad faith.<sup>112</sup>

## 6.1 All or Nothing

Traditionally, common law follows the “**all or nothing**” approach which either creates a binding and enforceable contract, or creates no obligation whatsoever. Thus, this approach prevents liability from being imposed unless a complete contract is found. In England the ”all or nothing” approach is formally maintained. English courts do not impose liability even if the precontractual document states that negotiations are to be conducted in good faith. U.S. courts have, however, shown to be fairly willing to move away from the approach and impose precontractual liability. Good-faith obligations have been enforced even if the letter of intent containing the agreement to negotiate in good faith is not enforceable.<sup>113</sup>

Although the trend, in the U.S., is moving towards enforcing preliminary agreements, courts sometimes find good-faith obligations too indefinite to enforce. Furthermore, the “all or nothing” approach is still applied. By focusing on factors such as the objective party intent and the definitiveness of the agreement, courts determine whether an enforceable contract has been entered. Courts often

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<sup>110</sup> Lake & Draetta p. 171. Further, EU law upholding contractual good faith standards have been implemented in English law as a result of the Unfair Terms in Consumer Contracts Directive 1994 (Cranston p. 214).

<sup>111</sup> Restatement (Second) of Contracts §205; U.C.C. §1-203 ).

<sup>112</sup> UNIDROIT Principles article 1.7; 2.15 ”Negotiations in bad faith” (“party who negotiates or breaks off negotiations in bad faith is liable for losses caused to the other party”).

<sup>113</sup> Lake & Draetta p. 172, 177, 127.

recognize the existence of an obligation to negotiate in good faith, but deny its existence in the absence of a final contract.<sup>114</sup> This infrequent and unpredictable use of the “all or nothing” approach has resulted in that some courts have permitted parties to withdraw in bad faith from negotiations, while others have held the withdrawing party liable as if a complete contract already existed. Such decisions do not reflect what the parties expected when they entered the letter of intent. A drastic example is the verdict in *Texaco v. Pennzoil*.<sup>115</sup>

## 6.2 Agreement to Negotiate

In more recent cases courts have avoided the “all or nothing” approach by adopting the concept of “**agreement to negotiate**” which obligates the parties to negotiate in good faith to attempt to reach a subsequent agreement.<sup>116</sup> Professor Knapp of New York University argued this approach, whereby an intermediate contract might exist even if no final enforceable contract has been reached, already in the 1960s. The idea is not to impose a general obligation of good faith to negotiating parties, but to recognize that they can bind themselves to a duty of good-faith obligations.<sup>117</sup>

In contrast to an agreement with open terms, the parties do not agree to be bound to specific substantive terms. Instead, they undertake to continue negotiating in good faith in order to reach an ultimate agreement. If, despite continued negotiation by both parties, an ultimate agreement is not reached, the parties are not bound by any agreement. If the agreement to negotiate is enforceable, a party will be liable for failure to reach ultimate agreement only if the failure results from a breach of that party’s obligation to negotiate.<sup>118</sup>

### 6.2.1 Explicit Good-Faith Obligation

Many letters of intent specifically require that their parties use their best efforts to reach a final agreement. Others provide that the parties must negotiate a subsequent contract in good faith. U.S. courts tend to recognize such express obligations.<sup>119</sup> The breakthrough was made in *Itek Corp. v. Chicago Aerial Industries*.<sup>120</sup> In this case, a letter of intent containing both a no binding-effect clause and a provision stating that its parties should “make every reasonable effort

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<sup>114</sup> Lake & Draetta p. 180. Knapp p. 673. The *Pueblo* case, see 5.1.1, is an example of a case in which the “all or nothing” approach was used.

<sup>115</sup> 729 S.W.2d 768 (Tex. Appl. 1987) see 5.3.

<sup>116</sup> Lake & Draetta p. 128.

<sup>117</sup> Knapp: *Enforcing the Contract to Bargain*.

<sup>118</sup> Farnsworth (1987) p. 251.

<sup>119</sup> Lake & Draetta, p 127.

<sup>120</sup> 248 A.2d 625 (Del. 1968).

to agree upon and have prepared as quickly as possible a contract”,<sup>121</sup> was found to impose liability. The Delaware Supreme Court held that the requirement to use reasonable efforts required the parties to negotiate in good faith. This ruling implies that the obligation of good faith overrides denials of contractual intent. Thus, parties are entitled to rely upon the expectation that their counterparts will act according to a least minimum standards of good faith and fair dealing.

A counterpart case is when a negotiating party promises not to negotiate with third parties. For example in *Channel Home Centers Divisions of Grace Retail Corp. v. Grossman*,<sup>122</sup> a letter of intent, that clearly did not constitute a complete agreement, was held to obligate the parties to use their best efforts and to negotiate in good faith.

*Itek* and *Channel* are examples of how otherwise non-binding letters of intent may impose obligation on the parties to negotiate in good faith if the parties had specifically agreed to negotiate. Furthermore, the cases reverse the classical rule that agreements to agree are unenforceable.

However, as discussed above, some courts refuse to give effect to the explicit intention of the parties to an agreement to negotiate. Professor Farnsworth argues that there is no adequate reason to do so.<sup>123</sup> When parties enter into commercial relationships, legal effect should be given to their intentions. The parties often consider themselves bound although certain terms have been left open for negotiation.<sup>124</sup> One reason why courts have refused to enforce explicit agreements to negotiate might depend on the difficulty in formulating an appropriate remedy since a court cannot know what the ultimate agreement would have resulted in and therefore not measure lost expectations.<sup>125</sup> However, as shown in the eighth chapter, the appropriate remedy is not expectation damages but reliance damages.<sup>126</sup> Another reason for not enforcing liability is the difficulty in determining the scope of good faith and fair dealing.<sup>127</sup>

Although not all courts have shared the willingness to enforce agreements to negotiate, the view taken in *Itek* and *Channel* has gained a substantial following, and the trend clearly favors enforceability. At least this is true where the parties have reached agreement on a significant number of the major terms of the ultimate agreement.<sup>128</sup> By focusing on contracts to negotiate, courts will determine more accurately what the parties intended when they entered the agreement. Courts will

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<sup>121</sup> *Id.* p. 627.

<sup>122</sup> *Channel Home Centers Divisions of Grace Retail Corp. v. Grossman*, 795 F.2d 291 (3d Cir. 1986).

<sup>123</sup> Farnsworth (1987) p. 286.

<sup>124</sup> Dugdale & Lowe p. 35-36.

<sup>125</sup> Temkin p. 130; Farnsworth (1987) p. 267.

<sup>126</sup> See 8.1 for definition of the terms.

<sup>127</sup> Farnsworth (1987) p. 267.

<sup>128</sup> Farnsworth CONTRACTS. p. 207.

also be more likely to find a remedy for the breach of the contractual duty that reflects the harm that the breach has caused.<sup>129</sup>

## 6.2.2 Implicit Good-Faith Obligation

In *Teachers' Insurance and Annuity Association v. Tribune Co.*,<sup>130</sup> Judge Leval of the Southern District of New York, developed an analysis of the duty to negotiate in good faith in the context of an *implicit* agreement to negotiate in good faith.

The construction company Tribune had entered negotiations to sell a building. According to the negotiations, Tribune would receive payment by a non-recourse long-term money mortgage note. To get cash, Tribune would borrow from a lender an amount approximately equal to the mortgage note. The loan could be paid off at any time by putting the mortgage note to the lender. Tribune got involved in negotiations with Teachers, a prospective lender, who later approved the loan. A commitment letter, which included "binding agreement" language, was executed. An attachment by Tribune stated that "acceptance and agreement is subject to the approval by the Company's Board of Directors and the preparation and execution of legal documentation satisfactory to the Company". At this time, Tribune had already entered into a letter of intent for the sale of the building. This sales related letter of intent expressly provided that it was a non-binding agreement. By the time Tribune's board of directors had adopted the resolutions, interest rates had dropped rapidly. This, and concerns that the accountant would not approve the technique that Tribune had planned to use to account for the transaction, made Tribune break away from the loan transaction by refusing to negotiate unless the lender agreed to modify the deal by accepting a new condition. The lender brought suit.<sup>131</sup>

Judge Leval began by pointing out that the court's task is to determine the intentions of the parties at the time of their entry into the understanding. Courts must be careful to avoid imposing liability where binding obligation was not intended. He continued by stating that it is equally important that courts enforce and preserve agreements that were intended as binding, despite a need for further documentation of additional negotiation. Moreover he stated: "Giving legal recognition to preliminary binding commitments serves a valuable function in the marketplace, particularly for relatively standardized transactions like loans. It permits borrowers and lenders to make plans in reliance upon their preliminary agreements and present market conditions. Without such legal recognition, parties would be obliged to expend enormous sums negotiating every detail of final

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<sup>129</sup> Temkin p. 170.

<sup>130</sup> 670 F. Supp. 491 (S.D.N.Y. 1987).

<sup>131</sup> Id. p. 494-496.

contract documentation before knowing whether they have an agreement, and if so, on what terms.”<sup>132</sup>

The judge then distinguished between commitment letters that created no binding obligation, and commitment letters that did create a binding obligation. The latter he labeled “preliminary contracts” and divided into two subcategories. The first type occurs when parties agree on all essential points but decide to memorialize their agreement in a more formal document. Such an agreement is preliminary only in form and therefore fully binding. The second stage is desirable but not necessary. Within the second type of preliminary contracts, there are both agreed and open terms, and the parties are bound to negotiate the open terms in good faith toward a final contract incorporating the agreed terms. This type, which the judge referred to as binding preliminary commitment, does not guarantee that the final contract will be concluded, although the obligation prevents a party from renouncing the deal, abandoning the negotiations or insisting on conditions that do not conform to the preliminary agreement.<sup>133</sup>

While applying the four factors New York courts previously had used to determine whether the parties had reached a binding agreement, the judge added a factor regarding the context of the negotiations. After examining these factors, the judge could conclude that the commitment letter between Tribune and Teachers represented a binding preliminary commitment. This obligated both sides to seek to reach a final loan agreement by negotiating in good faith.<sup>134</sup> In other words, the parties had implicitly adopted a good-faith obligation.

