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Avoiding "Benefit of the Bargain" Damages in Letters of Intent

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Prior to entering into a final contract, parties frequently memorialize certain key deal points in preliminary agreements. These preliminary agreements are known by many names: letters of intent, term sheets, letters of interest, expressions of interest, or memoranda of understanding. Preliminary agreements often contain both non-binding provisions and binding provisions, such as an exclusivity provision or an agreement to negotiate in good faith. When a party breaches a binding provision in an otherwise expressly non-binding preliminary agreement, the question inevitably arises: what is the proper measure of damages?

Although courts addressing this issue have generally held that the proper measure of damages is limited to out-of-pocket or reliance damages, dicta in an influential opinion by Judge Richard Posner leaves open the door for an award of "benefit of the bargain" or expectation damages such as lost profits. *Venture Associates Corp. v. Zenith Data Systems Corp.*, 96 F.3d 275 (7th Cir. 1996). Judge Posner's opinion, which has been favorably cited by a number of commentators, injects enough uncertainty into the damages analysis to expose unsuspecting parties to hundreds of thousands or even millions of dollars in damages, or, at the very least, subject them to litigation that is not easily or inexpensively resolved based on a preliminary agreement that a party thought to be non-binding.

In *Venture*, Judge Posner recognized the prickly issues surrounding preliminary agreements:

> One of the most difficult areas of contract law concerns the enforceability of letters of intent and other preliminary agreements, and in particular the subset of such agreements to negotiate toward a final contract. When if ever are such agreements enforceable as contracts? If they are enforceable, how is a breach to be determined? Is "breach" even the right word? Or is the proper rubric "bad faith"? Could the duty of good faith negotiation that a letter of intent creates be a tort duty rather than a contract duty, even though created by contract? *And can the victim of bad faith ever get more than his reliance damages*?

Whatever difficulties may inhere in the area of contract law surrounding so-called "preliminary agreements," determining the proper measure of damages for the breach of a binding provision contained in an otherwise expressly non-binding preliminary agreement should not be one of them. Bedrock principles of contract law, such as the requirement that damages be capable of proof to a reasonable degree of certainty and reasonably foreseeable as a consequence of the breach at the time the contract was made, should limit the non-breaching party's recovery to reliance damages. Nevertheless, because only a handful of courts have addressed the precise issue of the proper measure of damages for the breach of a deemed-to-be binding provision contained in an otherwise non-binding preliminary agreement, the possibility remains that a court faced with this issue for the first time may adopt the approach taken by Judge Posner in *Venture*.

The *Venture* "Rule"

A closer look at the facts in *Venture* is instructive. *Venture* involved the proposed acquisition by Venture Associates Corporation of certain assets of Zenith Data Systems Corporation. The purchaser, *Venture*, sent a letter to Zenith, the seller, proposing terms for the acquisition. The letter stated that it was not a binding obligation on either party, but was rather "merely a letter of intent" subject to execution of a definitive purchase agreement, *except* for a paragraph in the letter stating that the parties agreed to negotiate in good faith to enter into a definitive purchase agreement, and that pending execution of a definitive purchase agreement, the seller would not negotiate with other companies. The seller responded to the letter, agreeing to negotiate for the sale of the company and agreeing in principle to the purchaser's proposed terms. The Seventh Circuit found that the exchange of letters "established a binding agreement to negotiate in good faith toward the formation of a

contract of sale."

When the deal outlined in the purchaser's letter fizzled, the jilted purchaser sued, claiming that the seller breached the agreement to negotiate in good faith toward a definitive purchase agreement and seeking expectation damages for the breach. In considering the proper measure of damages, Judge Posner penned the following passage, which parties are sure to see if they ever find themselves embroiled in litigation over the proper measure of damages for the breach of a binding provision in an expressly non-binding preliminary agreement:

> Damages for breach of an agreement to negotiate may be, although they are unlikely to be, the same as the damages for breach of the final contract that the parties would have signed had it not been for the defendant's bad faith. If, quite apart from any bad faith, the negotiations would have broken down, the party led on by the other party's bad faith to persist in futile negotiations can recover only his reliance damages—the expenses he incurred by being misled, in violation of the parties' agreement to negotiate in good faith, into continuing to negotiate futilely. *But if the plaintiff can prove that had it not been for the defendant's bad faith the parties would have made a final contract, then the loss of the benefit of the contract is a consequence of the defendant's bad faith, and, provided that it is a foreseeable consequence, the defendant is liable for that loss—liable, that is, for the plaintiff's consequential damages.*

Judge Posner did point out the difficulties of proof plaintiffs would face: "The difficulty, which may well be insuperable, is that since by hypothesis the parties had not agreed to *any* of the terms of their contract, it may be impossible to determine what those terms would have been and hence what profit the victim of bad faith would have had." But, according to Judge Posner, this difficulty "goes to the practicality of the remedy, not the principle of it."