The judge found that Tribune’s reservation of board approval and similar did not override and nullify the agreement. Rather, the reservations recognized that various issues remained open for further negotiation and approval. He held that reservations are not to be considered alone, but in the context of the overall agreement. If full consideration indicates that there was a mutual intent to be bound, “the presence of such reservations does not free a party to walk away from its deal merely because it later decides that the deal is not in its interest”. Neither did the presence of open terms make the agreement unenforceable, since the important terms of the loan had been agreed upon.<sup>135</sup>

The *Tribune* method differs from the traditional “all or nothing” approach since it can oblige a party under a letter of intent to negotiate in good faith even if the parties have yet to reach a final contract. This approach, originally argued by Professor Knapp, is an intermediate stage, under which a party is obliged to *seek in good faith to reach a final contract*.

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<sup>132</sup> Id. p. 497-499.

<sup>133</sup> Id. p. 498.

<sup>134</sup> Id. p. 499-500.

<sup>135</sup> Id. p. 500-501.

Professor Johnston, arguing the no-liability default rule, thinks that the *Tribune* case made the New York four-factor test more complicated, introducing the factor of the negotiating history between the parties. According to Johnston, the introduction of binding preliminary agreements have created additional uncertainty, by making it possible for courts to find that the parties had not actually reached a binding agreement, but nonetheless were legally bound. This creates a risk of liability where liability is not consistent with the efficiency of courts.<sup>136</sup>

Professor Eisenberg of University of California, Berkeley, is much more positive about the *Tribune* approach. He recognizes the risk that courts might find a contractual obligation to negotiate when none in fact exists, but argues that if the *Tribune* test is applied only if the parties have a letter of intent, the risk is minimal. The parties can very easily include a provision not to be bound. Such provisions should be honored by the courts he says.<sup>137</sup>

A number of cases have followed in *Tribune*'s footprints. The *Tribune* approach is applicable to any letter of intent in which the parties have made an implicit commitment to negotiate in good faith.<sup>138</sup>

*LLMD v. Marine Midland Realty Credit Corp.*<sup>139</sup> involved a potential borrower, a short-term lender, and a permanent lender. The short-term lender would sell the loan to the permanent lender within a certain time. A provision in the loan commitment letter required that the "buy sell" agreement should be acceptable to the short-term lender and satisfactory to the permanent lender. The closing of the loan did not occur, since the buy sell agreement was never finalized.<sup>140</sup> The district court pointed out that it is well settled under Michigan law that there is an implied obligation of good faith and fair dealing which applies to the performance and enforcement of contracts. Consistent with this approach, the implied obligation has been applied where the parties have reached a binding loan commitment, but have left various terms of the commitment open for future negotiations. Further, while referring to the *Tribune* case, the court held that when parties enter into such preliminary commitment where they accept a mutual commitment to negotiate together in good faith in an effort to reach final agreement, they also simultaneously accept the obligation of negotiating the open terms in good faith. The court did not continue to examine whether there had been a breach against the good faith obligation since the case was brought to the court as a summary judgement.<sup>141</sup>

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<sup>136</sup> Johnston p. 480.

<sup>137</sup> Eisenberg p. 151.

<sup>138</sup> Eisenberg p. 146.

<sup>139</sup> 789 F. Supp 657 (E.D. Pa. 1992).

<sup>140</sup> Id. p. 658.

<sup>141</sup> Id. p. 660-661.

### 6.3 Agreements Without Good-Faith Provisions

In cases like *Itek*, *Channel*, and *Tribune*, the obligation to negotiate in good faith arises from either an explicit or implicit commitment in an agreement. When there is no such commitment, most agree that the traditional theory of freedom of contract applies. Thus, there is no contractual liability until a contract is made. This means that, until an offer has been accepted, a party is free to back out of a deal and break off negotiations for any reason without being held liable.<sup>142</sup> The party who enters negotiations with the hopes of arriving in an agreement bears the risk of any loss, should the other party break off negotiations. This view rests on a concern that limiting the freedom of negotiation might encourage unnecessary litigation and discourage parties from entering negotiations.<sup>143</sup>

However, the classical idea of freedom of contract is constantly being challenged and modified in response to the demands of good faith, fair dealing and business convenience.<sup>144</sup> The concept that there is a separate duty to negotiate in good faith arises originally out of the law doctrine of culpa in contrahendo.<sup>145</sup> Professor Farnsworth is against the idea of a general obligation of good faith. He argues that courts should not abandon the traditional view under which each party bears the risk that its efforts will go uncompensated if the negotiations fail.<sup>146</sup> Moreover, he argues that the difficulty of determining a point in the negotiations at which the obligation of fair dealing arises would create uncertainty. Such an obligation might discourage parties from entering negotiations if chances of success are slight. The obligation might also have an undesirable accelerating effect, increasing the pressure on parties to bring negotiations to a final but hasty conclusion.<sup>147</sup> Professor Kessler of Yale Law School, and Mrs. Fine from Harvard Law School have held that “if the utility of contract as an instrument of self-government is not to be seriously weakened, parties must be free to break off preliminary negotiations without being held to an accounting”.<sup>148</sup> A common concern among American lawyers is that the imposition of a precontractual duty of good faith would interfere with the freedom of contracts and result in a hesitancy to engage in business.<sup>149</sup>

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<sup>142</sup> Kessler & Fine p. 409.

<sup>143</sup> Farnsworth (1987) p. 221; Nedzel p. 157.

<sup>144</sup> Kessler & Fine p. 412, 449.

<sup>145</sup> Kessler & Fine p. 401.

<sup>146</sup> Farnsworth (1987) p. 266. “One may doubt the wisdom of those courts that have strained to find an agreement to negotiate in the absence of a clear indication of assent, for if carried to an extreme this would enable courts to impose a general obligation of fair dealing.”; p. 285.

<sup>147</sup> Farnsworth vol. I p. 328.

<sup>148</sup> Kessler & Fine p. 412.

<sup>149</sup> For example Grossman, Nedzel, Ominsky and Volk.

Although American courts do not use the term culpa in contrahendo, its underlying philosophy of responsibility for blameworthy conduct has found expression in numerous ways. Remedies for precontractual misbehavior can be provided by various doctrines such as promissory estoppel, misrepresentation, implied contracts and unjust enrichment.<sup>150</sup>

Under the doctrine of promissory estoppel, a clear and unambiguous promise made by one party may, even if it is inadequate to establish a contract, still create an obligation to pay damages if the other party, by relying and acting on these statements, become injured.<sup>151</sup> Thus, the doctrine might be possible to use in situations involving letters of intent that have failed to be considered complete contracts. Courts have however usually rejected promissory estoppel as a basis for recovery, finding the promise not to be clear and unambiguous. In addition, lawyers do not always plead promissory estoppel since the reliance damages are thought to be much lower than the expectation damages associated with a claim that a precontractual document is a complete agreement.<sup>152</sup> However, in *Budget Marketing Inc .v. Centronics Corp.*<sup>153</sup> the court found a party liable under the doctrine. A letter of intent between the two parties included a specific disclaimer. The court held that no binding commitment to negotiate in good faith could be implied from the letter of intent because of the disclaimer. Nevertheless, the parties' conduct after the agreement could establish a claim under the promissory estoppel doctrine.

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<sup>150</sup> Kessler & Fine p. 401, 448 ; Farnsworth (1987) p. 222.

<sup>151</sup> Ominsky p. 32; Restatement (Second) of Contracts § 90.

<sup>152</sup> Lake & Draetta p. 194-195. See 8.1 for definition of the damages terms.

<sup>153</sup> 927 F.2d 421 (8<sup>th</sup> Cir. 1991).



# 7 The Concept of Good Faith

“Good Faith” is defined in the Uniform Commercial Code as “honesty in fact in the conduct or transaction concerned.”<sup>154</sup> Good faith performance of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party. It excludes a variety of types of conduct involving “bad faith” because they violate community standards of decency, fairness or reasonableness.<sup>155</sup> However, as said before, neither the Restatement nor UCC deal with good-faith obligations in the precontractual stage. There is no clear following of what constitutes precontractual good faith and the topic has not been heavily discussed among scholars.<sup>156</sup> However, some views will be described below in 7.1.

The UNIDROIT Principles holds it to be bad faith if a party enters into or continues negotiations when not intending to reach an agreement with the other party. Misleading the other party, either by actually misrepresenting facts, or by not disclosing important facts, also qualifies as a conduct in bad faith under the principles. Furthermore, a party can be held liable for breaking off negotiations abruptly and without justification if a point of no return has been passed. When this point is reached depends on the circumstances of the case, in particular to the extent to which the other party had reason to rely on the positive outcome of the negotiations, and on the number of terms left open.<sup>157</sup>

## 7.1 What Scholars Say

Professor Summers of the University of Oregon has suggested that bad faith at the negotiating stage includes negotiating without serious intent to contract, abusing the privilege to break off negotiations and entering into a contract without having the intent to perform. Further, he holds that it would be bad faith to fail to disclose known defects in goods being sold and take undue advantage of superior bargaining power to strike an unconscionable bargain.<sup>158</sup>

It is Professor Farnsworth’s opinion that under an agreement to negotiate, the standard of fair dealing ordinarily requires that each party actually negotiates with each other and refrains from using improper bargaining tactics and imposing unreasonable conditions. Furthermore, a party should be required to disclose enough about any parallel negotiations as is necessary to allow its counter-party a reasonable opportunity to make competing proposals. In addition, a party is not

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<sup>154</sup> U.C.C. § 1-201(19).

<sup>155</sup> Restatement of Contracts (Second) §205 comments.

<sup>156</sup> Farnsworth (1987) p. 269.

<sup>157</sup> UNIDROIT Principles article 2.15 comments.

<sup>158</sup> Summers p. 220.

allowed to renege on already agreed terms, and must continue negotiations until deadlock has been reached or until it is justified on some other ground to break off the negotiations.<sup>159</sup>

Professor Knapp argues that withdrawal because a better offer has been received from others is the most obvious case of bad faith.<sup>160</sup> Farnsworth finds it hard to see how there can be a requirement to negotiate with only one party in the absence of an undertaking that negotiations will be exclusive since parallel negotiations are so common in practice and so important to competition. According to Farnsworth, a party should not have to forgo the opportunity to conclude a deal with a third party before deadlock has been reached. Restrictions may however be explicitly imposed by the agreement<sup>161</sup>

## 7.2 What Courts Say

The Court of Appeals for the Seventh Circuit showed in *Feldman v. Allegheny International*<sup>162</sup> a very negative position towards precontractual liability by holding that:

“‘Good faith’ is no guide. In a business transaction, both sides presumably try to get the best of the deal. That is the essence of bargaining in the free market. In the context of this case, no legal rule bounds the run of business interest, so one cannot characterize self-interest as bad faith. No particular demand in negotiations could be termed dishonest, even if it seemed outrageous to the other party. The proper recourse is to walk away from the bargaining table, not to sue for bad faith negotiations.”<sup>163</sup>

In *First National Bank of Chicago v. Atlantic Tele-Network*,<sup>164</sup> the seventh circuit adjudicated less strictly. A bank was to lend \$ 75 million so the prospective borrower could buy another company. The bank had sent two letter-offers to the prospective borrower, one commitment letter and one fee letter. The borrower accepted these letters and sent them back. The bank then drafted the loan agreement and inserted as a condition that a commission had to approve the borrower’s purchase. Because of certain terms in the draft agreement, the commission did not approve the purchase, and the bank and the borrower had to negotiate how to overcome the commission’s objection. The borrower, impatient at the bank’s failure to come up with a satisfactory revision of the agreement, broke off the negotiations and obtained financing from another financial institution.

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<sup>159</sup> Farnsworth (1987) p. 279.

<sup>160</sup> Knapp p. 721.

<sup>161</sup> Farnsworth (1987) p. 279, 284.

<sup>162</sup> *Feldman v. Allegheny International, Inc.*, 850 F.2d 1217 (7th Cir. 1988).

<sup>163</sup> *Id.* p. 1223.

<sup>164</sup> 946 F.2d 516 (7<sup>th</sup> Cir. 1991).

The borrower was now arguing that the fee agreement never came into effect since it was conditional on the parties' agreeing on the material terms of the loan. They did not agree, because the borrower withdrew from the transaction. Therefore, the borrower argued, it is entitled to the refund of a nonrefundable fee and is not liable for the termination and commitment fees.<sup>165</sup>

The court of appeal first turned to whether the condition added by the bank was part of the contract. That is if the borrower had rejected or accepted it. It was held that the law ordinarily treats silence as rejection of an offer, but if circumstances make it reasonable, the offeror may understand it as acceptance. The borrower's behavior, however, was best viewed not as an acceptance by silence, but rather as acceptance by conduct. By negotiating over the conditions, the borrower may have indicated that it had accepted the contract in principle and would have given the bank reason to presume that it had been accepted in the absence of an explicit rejection. Also, the condition was very reasonable given the bank's security. By explaining the purpose of the fee letter, and pointing out that the fees are not contingent on the loan actually being made, the court could show that the borrower's argument were based on a misunderstanding.<sup>166</sup>

The court then moved on to discuss the duty of good faith and noted that although there is no general duty to bargain in good faith, parties can impose such a duty on themselves. It was stated that the duty of good faith is weak in the formation stage of a contract, if it exists at all. Once a contractual relation is formed, the duty of good faith performance enters the picture and requires bargaining in good faith over terms left open. In this case, the commitment and fee letters formed a contract. However, the bank did not violate its duty of good faith by insisting that the loan should be conditional on approval by the commission. After determining this, the court asks why the borrower, which is protected by the doctrine of good faith from being taken advantage of, "should be permitted to waltz from bank to bank collecting commitment letters free of charge while planning to use only one of them".<sup>167</sup>

The borrower tried to avoid the fee agreement by invoking several other arguments, like that the "termination fee is a penalty because it is not proportioned to the actual harm likely to be suffered by the bank". The court dismissed the different arguments, holding for example that "ATN cannot make performance impossible and then cry impossibility".<sup>168</sup>

A similar case is *International Minerals and Mining Corporation v. Citicorp North America, Inc.*<sup>169</sup> Here a mining company and a bank had entered

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<sup>165</sup> Id. p. 518-519.

<sup>166</sup> Id. p. 518-519.

<sup>167</sup> Id. p. 520-521.

<sup>168</sup> Id. p. 520-521.

<sup>169</sup> 736 F. Supp. 587 (D.N.J. 1990).

negotiations regarding a twenty million-dollar loan for financing an acquisition of a mine. A standard proposal letter specifying a set of terms had been drafted and submitted to the borrowers. The letter explicitly stated that it was merely a proposal for a loan and not a commitment to lend. As is usual, the terms in the proposal letter were subject to negotiation between the parties. Once the borrower had accepted the draft, it would be made into a formal application for the loan. The borrower was then to pay a “good faith deposit” to the bank to indicate its willingness to fulfill the pending arrangement.

After the borrower had accepted the proposal letter and the deposit had been paid, a due diligence procedure started. When this investigation was finished a recommendation memo was issued. Before a commitment to lend could be made, this memo would have to be approved by six specific persons holding different titles in the company. In this case, one of the persons refused to recommend approval of the loan. After reworking the transaction, the loan was reviewed again. Now, the bank learned that a company related to the borrower was in bankruptcy. Therefore, the bank ultimately determined that it could not recommend approval. This led the borrower to file action, alleging that the bank improperly had denied its request for the loan.<sup>170</sup>

The District Court for New Jersey held that there was little doubt that the proposal letter did not constitute a binding contract since the language clearly stated that it was not intended to be a commitment. The subtler question was whether the bank’s denial of final approval was reasonable or unreasonable. The borrowers claimed that the bank was bound by an obligation of good faith and fair dealing implicit in any contract entered in the state of New Jersey. The court’s first task was to consider whether the bank’s failure to approve the loan was subject to a test of good faith and fair dealing. It found that the letter clearly constituted an integrated agreement to bargain in good faith. In exchange for the commitment fee paid by the borrower, the bank had agreed to investigate the possibility of funding the borrowers’ acquisition of the mine. If the borrower would have decided to get the loan elsewhere, the bank would have been entitled to keep the deposit. However, the court stressed that a proposal to agree in good faith to consider a loan is not the same as an agreement to lend money. The bank had agreed to consider the proposed transaction and fund the acquisition if, and only if, the conditions precedent in the proposal letter were fulfilled. As long as the bank had made its decision in a reasonable manner, no liability could be imposed. Thus, the next task was to determine if the bank’s decision was reasonable. The court stated that there could be no doubt that the bank had fulfilled its duties under the agreement to reasonably investigate the proposed transaction. As a result, there was no evidence that the bank had breached its agreement to properly investigate the proposed transaction.<sup>171</sup>

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<sup>170</sup> Id. p. 589-593.

<sup>171</sup> Id. p. 594-595.

As mentioned in 5.2.2, parties to an agreement with open terms are subject to a general obligation of fair dealing in negotiating those terms. This follows from the fact that an agreement with open terms is a contract. Thus, a party may be held liable if the failure to reach agreement on the open terms results from a breach of that party's obligation to negotiate. However, there are not many cases where this obligation has been recognized.<sup>172</sup> Although, in *Teachers Insurance and Annuity Association. v. Butler*,<sup>173</sup> the court held the borrowers liable for breach of a duty to negotiate in good faith.

In this case, the prospective borrower needed a commitment for permanent financing in order to get construction financing. The lender issued a commitment letter, which was accepted by the prospective borrower, to make the permanent loan. Just before closing, the borrower notified the lender that it was unwilling to accept the loan as long as the document contained a specific clause. The lender then sued to recover damages, arguing that the defendant had failed to negotiate in good faith. Further, it claimed that the objection to the language was only a result of a dramatic decline in interest rates after the commitment letter was signed. The borrower agreed that the commitment letter was binding, but argued that the specific clause was not part of the letter.<sup>174</sup>

The court rejected the borrower's argument and found that both parties, since they understood that the commitment letter did not contain all the final and definite terms that were to be incorporated in the closing documents, were required to negotiate in good faith with respect to the closing documents needed to consummate the transaction. The court found numerous reasons why the borrower had not negotiated in good faith. For example, it had communicated with various lenders during the period before the scheduled closing to seek a more favorable loan. Furthermore, less than three weeks before the closing it had requested the lender to reduce the interest rate. Also, the borrower did not make any objections to any provision of the closing documents until only four days before the closing, when it became apparent that it would not get away from the loan or get the interest rate lowered. In addition, the court found that the provision reflected the intent of the deal. Thus, the borrowers had breached the commitment letter and were obligated to pay damages for breach of contract.<sup>175</sup>

In *Jacques v. First National Bank of Maryland*,<sup>176</sup> the issue was whether a bank that had agreed to process an application for a residential mortgage loan, owed a duty of reasonable care to its customer while processing the application. A couple had applied to the bank for a \$112,000 loan, but only qualified for a loan of \$74,000. Later, the bank informed them that it had erred in its original

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<sup>172</sup> Farnsworth (1987) p. 253-254.

<sup>173</sup> 626 F. Supp. 1229 (S.D.N.Y. 1986).

<sup>174</sup> Id. p. 1229-1231.

<sup>175</sup> Id. p. 1232-1236.

<sup>176</sup> 515 A.2d 756 (Md 1986).

determination and that in fact, the couple only qualified for a \$41,400 loan. Because interest rates had dramatically escalated, obtaining financing from another lending institution was no real option for the borrowers. The bank argued that there was no contract and therefore no legal relationship between it and the Jacques at the time of the bank's alleged negligence. The Court of Appeal for Maryland disagreed by holding that the bank had made at least two express promises to the Jacques. It agreed first to process their loan application and second to guarantee the interest rate for a period of ninety days. These promises were supported by a valid consideration and therefore enforceable. When the Jacques accepted the offer by paying the required fee and submitting the loan application, the bank obtained a business advantage and potential benefits sufficient to support its promise. The court thus concluded that the initial agreement to process the loan application was intended to, and did, result in a binding contract. The court then held that implicit in the undertaking of the bank to process the loan application is the agreement to do so with reasonable care.<sup>177</sup> The court found this case different from those when a prospective customer simply submits an application for a loan and thereafter claims that the unilateral act of submitting the application gives rise to a duty on the other part to act. Under such circumstances, courts have generally held that the bank has not undertaken any obligation to process the application and therefore has no duty at all. Further, the fact that the Jacques had sued for breach of contract did not rule out that the court also tried the claim under a tort duty.<sup>178</sup>

### 7.3 Some Observations

A complete bank commitment letter, appearing as an "agreement to engage in transaction",<sup>179</sup> commits the lender to extend credit at stated interest rate and repayment terms. It also commits the borrower to take credit at stated terms. However, sometimes the parties do not intent for the commitment to be absolute and might be allowed to back out of the deal if they have justifiable reasons. The lender, for instance, would typically be allowed to leave the deal if investigation of the buyer's financial condition proves unsatisfactory.<sup>180</sup> However, implicit in the undertaking to process the loan application might follow an obligation of good faith in making this decision.<sup>181</sup> If the only reason for backing out is that an alternative with better terms has arisen, the party might not be free to withdraw.

Courts have generally enforced commitment letters against lenders that have refused to make the loan in conformity with the commitment letter, maybe because interest rates have risen or because its lawyers is questioning the

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<sup>177</sup> Id. p. 756-762.

<sup>178</sup> Id. p.762-765.

<sup>179</sup> See 5.2.1 above.

<sup>180</sup> The *Clardy* case. See 5.1.1.

<sup>181</sup> The *Jacques* case. See 7.2.

terms.<sup>182</sup> Other situations where a lender usually will be held liable is when it has imposed additional conditions not set forth in a commitment letter and then refuse to make a loan based on failure of the borrower to fulfill such conditions.<sup>183</sup> The *Zelazny*<sup>184</sup> case can serve as an example. Here the court did not let the bank put more into a subject provision than originally intended, in order to get out of the agreement because the borrower had lost his job.

If a case would arise where the bank would refuse to accept a term offered by the borrower merely because the bank wanted to get out of its loan commitment and pocket the fees, the bank may have to face liability for bad-faith performance. According to case law, a party can not take the position that it is not satisfied when in fact it is. However, by getting out of the deal, the bank would miss out on the significant closing fee.<sup>185</sup>

The lender's rights against the borrower are less clear. Lenders generally just take the refundable commitment fee without arguing that the commitment is binding.<sup>186</sup> However, the *Butler* and *Ormesa* cases<sup>187</sup> show that the borrowers too can be held liable for bad faith when trying to change already set conditions. In *Butler*, another reason for holding the borrower liable was that it had negotiated with other lenders.

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<sup>182</sup> Farnsworth (1987) p. 290.

<sup>183</sup> *Freeman Horn, Inc. v. Trustmark National Bank*, 245 B.R. 820 (S.D. Miss. 1999) at p. 826.

<sup>184</sup> See 5.3.2.3.

<sup>185</sup> 946 F.2d 516 (7<sup>th</sup> Cir. 1991) at p. 520-521.

<sup>186</sup> Farnsworth (1987) p. 290.

<sup>187</sup> See 7.2 and 8.2.

# 8 Remedies

## 8.1 Possible Remedies

If a letter of intent is found to constitute a final contract, a party can be held liable for breach. Recovery will then be measured in the most generous way, by the **expectation interest** the injured party had when it made the contract. The purpose is to put the injured party in the position it would have been had there been no breach.<sup>188</sup>

Under the **reliance interest** the party in wrong is liable for the loss caused to the injured party by its reliance that the other party would negotiate in good faith according to the agreement. The purpose of this measure is to put the injured party back in the position in which it would have been had the contract not been made, thus covering out-of-pocket costs but not the lost profit that the original contract would have resulted in.<sup>189</sup>

A way to measure recovery when the party in wrong has received a benefit is by the other party's **restitution interest**. To put the party in wrong back in the position had there been no wrong, it would be required to hand over the benefit to the other party. Because such recovery does not take account of either the injured party's lost profit or reliance, it is usually less generous than recovery measured by the expectation or reliance interest.<sup>190</sup>

If a contract is not found, the question of precontractual liability may arise. Under American law, a court has free reins to grant whatever remedy it feels appropriate.<sup>191</sup> Contract law generally imposes a requirement that damages claimed must be proved with reasonable certainty. Agreements to negotiate may have greater uncertainty than usual contracts since several terms are left open. Therefore, a court is more likely to grant recovery measured by the reliance interest than by expectation interest in a precontractual situation. If the main terms were agreed upon, damages might also include the injured party's loss of expected profits under the contemplated contract.<sup>192</sup> However, there are only a few cases where courts have taken account of lost profits.

Professor Eisenberg is of the opinion that the injured party in an agreement to negotiate should be awarded expectation damages. Since the other party's wrongful acts made it impossible to determine what would have happened if the

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<sup>188</sup> Farnsworth vol. I p. 60.

<sup>189</sup> Farnsworth vol. I p. 61.

<sup>190</sup> Farnsworth vol. I p. 61.

<sup>191</sup> Nedzel p. 149.

<sup>192</sup> Knapp p. 723



act was not made, that party should bear the burden of proving that the deal would have broken down even if there would have been no wrongful act. However, if expectation damages are too uncertain, Eisenberg thinks the court should award reliance damages measured by out-of-pocket costs or, where appropriate, by lost opportunities.<sup>193</sup>

An analysis by some Law and Economic professors shows that imposing liability for precontractual reliance will not, like held by some legal scholars, discourage parties from entering negotiations. The analysis proposes that the best way to regulate precontractual investments might be through an intermediate approach where the party in breach is inflicted with reliance liability.<sup>194</sup> Similar to Professor Knapp's concept, and in contrast to the "all-or-nothing" position where the agreement is either fully dismissed or fully enforced with expectation remedies, it does not deal with the determination of the preliminary agreement.

If a preliminary agreement is enforced, there will be no lost opportunity to be counted in damages. More importantly, a significant breach of the duty to negotiate fairly will justify the other party in refusing to perform under the agreement. If the breach is not cured, the injured party will be entitled to terminate the agreement as a whole and to claim damages for total breach of agreement. Damages would then be based on the injured party's lost expectation under the agreement and would not be limited to reliance losses. Only in exceptional cases, however, will a breach of the general obligation of fair dealing be sufficiently serious to be treated as a total breach. More often, it will justify a demand for assurance or performance.<sup>195</sup>

## 8.2 A Final Illustration

In *Teachers v. Ormesa Geothermal*<sup>196</sup> the lender sought damages for breach of contract by the prospective borrower. According to the lender, the borrower had refused to continue negotiations, alleging that the lender had "walked" from the deal, when in fact it was the borrower that wanted to get away from the deal because of a sharp decline in interest rate. The borrower argued that a commitment letter did not bind the parties to complete the transaction. Referring to Judge Leval's analysis in the *Tribune* case, the court decided that the agreement at issue was an "agreement in which the parties have committed themselves to some major terms, but other terms remain to be negotiated in the future".<sup>197</sup> The New York district court used the five-factor version of the New York multi-factor test to determine whether the parties intended to be bound by

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<sup>193</sup> Eisenberg p. 156.

<sup>194</sup> Bebchuk & Ben-Shahar p. 423.

<sup>195</sup> Farnsworth (1987) p. 255.

<sup>196</sup> 791 F. Supp 401 (S.D.N.Y. 1991).

<sup>197</sup> Id. p. 402, 414.

an incomplete, preliminary agreement. The language of the commitment agreement expressly said that it was a “binding agreement”. Although there were many open terms to be negotiated, all of the crucial economic terms of the loan were set forth in the commitment letter, including amount and term, interest rate, repayment schedule, description of security and guarantee, and prepayment penalties. Also the context of the negotiations, a factor introduced in *Tribune*, supported the view that the commitment agreement was intended as a binding agreement. Further, the court found that the lender had partially performed its contract with the borrower by committing \$25 million of its funds to the transaction. Moreover, the court held that it is customary for borrowers and lenders to accord binding force to preliminary agreement. Thus, the court concluded that the commitment agreement was a binding preliminary agreement that obligated the borrower and the lender to seek to reach a final loan agreement on agreed terms by negotiating in good faith to resolve other terms customarily found in loan agreements. The court then stated that the borrower had breached this duty. By, among other things, insisting on lowered interest rate, the borrower had attempted to change and undercut terms that had been agreed to in the commitment letter. It was pointed out that a party injured by breach of contract should be placed in the same economic position as it would have been in had the contract been performed. Thus, the lender was entitled to damages for lost expectations measured by difference between the interest income the lender would have earned had the contract been performed, and the interest income the lender would have earned by making a similar investment at the time of the break.<sup>198</sup>

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<sup>198</sup> Id. p. 414-416.

# 9 A Swedish Overview

## 9.1 Letter of Intent in Sweden

The topic “letter of intent” was unknown in the Swedish legal debate until the mid 1980s when the topic was discussed by Professor Gorton and debated at a Nordic Legal Meeting. However, letters of intent were known since years, and, after time, frequently applied, in the business world.<sup>199</sup> Still, litigation concerning letters of intent is very unusual in Sweden. A survey done for a law school thesis shows that subsidiaries to foreign companies or companies with overseas interests are more likely to get involved in litigation. The companies involved in most litigation have an American viewpoint. An interesting remark is that although an American contract generally is considerably more detailed than a Swedish one, an American company is more likely to begin performance before the final contract has been issued. This is partly the reason why American companies are more likely to litigate.<sup>200</sup>

## 9.2 Enforceability and Precontractual Liability

According to the “principle of promise” in Swedish contract law, the offeror is unilaterally bound by his or her written promise. This means that the offeror is not entitled to revoke the offer for a period of time after read by the offeree.<sup>201</sup>

Like in the U.S., the general idea is that a party has to bear his or her own expenses while negotiating an agreement that is not finalized.<sup>202</sup> According to the Swedish tort law, economic damages will not be awarded unless not connected with a criminal act.<sup>203</sup> If a party has acted in bad faith during the negotiations it is possible that he or she might be liable under the doctrine of culpa in contrahendo to compensate the other party. However, it has, for a long time, been uncertain if a liability under this doctrine really exist. Only a number of cases from the Swedish Supreme Court deal with culpa in contrahendo in the precontractual stage and only in one clear case, *NJA 1963 p. 105*, has the court found liability and awarded damages.

The general opinion is that precontractual damages would be awarded up to the “negative contractual interest”.<sup>204</sup> This, corresponding with the American reliance

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<sup>199</sup> Gorton p. 43; Gomard, NJM II 1984 p. 443.

<sup>200</sup> Holmgren & Lundqvist p. 41, 58, 90-91.

<sup>201</sup> Adlercreutz p. 51.

<sup>202</sup> Adlercreutz (2002) p. 110.

<sup>203</sup> 2 Chapter 2 § Tort Liability Act.

<sup>204</sup> Adlercreutz (2002) p. 110-111; NJA 1963 p. 105.

interest, would put the injured party back in the situation had there been no contract. In contractual relations, damages according to the “positive contractual interested” is generally awarded. Corresponding with the expectation interest, it puts the injured party in the same economical position had there been no breach.

Professor Grönfors argues that the legal status of a letter of intent is related to when during the negotiations the agreement was created. A writing early on in the negotiation is merely a mutual commitment to seriously move on with the negotiations. A party who later refuses to continue negotiations may be held liable for culpa in contrahendo and might be held to pay damages for the negative contractual interested, but can not be forced to enter into the complete contract. If the writing is created in the final part of the negotiations, Grönfors holds that it would be unreasonable under Section 36 Contracts Act to let a party get away from the deal. The parties would instead be under an obligation to conclude the negotiations.<sup>205</sup>

The “*Baladi case*”<sup>206</sup> was the first case to reach the Swedish Supreme Court, dealing with a possible letter of intent. A company had sent a letter to a person offering him to become a representative for the company. Later, after the person had started making preparations, the company backed out claiming there was no contract. The court of appeal had referred to the writing as a letter of intent, but the Supreme Court chose not to. The Supreme Court held that the letter itself did not bind the company, but its later conduct did.

In *NJA 1978 p. 147*, a real estate company had entered an oral agreement with a prospective lease-taker. When the premises had already been prepared for the lease, the lease-taker backed away from the deal. The court found that the lease-taker had not acted in bad faith and thus, the real estate company was not awarded any damages. Although not clearly saying so, it seems as the court regarded the disputed agreement as a letter of intent. Thus, this case indicated that culpa in contrahendo is a necessary condition for a letter of intent to result in liability.<sup>207</sup>

In the “*Super V pump case*”,<sup>208</sup> the Supreme Court took one step further. Initially it stated that a letter of intent is generally not legally binding, although provisions included might be. Yet, a letter of intent would create a certain obligation of loyalty toward the other party. The court found the writing in question not to be a letter of intent since neither its context, circumstances of its execution, or other conditions so indicated. However, the existence of a letter of intent was not a necessary condition for liability under culpa in contrahendo to

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<sup>205</sup> Grönfors p. 75-76.

<sup>206</sup> *NJA* 1977 p. 92.

<sup>207</sup> Adlercreutz (1987) p. 502, 513.

<sup>208</sup> *NJA* 1990 p. 745.

arise. In this case, negotiations had come so far that the parties were under an obligation to act loyally towards each other. The court held that liability would arise on a party failing to provide information to the other party in long-term negotiations that it no longer intended to conclude the contract. In this case, no liability was found, and no damages were awarded, especially since the offended party had not incurred any losses.

Professor Kleineman has held that this case shows that there is a general principle of law according to which a person injuring another by culpa in contrahendo can be held liable to pay damages. Characteristic for this principle is that the party in wrong has, in some way, misled the other party causing damage. Ethical business norms will be used to decide whether the party should be liable for its negligence. Further, the party in wrong must have realized the result of its acting and the injured party must have had reasons to believe information from the other party. Thus, the injured party does not need to show that the other party acted disloyally, only negligently. Despite this, Kleineman considers it difficult to be awarded damages for culpa in contrahendo.<sup>209</sup>

### 9.3 Concept of Good Faith

In the *Super V pump* case discussed above, it was held that the estimation of negligence should be based on ethical business norms. Thus, a party must inform the other party in long term negotiations if he or she does no longer intend to conclude the deal. Otherwise, court ruling do not give much guidance on the concept of good faith regarding precontractual liability.

The general opinion at the Nordic Legal Meeting in 1984 was that a party to a letter of intent can not break off negotiations without a satisfactory cause. It was argued that the parties have agreed to negotiate exclusively. Breaking off negotiations to cut a deal with somebody else was considered culpa in contrahendo. It was also held that a party is under an obligation of good faith in obtaining the necessary permits that the agreement has been made subject to. A failure to do so would result in sanctions.<sup>210</sup>

I will now turn the discussion to a banking perspective. According to Swedish law, a loan will be granted only if the bank has a good basis to believe that the borrower will be able to fulfill its obligation. Further, a bank has to receive a satisfactory collateral to be able to make the loan.<sup>211</sup> Finance institutions are not governed under the same obligation. Thus, a finance institution is able to take

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<sup>209</sup> Kleineman p. 138, 140.

<sup>210</sup> NJM I: Gomard p. 309; NJM II: Portin p. 450, 448; Hellner p. 453; Lind p. 461.

<sup>211</sup> 2 chapter 13§ Bank Act.

greater risks than banks.<sup>212</sup> However, according to the Consumer Credit Act all lenders must consider private borrowers' interests with proper care and thus perform some kind of investigation into their credit eligibility before making a loan.<sup>213</sup> However, this obligation does not have a remedy. According to the motives, a breach can be argued from Section 36 in the Contracts Act dealing with unreasonable provisions, adjusting the deal or setting it aside. When the loan might have an impact on the borrower's private finances, it would be considered a breach against the generally accepted accounting principles to skip the credit investigation without proper cause.<sup>214</sup>

In *NJA 1996 p. 3*, the Supreme Court dealt with the question of professional lender's advisory responsibility. The borrower had received the loan in capacity of being an employee in a company. The company had offered its employees convertible promissory notes. To finance the purchase of the notes the employees would obtain a loan from a bank. The bank paid the loan directly to the company, which never issued any notes but instead went into bankruptcy. In this case, one of the employees tried to get away from a loan commitment, arguing that the lender had not fulfilled its advisory responsibilities.

The court upheld the loan commitment and found that the bank did not have any general advisory responsibilities. Although when granting a loan, the bank usually is informed of the loan's purpose, the bank does not have any general obligation to try the suitability of how the borrower will use the money. The purpose of the investigation of the borrower's credit eligibility is to examine if the borrower is in position to fulfil its obligation according to the loan commitment and can fit the obligation into its finances. Only in exceptional cases will a lender's negligent examination free the borrower from the obligation to repay the loan. Such a case would most likely be based on Section 36 in the Contracts Act.<sup>215</sup>

A similar situation arose in *NJA 1999 p. 304*. Just as in the case above, an employee tried to be released from repaying a loan by arguing that the bank had not performed a thorough examination of the borrower's credit eligibility. The bank had not been in personal touch with any of the employees. The Supreme Court held that the bank had not obligated itself to examine the economic position of the company where borrowers were employed and to give advice whether or not it was wise of the employees to invest in the company. Thus, the bank did not have any contractual obligation to examine whether the bank was in position to fulfill its obligation toward the employees. Neither was the bank under any obligation, in relation to the borrower, to have examined the nature of the

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<sup>212</sup> Statement of "Finansinspektionen" in *NJA 1997 s. 524* at p. 529.

<sup>213</sup> 5 § Consumer Credit Act (1992:830).

<sup>214</sup> Prop. 1991/92:83 p. 107-108.

<sup>215</sup> *NJA 1996 p. 3* at p. 13.

promissory notes. In conclusion, the bank had not breached the loan agreement and the borrower was not entitled to receive damages.<sup>216</sup>

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<sup>216</sup> NJA 1999 p. 304 at p. 323.

# 10 Conclusion and final remarks

This thesis has shown the difficulty in giving a simple answer to questions regarding the legal nature of a letter of intent. Since parties are free to give the agreement whatever meaning they think will fit their special needs, the diversity of preliminary agreements are considerable. The flexibility, being one of the key purposes in creating a letter of intent, makes it impossible to set up a specific template for what legal obligations might arise from different forms of precontractual agreements. The text of an agreement must be interpreted, and the context in which it was agreed upon must be considered, in order to find out if any legal effects will follow.

Traditionally, a “letter of intent” is a precontractual agreement: an agreement to agree without any legal effects. The parties have no intention of being legally bound, but use the writing as a way of memorializing where the negotiations stand. The purpose might be to create a psychological effect, making the parties feel more committed to each other than the law would. To these parties, the moral obligation is of greater interest than the legal obligation. In other instances, although terms have been left open, parties might intend their agreement to be a binding contract.

In the banking sector, letters of intent often appear as “commitment letters”. The name indicates a stronger intent to be bound than a typical letter of intent appearing in, for example merger and acquisitions. An ultimate commitment letter, that is a writing that manifests intent to be bound and contains all essential terms of the agreement, falls into the category of “agreements to engage in transactions”. Documents in this category are preliminary only in form. They bind both parties to act according to the document but postpone the preparation and execution of the necessary documents until a later time. Memorizing the agreement in a more formal document is not a necessary step for creating binding force. Thus, an ultimate commitment letter is in fact a complete contract, binding the lender and the borrower to perform according to it. This means that basic contract principles apply. A party who does not act according to the commitment is in breach of the contract and might face contractual liability.

However, the legal effect of a contract does not depend on its labeling, but on its content. The premise in U.S. law, and probably also in Swedish, is that there is no final contract until the parties so intended and all the essential terms have been decided. At the other end of the spectrum, very detailed agreements might be considered complete contracts thus binding the parties. Generally, terms regarding the amount, interest, dates and fees have to be included in a binding loan commitment, but court conduct shows that there is no clear following regarding



essential terms. Thus a party should never rely on omitted terms to prevent a binding contract.

The most important factor in determining whether an agreement is binding is the apparent intent of the parties. Thus, missing terms in a writing can be supplied by oral agreement or actions of the parties. Courts might sometimes find that letters of intent that are preliminary in form have moved from the preliminary stage to the contractual stage due to parties actions. Court conduct has shown that it is not enough to prevent an agreement from become binding to label the writing a preliminary agreement, or to condition the deal on board approval, formal agreement, or on completion of negotiation. Further, courts may hold that the party has a duty to negotiate in good faith, even if the agreement is not otherwise binding. Such obligation can result from the wording in the letter or from the actions of the parties. This is why parties entering a letter of intent should be very careful about the language in the writing. If the parties want to prevent the agreement from being binding, a provision clearly stating that the letter is nonbinding should be included. In addition, the parties must take care that their behavior, even after the letter of intent is issued, is in line with their intentions.

Thus, the very existence of a letter of intent will not impose any legal effects unless the writing is considered a complete contract, but a party can be held liable because of its conduct.

I now turn to the question of whether an obligation of good faith exists in precontractual negotiations and in what circumstances such obligation would be imposed. I can conclude that U.S. courts have not accepted a general obligation of good faith. However, parties can be under an obligation to negotiate in good faith due to explicit or implicit provisions in the agreement. What constitutes a breach against good faith must be considered from case to case. Backing out of an agreement just to cut a deal with somebody else or to pocket the nonrefundable commitment fee are possible behaviors that would qualify as bad faith. Other unacceptable conduct would be changing already agreed-upon conditions or imposing new ones just before closing.

In Sweden, although very rarely applied, it would be possible to impose liability under the doctrine of culpa in contrahendo. Court rulings indicate that a party who negligently has misled the other party can be held liable under this doctrine. A letter of intent seems to make the precontractual obligation of good faith that the parties are under stronger. In addition, liability might be imposed at an earlier stage of the negotiations than had there been no letter of intent.

A specific good-faith obligation applies under Swedish law to a lender making a loan to a consumer. The lender must consider the borrowers' interests with proper care and perform some kind of examination in the borrower's credit eligibility before making a loan. However, only in exceptional cases would a bank

be held liable under this obligation. A similar obligation applies according to American case law, since included in a lenders' undertaking to process an application lies an agreement to do so with reasonable care.

In conclusion, there are no easy, and certainly no unambiguous authoritative answers to the legal effects of letters of intent. It is impossible to exclude any binding effect without having studied the agreement's particular content and the surrounding circumstances. Facts such as the wording of the agreement, time, and the parties behavior during and even after the time when the contract is suggested to have arisen must be considered. After an analysis, the court might find that the agreement is not binding because not definite enough, or because the parties did not intend to be bound. Then no contractual legal effects will be imposed. This would be the traditional, and perhaps "safest" ruling. However, it would still be possible, although not likely, for a U.S. court to award compensation to an injured party according to the principle of promissory estoppel or various tort instruments.

On the other hand, the court might hold that the letter of intent is in fact a complete contract that the parties are bound by and thus need to perform according to. This finding would also result in awarding the injured party with contractual damages to the amount of its expectation interest, unless the contract stated otherwise. A lender would then receive damages for the difference in interest it would have earned had the contract been performed and the interest it would have earned by making a similar investment with somebody else. A borrower would be entitled to the difference in interest and additional fees that it had to pay for a substitute loan.

A third option is that there is no complete contract, but that the parties nevertheless are bound by an obligation to negotiate in good faith to reach it. American case law took a significant step forward in the *Tribune* case. Here an obligation to negotiate in good faith was recognized as inherent in the preliminary agreement. This approach provides a solution to the problem of one party withdrawing in bad faith from a letter of intent that the traditional "all or nothing" principle is incapable of. If a party is found not to have fulfilled the obligation of good faith, it might be subject to pay damages equivalent to the injured party's reliance, or more seldom like in the *Ormesa* case, expectation interest. Under the reliance interest, the party will be compensated for out of pocket costs, but not for lost opportunities.

While keeping in mind that this is not a comparative study, it seems as if basic considerations made by American and Swedish courts are not too different. In both systems a letter of intent might or might not impose any legal effects depending on relevant circumstances. Although, the culpa in contrahendo doctrine has not been accepted by the U.S. legal system, similar results can often be reached under grounds recognized by American courts.

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Act

# Appendix

EXHIBIT 10<sup>217</sup>

FLEET BANK,  
N.A. 1185 Avenue of the Americas  
New York, New York 10036

May 30, 2001

Cantel Medical Corp.  
Overlook at Great Notch  
150 Clove Road – 9th Floor  
Little Falls, NJ 07424  
Attn.: James P. Reilly

Ladies and Gentlemen:

You have advised Fleet Bank, N.A. ("FLEET") that Cantel Medical Corp., a Delaware corporation (the "BORROWER") will acquire all the outstanding stock of the TargetCo pursuant to a statutory merger of TargetCo and Borrower or Borrower's wholly owned subsidiary (such transaction being the "ACQUISITION"). The Acquisition will be financed, in part, through an equity issuance by you, and from funds borrowed pursuant to the Credit Facilities (as defined below).

Fleet is pleased to advise you of its commitment to provide up to the full amount of \$47,500,000 senior secured credit facilities (the "CREDIT FACILITIES") on the terms and conditions summarized in this letter and in the Summary of Terms and Conditions attached to this letter (the "TERM SHEET"). The Credit Facilities will be used (i) to finance, in part, the purchase price for the Acquisition and to pay fees and expenses of the Acquisition (ii) to repay existing indebtedness and (iii) for general working capital purposes.

Although Fleet is committing to provide all of the Credit Facilities on a fully underwritten basis, Fleet expects that a portion of the Credit Facilities will be made available by other financial institutions (such lenders including Fleet, the "LENDERS"). It is agreed that Fleet will act as the sole administrative agent

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<sup>217</sup> U.S. Securities & Exchange Commission's Public Information Server 2003-01-25  
<http://www.sec.gov/Archives/edgar/data/19446/000091205701518194/a2050895zex-10.txt>

(in such capacity, the "ADMINISTRATIVE AGENT") for the Credit Facilities and Fleet Securities, Inc ("FSI") will act as arranger for the Credit Facilities. Fleet will be responsible for preparing and negotiating definitive documentation for the Credit Facilities, and Fleet and FSI will manage the syndication effort of forming the syndicate of lenders that will make the Credit Facilities available. Additional agents, co-agents or arrangers may be appointed at the discretion of Fleet and FSI.

You agree to assist Fleet and FSI in forming any such syndicate and to provide Fleet, FSI and the other Lenders, promptly upon request, with all information reasonably deemed necessary by them (consistent with industry practice) to complete successfully the syndication, including, but not limited to, (i) an information package for delivery to potential syndicate members and participants and (ii) all information and projections prepared by you or your advisers relating to the transactions described herein. Prior to the closing of the Credit Facilities you agree to refrain from any other financings (except equity issuances having no debt characteristics) during such syndication process unless otherwise agreed to by Fleet. You further agree to make appropriate officers and representatives of the Borrower and its subsidiaries available to participate in informational meetings for potential syndicate members and participants at such times and places as Fleet or FSI may reasonably request.

Fleet and FSI reserve the right, based on market reception, in consultation with the Borrower, to reallocate the aggregate principal amount of the Credit Facilities among the Revolving Facility and the Term Facility (as defined in the Term Sheet) and/or to otherwise change the structure or terms thereof prior to the closing of the Credit Facilities if Fleet and FSI determines that such reallocation or changes are advisable in order to ensure a successful syndication and if the aggregate amount of the Credit Facilities remains unchanged and if any pricing changes are consistent with credits of similar quality.

You represent and warrant and covenant that (i) all information which has been or is hereafter made available to Fleet or FSI by you or any of your representatives in connection with the transactions contemplated hereby is and will be complete and correct in all material respects with respect to the matters such information purports to cover and does not and will not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements contained therein not materially misleading in light of the circumstances under which such statements have been or will be made and (ii) all financial projections that have been or are hereafter prepared by you and made available to Fleet, FSI or any other participants in the Credit Facilities have been or will be prepared in good faith based upon reasonable assumptions. You agree to supplement the information and projections referred to in clauses (i) and (ii) above from time to time until completion of the syndication so that the representations and warranties in the preceding sentence remain correct. In

arranging and syndicating the Credit Facilities, Fleet and FSI may use and rely on such information and projections without independent verification thereof.

In connection with the syndication of the Credit Facilities, Fleet and FSI may, in their discretion, allocate to other Lenders portions of any fees payable to Fleet or FSI in connection with the Credit Facilities. You agree that no Lender will receive any compensation of any kind for its participation in the Credit Facilities, except as expressly provided for in this letter, the Term Sheet or in the Fee Letter referred to below.

Please note, however, that the terms and conditions of this commitment and undertaking are not limited to those set forth in this letter. Those matters that are not covered or made clear herein or in the attached Term Sheet (which is a part of this Commitment) are subject to mutual agreement of the parties. The terms and conditions of this commitment and undertaking may be modified only in writing. In addition, this commitment and undertaking is subject to: (i) the preparation, execution and delivery of mutually acceptable loan documentation, including a credit agreement incorporating substantially the terms and conditions outlined herein and in the Term Sheet, (ii) the absence of (a) a material adverse change in, or a development that would reasonably be expected to have a material adverse effect on, the business, condition (financial or otherwise), operations, properties or prospects of the Borrower and TargetCo and their respective subsidiaries, taken as a whole, since July 31, 2000 to the date of this Commitment Letter in respect of Borrower and its subsidiaries and since March 31, 2000 to the date of this Commitment Letter in respect of TargetCo and its subsidiaries (other than items disclosed specifically in the Disclosure Schedules to the Merger Agreement referred to in paragraph 1 of the "Conditions Precedent to Funding" in the attached Term Sheet the Agent acknowledges (for purposes of this clause (a) and the following clause (b) that it has received the publicly released preliminary summary 2001 fourth quarter balance sheet as at March 31, 2001 and the income statement for the quarter ended March 31, 2001 of TargetCo and its subsidiaries, and TargetCo's financial projections dated May 4, 2001) and (b) a material adverse change in, or development that would reasonably be expected to have a material adverse effect on, the condition (financial or otherwise), operations, business, properties or prospects of the Borrower and TargetCo, and their respective subsidiaries, taken as a whole, following the date of this Commitment Letter, and (c) any material adverse change in loan syndication or financial or capital market conditions generally from those currently in effect that would be reasonably likely to have a material adverse effect on the ability of Fleet to successfully syndicate the commitment under this letter, (iii) the accuracy and completeness in all material respects of all representations, taken as a whole, that you make to us and all information, taken as a whole, that you furnish to us in connection with this commitment and undertaking and your compliance with the terms of this letter, (iv) no development or change occurring after the date hereof, and no information

becoming known after the date hereof, that (a) results in or would reasonably be expected to result in a material change in, or material deviation from, the information, taken as a whole, previously delivered by you or would reasonably be expected to be materially adverse to the condition (financial or otherwise), business, operations, properties or prospects of the Borrower and TargetCo and their respective subsidiaries, taken together, or to the Administrative Agent, the Arranger or the Lenders, or to the legal, tax, accounting or financial aspects of the Acquisition, or (b) has had or would reasonably be expected to have a Material Adverse Effect (as defined under the section "Conditions Precedent to Funding" in the Term Sheet) and (v) the negotiation and delivery of definitive documentation on or before November 15, 2001.

The costs and expenses of Fleet and FSI (including, without limitation, the reasonable fees and expenses of its counsel and its syndication and other out-of-pocket expenses) in connection with the preparation, execution and delivery of this letter and the definitive financing agreements shall be for your account. You further agree to indemnify and hold harmless Fleet, FSI and each director, officer, employee and affiliate or control person of either Fleet or FSI (each an "indemnified person") from and against any and all actions, suits, proceedings (including any investigations or inquiries), claims, losses, damages, liabilities or expenses of any kind or nature whatsoever which may be incurred by or asserted against or involve Fleet, FSI or any such indemnified person as a result of or arising out of or in any way related to or resulting from the Acquisition, or this letter or any eventual extension of credit, and, upon demand, to pay and reimburse Fleet, FSI and each indemnified person for any legal or other out-of-pocket expenses incurred in connection with investigating, defending or preparing to defend any such action, suit, proceeding (including any inquiry or investigation) or claim (whether or not Fleet, FSI or any such person is a party to any action or proceeding out of which any such expenses arise); PROVIDED, HOWEVER, that you shall not have to indemnify any indemnified person against any loss, claim, damage, expense or liability to the extent that it resulted from the gross negligence or willful misconduct of such indemnified person. This letter is issued for your benefit only and no other person or entity may rely hereon. Under no circumstances shall Fleet, FSI or any of their respective affiliates be liable to you or any other person for any punitive, exemplary, consequential or indirect damages which may be alleged in connection with this Commitment Letter, the Fee Letter, the Term Sheet, the Acquisition, the Credit Facilities or the documentation related thereto or any other financing, regardless of whether the commitment herein is terminated or the Acquisition or the Credit Facilities close.

The provisions of this letter are supplemented as set forth in a separate fee letter dated the date hereof from us to you (the "FEE LETTER") and are subject to the terms of such Fee Letter. By executing this letter, you acknowledge that this letter and the Fee Letter are the only agreements among you, Fleet and FSI with respect to the Credit Facilities and set forth the entire

understanding of the parties with respect thereto and you agree that this letter and the Fee Letter are for your confidential use only and neither their existence nor the terms hereof or thereof will be disclosed by you to any person or entity other than your and TargetCo's respective officers, directors, accountants, attorneys and other advisors, and then only on a "need to know" basis in connection with the transactions contemplated by this letter and on a confidential basis (except that, notwithstanding the foregoing, you may make such public disclosures as you are required by law, in the opinion of your counsel, to make). Neither this letter nor the Fee Letter may be changed except pursuant to a writing signed by each of the parties hereto.

Your obligations under this letter and the Fee Letter with respect to fees (to the extent that, at the time of expiration or termination they are owed pursuant to the second paragraph of the Fee Letter), indemnification, costs and expenses, and confidentiality shall survive the expiration or termination of this letter.

This letter is intended to be solely for the benefit of the parties and is not intended to confer any benefits upon, or create any rights in favor of, any person other than the parties hereto and shall not be assignable by you without the prior written consent of Fleet and FSI. This letter may be executed in any number of counterparts, each of which shall be an original and all of which, when taken together, shall constitute one agreement. Delivery of an executed counterpart of this letter by telecopier shall be effective as delivery of a manually executed counterpart of this letter. This letter shall be governed by, and construed in accordance with, the laws of the State of New York.

If you are in agreement with the foregoing, please sign and return to Fleet the enclosed copies of this letter and the Fee Letter no later than 5:00 P.M., New York time, on May 31, 2001. This offer shall terminate at such time unless prior thereto we shall have received duly signed and completed copies of such letters.

[SIGNATURE PAGE FOLLOWS]

We look forward to working with you on this transaction.

Very truly yours,

FLEET BANK, N.A.

By: /s/ Steve Deluise

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Name: Steve Deluise

Title: Vice President

Accepted and agreed to as of the date first above written:

CANTEL MEDICAL CORP.

By /s/ Craig A. Sheldon

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Name: Craig A. Sheldon

Title: Vice President and Controller

CONFIDENTIAL

CANTEL MEDICAL CORP.  
SUMMARY OF TERMS AND CONDITIONS  
\$47,500,000 SENIOR SECURED CREDIT FACILITY  
MAY 30, 2001

**BORROWERS:** Cantel Medical Corp. ("Cantel" or the "Borrower") and certain designated subsidiaries acceptable to the agent. Carsen Group Inc. ("Carsen"), a wholly owned subsidiary of Cantel, will serve as the borrower for all Canadian borrowings.

**GUARANTORS:** All obligations of any Borrower will be guaranteed in full by each of Cantel's existing and future domestic subsidiaries, as permitted.

**ADMINISTRATIVE AGENT:** Fleet Bank NA ("Fleet" or the "Agent").

**ARRANGER:** Fleet Securities, Inc. (the "Arranger").

**CREDIT FACILITIES:** a) **SENIOR SECURED TERM LOAN FACILITY:** (the "Term Loan Facility") available in a single draw, for a maximum original principal amount of up to \$25,000,000.

b) **SENIOR SECURED REVOLVING CREDIT FACILITY:** for a maximum principal amount of up to \$22,500,000 (the "Revolving Credit Facility"). The Revolving Credit Facility also includes sublimits for (i) \$5,000,000 working capital availability for U.S. dollar borrowings by Carsen and (ii) a \$2,000,000 swingline facility available for short term borrowings by Cantel and (iii) of \$2,000,000 for letters of credit (L/C's to be issued by Fleet Bank as L/C Issuing Bank).



The Revolving Credit Facility will be subject to a Borrowing Base equaling to an amount not to exceed 85% of Eligible Accounts Receivable (definition and final advance rate to be determined), plus approximately 50% of Eligible Inventory (eligibility definition and final advance rate to be determined).

Together, the above are referenced as the "Credit Facility".

**LENDERS:** Fleet and lenders acceptable to the Agent, Arranger and Cantel.

**USE OF PROCEEDS:** To finance, in part, the acquisition of the common stock of the TargetCo by the Borrower pursuant to a statutory merger ("Merger") of TargetCo & Borrower or Borrower's wholly owned subsidiary, pay fees and expenses of the Merger, repay any existing indebtedness of the Borrower and TargetCo, and general working capital purposes.

**CLOSING DATE:** The date of the closing of the Merger, which shall be on or before November 15, 2001.

**SECURITY:** The loans under the Credit Facilities will be secured by perfected first priority liens on all of the domestic tangible and intangible assets of the Borrower and its subsidiaries and the TargetCo and its subsidiaries, including, but not limited to, accounts receivable, inventory, property, plant and equipment. A pledge of stock by Cantel and its domestic subsidiaries will also be required, along with a pledge of 65% of the stock of all foreign subsidiaries. The Borrower shall also provide a negative pledge on all present and future assets and properties (excluding assets pledged for any outstanding working capital lines of Carsen) of each of the Borrower's existing and future foreign subsidiaries.

**INTEREST RATE  
AND COMMITMENT  
FEE:**

Fleet's Alternate Base Rate ("ABR", as defined below) or, at the Borrowers' option, the reserve adjusted LIBOR Rate, plus the Applicable Margin. The initial Applicable Margin is as follows:

	Applicable Margin		
	Libor Margin	ABR Margin	Commitment Fee
	-----	-----	-----
<S>	<C>	<C>	<C>
Revolving Credit Facility:	325 bps	200 bps	50 bps

Term Loan Facility:                    325 bps                    200 bps

The initial level of the commitment fee shall be .50% per annum on the unused portion of the Revolving Credit Facility

After six months from closing, the Applicable Margin and Commitment of the Revolving Credit Facility and Applicable Margin of the Term Loan will be subject to a performance based pricing grid as follows:

Total Debt/EDITA	Applicable Margin		
	Libor Margin	ABR Margin	Commitment Fee
<S>	<C>	<C>	<C>
Greater than and equal to 2.0x	325 bps	200 bps	50 bps
1.75x Less than and equal to 2.0x	300 bps	175 bps	50 bps
1.5x Less than and equal to 1.75x	275 bps	150 bps	40 bps
1.0x Less than and equal to 1.5x	250 bps	125 bps	35 bps
Greater than and equal to 1.0x	200 bps	75 bps	30 bps

"LIBOR" means the average (rounded upward to the next higher 1/8 of 1%) of the rates offered to Fleet in the London interbank market for deposits in an amount and maturity corresponding to the loan amount and the interest period for the advance, adjusted for reserve requirements as incurred. Interest periods for LIBOR loans shall be one, two, or three months. In no event shall LIBOR based advances extend beyond the Termination Date of the Facility.

Alternative Base Rate shall mean the greater of (i) Fleet's Base Rate as announced from time to time and (ii) the Federal Funds Rate plus 0.50% per annum.

TICKING FEE:                    A ticking fee equal to 0.25% per annum of the total Credit Facility, which will start accruing 30 days from the signing of the Credit Documents, and is payable at the earlier of the commitment expiration date or the Initial Funding Date.

LETTER OF

**CREDIT FEES:** The Borrower shall pay a commission on all outstanding Letters of Credit at a per annum rate equal to the Applicable Margin (on the Revolving Credit Facility) then in effect with respect to LIBOR loans on the face amount of such Letter of Credit. Such commission shall be shared pro rata among Lenders participating in the Revolving Credit Facility and shall be payable quarterly in arrears.

A fronting fee equal to 0.25% per annum on the face amount of each Letter of Credit shall be payable quarterly in arrears to the Issuing Lender for its own account. In addition, customary administrative, issuance, amendments, payments, and negotiation charges shall be payable to the Issuing Lender for its own account.

**MATURITY DATE:** a) The Term Loan Facility will be amortized on a quarterly basis with final maturity five years from the Closing Date. Quarterly amortization will commence three months from the Closing Date as follows:

Quarters 1 to 4	\$500,000 per Quarter
Quarters 5 to 8	\$750,000 per Quarter
Quarters 9 to 12	\$1,250,000 per Quarter
Quarters 13 to 16	\$1,750,000 per Quarter
Quarters 17 to 20	\$2,000,000 per Quarter

b) The Revolving Credit Facility shall mature, and any outstanding loans thereunder shall be repaid in full five years from the Closing Date. No Letter of Credit shall have an expiration date 14 days prior to five years from the Closing Date.

**VOLUNTARY PREPAYMENTS:** The Credit Facilities may be repaid in full or in part at any time at the option of the Borrower without premium or penalty in minimum increments of \$500,000. Subject to the satisfaction of applicable conditions, amounts prepaid or repaid under the Revolving Credit Facility may be re-borrowed prior to maturity.

**MANDATORY PREPAYMENTS:** In the event that Total Debt to EBITDA is greater than or equal to 1.50x, Mandatory prepayments of the Term Loan will be required from 100% of net cash proceeds received by the Borrower from asset sales (other than those incurred in the ordinary course of business) and from all net proceeds from the

sales of any public equity securities or issuance of debt. A mutually agreed upon basket for asset sale proceeds that may be retained by the Borrower to acquire replacement property or other assets will be established.

MANDATORY  
PREPAYMENT  
FROM EXCESS CASH  
FLOW SWEEP:

In addition to the scheduled principal amortization, in the event that Total Debt to EBITDA is greater than or equal to 1.50x, 50% of Excess Cash Flow shall be applied to the payment of the Term Loan Facility.

Excess Cash Flow will generally be defined as EBITDA less (i) capital expenditures, (ii) cash taxes paid or to be paid within 90 days of calculation date, (iii) scheduled amortization of debt and voluntary permanent prepayments of debt, (iv) cash interest, and (v) plus or minus changes in working capital.

CONDITIONS  
PRECEDENT TO  
FUNDING:

Funding shall be conditioned upon the satisfaction of the following conditions precedent and other conditions customary in transactions of this type, or reasonably required by the Agent:

1. The Merger shall have been, or shall be concurrently, consummated pursuant to the terms and conditions of the Merger Agreement in the form of the draft dated May 30, 2001 (with Disclosure Schedules draft dated May 30, 2001) previously delivered to the Agent and in accordance with applicable law and the documentation for the financing of the Merger and related transactions, and otherwise on terms reasonably satisfactory to the Agent. The conditions of the Merger shall have been satisfied without giving effect to waivers, amendments, modifications or supplements except as approved in advance in writing by the Agent and without amendments, modifications or supplements to any related disclosure letter or schedule not approved in writing in advance by the Agent. The documents and materials filed publicly by the Borrower and TargetCo in connection with the Merger shall have been furnished to the Agent in form and substance reasonably satisfactory to the Agent. All required stockholder approval to effect the Merger shall have been obtained.

The Agent shall not have become aware of any information not disclosed to it prior to the date of this letter which it considers to be inconsistent with its understanding of the proposed business, assets, operations, structure, prospects and conditions of each of the Borrower, TargetCo and their respective subsidiaries that results in or would reasonably be expected to result in a material change in, or material deviation from, the information, taken as a whole, previously delivered to the Agent or would reasonably be expected to be materially adverse to the condition (financial or otherwise), business, operations, properties or prospects of the Borrower and TargetCo and their respective subsidiaries, taken as a whole, or to the Agent, the Arranger or the Lenders, or to the legal, tax, accounting or financial aspects of the Acquisition or the Merger.

2. Minimum Consolidated LTM Pro Forma EBITDA of \$15,250,000 at Closing (as used in this paragraph 2 and the following paragraph 3, LTM of Cantel and TargetCo respectively to be measured from their respective most recently publicly filed financial information in their SEC quarterly or annual filing prior to the Closing Date; and each reference in this Term Sheet to EBITDA shall mean excluding non-recurring charges);
3. Maximum Consolidated Total Debt/LTM EBITDA at Closing not to exceed 2.60x;
4. All contracts with Olympus America Inc. remain valid and are in force, except to the extent that the failure of any one or more such contracts to remain valid and in force with Olympus America Inc. or its affiliates, would not, individually or together, have or reasonably be expected to have a material adverse effect on the condition (financial or otherwise), business, operations, properties and/or prospects of Borrower and TargetCo and their respective Subsidiaries, taken as a whole (a "Material Adverse Effect");
5. Satisfactory review by legal counsel to the Agent of all appropriate documentation to be entered into and other corporate documents;
6. The negotiation, execution and delivery of loan documentation satisfactory to the Agent, the Arranger, and

the Borrowers and their respective counsel, (each of which shall be in full force and effect on the Closing Date), containing customary representations and warranties, conditions, covenants, events of default, indemnifications, opinions and increased cost and capital requirement provisions customary in bank financing documents in transactions of this type, including, without limitation, the financial covenants described herein;

7. The commitment contained herein is based on certain information you have supplied to us and is subject, INTER ALIA to the accuracy and completeness of such information, taken as a whole, in all material respects. The Agent shall have been satisfied with the structure for the financing and related processes and with the legal and tax opinions requested by the Agent in connection therewith, all of which opinions shall be customary in the Agent's reasonable judgment for financings of similar type;
8. Absence of any material adverse change in the condition (financial or otherwise), operations, business, properties and/or prospects of the Borrower and TargetCo, and their respective subsidiaries, taken as a whole, since July 31, 2000 to the date of this Commitment Letter in respect of the Borrower and its subsidiaries and since March 31, 2000 to the date of this Commitment Letter in respect of TargetCo and its subsidiaries (other than the items disclosed specifically in the Disclosure Schedules referred to in paragraph 1 above of "Conditions Precedent to Funding"). The Agent acknowledges, for purposes of this paragraph 8 and 9 below, that it has received the publicly released preliminary summary 2001 fourth quarter balance sheet as at March 31, 2001 and the income statement for the quarter ended March 31, 2001 of TargetCo and its subsidiaries, and TargetCo's financial projections dated May 4, 2001, delivered to the Agent prior to the date hereof;
9. Absence of any material adverse change in the condition (financial or otherwise), operations, business, properties and/or prospects of the Borrower and TargetCo, and their respective subsidiaries, taken as a whole, following the date of this Commitment Letter;

10. There shall be no litigation or administrative proceedings or other legal or regulatory developments actual or threatened that would be reasonably expected to result in a material adverse effect on (a) the condition (financial or otherwise), business, properties, operations, or prospects of the Borrower and TargetCo and their respective subsidiaries taken as a whole since July 31, 2000 to the date of this Commitment Letter in respect of the Borrower and its subsidiaries and since March 31, 2000 to the date of this Commitment Letter in respect of TargetCo and its subsidiaries (taking into account items disclosed specifically in the Disclosure Schedules referred to in paragraph 1 above of "Conditions Precedent to Funding", and the preliminary summary 2001 fourth quarter results and the projections referred to in the preceding paragraph 8), (b) the condition (financial or otherwise), operations, business, properties or prospects of the Borrower and TargetCo and their respective subsidiaries, taken as a whole, following the date of this Commitment Letter or (c) on the rights and remedies of the Agent or on the ability of the Borrower, the TargetCo and their respective subsidiaries to perform their obligations;
11. Receipt of all necessary governmental and third party approvals (which third party approvals are material) and compliance with all laws, including ERISA, except to the extent that failure by the Borrower, TargetCo or their subsidiaries in connection with the operations of their business to comply with laws would not have or would not reasonably be expected to have a Material Adverse Effect (excluding for purposes of this exception the consummation of the Merger and financing transaction contemplated herein);
12. Receipt of a copy of a fairness opinion from TargetCo's investment banker addressed to TargetCo's board of directors, relating to the terms of the Merger;
13. Receipt by the Agent of a report by ENVIRON International Corporation or another acceptable third party of the results of a Phase 2 environmental diligence review on which the Agent will be expressly entitled to rely (including soil samples and impact on groundwater) relating to the Netherlands property of TargetCo and/or its Netherlands subsidiary, the conclusion of which is that

TargetCo and/or its Netherlands subsidiaries are not reasonably likely to have environmental liabilities relating to the Netherlands property of more than \$1,000,000, based on the results of the Phase 2 review. This condition will be deemed waived if not invoked within 5 business days after receipt by the Agent of a copy of the results of such review.

14. Purchase of Interest Rate Protection for 50% of the Term Facility in a manner satisfactory to the Agent.

REPRESENTATIONS  
AND WARRANTIES:

Customary for credit agreements of this nature.

AFFIRMATIVE  
COVENANTS:

Customary, including but not limited to, delivery of financial statements, reports, accountants' letters, projections and other information requested by Agent; payments of obligations; continuation of business and maintenance of existence, rights and privileges; compliance with contractual obligations and laws; maintenance of property and insurance; maintenance of books and records; right of Agent to inspect property and books and records as it deems reasonably necessary; and notices of default, litigation and material events and other reasonable and customary covenants.

NEGATIVE  
COVENANTS:

Financial covenants will include, without limitation, the covenants set forth below and as may be adjusted by Agent in its sole discretion:

- Maximum Total Debt / Consolidated LTM EBITDA:

Through 7/30/02:	2.6X
7/31/02 through 7/30/03:	2.00X
7/31/03 through 7/30/04:	1.75X
7/31/04 and thereafter:	1.50X.

- Minimum Consolidated LTM EBITDA:

4/30/01:	\$15,250,000
7/31/01	\$15,500,000
10/31/01, 1/31/02 and 4/30/02	\$16,000,000
7/31/02	\$17,500,000
10/31/02	\$17,500,000
1/31/03 and 4/30/03	\$18,000,000



7/31/03 and thereafter \$20,000,000

- Minimum Fixed Charge Coverage:
  - Through 7/30/02: 1.2X
  - 7/31/02 through 7/30/03: 1.35X
  - 7/31/03 and thereafter: 1.50X.
- Maximum annual Capital Expenditures of \$4,000,000
- Minimum Available Adjusted US\$ Cashflow Coverage:
  - So long as Total Debt/Total Consolidated EBITDA is greater than or equal to 1.5X, the ratio of:
    - a) the sum of rolling four quarter EBITDA from the Borrower's US operations plus dividends received from foreign subsidiaries (net of applicable withholding taxes) in the latest four quarter period, available in US Dollars,

to:

- b) the sum of the Borrower's US Fixed Charges for the latest rolling four quarter period,

shall not be less than 1.1x.

"US Fixed Charges" shall be defined as the sum of:

- a) cash interest payments in the US,
  - b) required principal amortization payments on the Term Loan,
  - c) cash taxes paid in the US, and d) capital expenditures in the US not financed separately.
- Maximum Annual Investment in foreign subsidiaries of \$2,000,000
  - Maximum Total Liability to Total Capitalization of 50% for Carsen Group, Inc.

Other negative covenants will include without limitation, restrictions on indebtedness and other liabilities, liens, dividends, contingent obligations, investments and acquisitions, asset sales, third party management fees, creation of subsidiaries, guarantees, loans and advances, leases, mergers, negative pledges, consolidations, sales and leasebacks, voluntary

prepayments of other debt, and other reasonable and customary covenants.

**EVENTS OF  
DEFAULT:**

Customary for credit agreements of this nature, including but not limited to:

Failure to pay principal or interest; inaccurate or false representations or warranties; failure to meet covenants; cross default to indebtedness; failure to observe terms of this agreement; bankruptcy; insolvency; ERISA violation judgments; change in control; environmental.

**INDEMNIFICATION:**

Borrower will indemnify Lenders against losses, liabilities, claims, damages, or expenses relating to their loans, Borrower's use of the loan proceeds or commitments, or Borrower generally, including but not limited to reasonable attorney's fees and settlement costs, except to the extent that they are as a result of Lender's gross negligence or willful misconduct.

**EXPENSES:**

The Borrower shall pay all of the Agent's reasonable out-of-pocket costs and expenses in connection with this transaction, including, without limitation, the reasonable fees and expenses of counsel to the Agent.

**GOVERNING LAW:**

State of New York

**AGENT'S COUNSEL:**

Winston & Strawn