What Judge Posner's opinion in *Venture* does, perhaps unwittingly, is create an expedient means for plaintiffs to survive summary judgment in lawsuits seeking expectation damages based on the breach of a binding provision of an otherwise expressly non-binding preliminary agreement. If a non-breaching party can convince a court that a binding provision "found" in an otherwise non-binding preliminary agreement carries with it an obligation to negotiate in good faith toward a final deal, then the non-breaching party can argue under *Venture* that it is entitled to expectation damages because "but for" the breaching party's bad faith, a final deal would have been reached.

The problem with applying the *Venture* "rule" to binding provisions contained in expressly non-binding letters of intent is manifest: it holds the parties to the terms of a contract to which they expressly disavowed any intent to be bound. This fundamental problem is magnified by the fact that *Venture*'s analysis makes it difficult to obtain summary judgment or other pre-trial resolution in such cases because the "but for" causation standard it adopts typically involves factual disputes to be resolved by a jury. This, in turn, creates several perverse incentives for the disappointed party to such a preliminary agreement. Specifically, the disappointed party has an incentive to bring a case since it knows that defense costs may force a settlement in excess of its out-of-pocket or reliance damages, even if the merits of its case are lacking. More troubling, though, is the incentive it creates for the disappointed party to "roll the dice" with a jury and actually obtain an award of its expectation damages. Obviously, these perverse incentives are not desirable consequences for any legal standard.

The Scope of the *Venture* "Rule" is Limited

While the *Venture* case creates uncertainty, breaching parties do have recourse to a body of case law that rejects the notion that "benefit of the bargain" or expectation damages are available for the breach of binding provisions of expressly non-binding preliminary agreements.

First, the rule of *Hadley v. Baxendale* requires that contract damages be the "natural and necessary consequence" of the breach and must have been in the contemplation of the parties at the time the contract was made. When parties expressly disavow any intent to be bound by the substantive terms outlined in a preliminary agreement, it runs counter to *Hadley* and defies logic to suggest that the non-breaching party's "benefit of the bargain" damages were within the contemplation of the parties at the time the agreement was made, since those are the same damages that would be available for a breach of the completed contract. In effect, the parties' intent not to be bound by the terms in the preliminary agreement should shield them from the liability that would attach for a breach of the final agreement.

In *Logan v. D.W. Sivers Co.*, 169 P.3d 1255 (Or. 2007), the Oregon Supreme Court, echoed the rule in *Hadley* and found just such a shield to exist and held that consequential damages were not available for the breach of a binding non-solicitation provision contained in an otherwise non-binding letter of intent that detailed the plaintiff's proposed purchase of a shopping mall owned by the defendant. Given the parties' disclaimer of any intent to be bound by the overall terms of the preliminary agreement, the court found it to be irrelevant that "a reasonable person in the same position as defendant might have foreseen that plaintiff would suffer tax losses down the road" if the defendant breached the non-solicitation provision. The court also found it to be irrelevant that the defendant might have sold the property to the plaintiff "but for" the defendant's breach of the non-solicitation provision because the "parties expressly declined . . . to assume the risks of injury in a completed contract of purchase and sale," and the "defendant cannot now be saddled with those very same liabilities on the theory that, because defendant likely would have sold the property to plaintiff except for its breach of the lesser promise not to sell the property to someone else for 60 days, those liabilities are the natural and foreseeable consequences of defendant's breach."

In an analogous context, the New York Court of Appeals has aptly described the trouble with awarding expectation damages based on the breach of a binding provision found in an otherwise non-binding letter of intent. In *Goodstein Construction Corp. v. City of New York*, 604 N.E.2d 1356 (N.Y. 1992), the court reasoned that the "loss of profits based on fulfillment of the terms of the contract being negotiated could not have been reasonably contemplated as damages for a breach of the agreement to negotiate those very contractual terms."

Simply put, parties have a right to rely on the language they choose to include in their preliminary agreement. If the parties choose to include language expressly making the preliminary agreement non-binding, they are entitled to rely on that language. If they do include such language, it is not foreseeable that the same measure of damages that would be available for breach of a completed contract would be available for the breach of a lesser-included binding provision of a preliminary agreement. A contrary rule would have the anomalous effect of holding the breaching party as guarantor for the profits the non-breaching party expected to earn from a final contract that may never have been executed.

Second, only damages that can be proved with reasonable certainty are recoverable. Damages cannot be based on speculation and conjecture. Two layers of speculation inhere in every claim for damages based on the breach of a binding provision contained in a non-binding letter of intent: first, because the parties never agreed to be bound, it cannot be determined without resort to speculation and conjecture that a final deal would have been reached absent the breach; and, second, because the letter of intent, by its very nature, did not set terms, it cannot be determined without resort to speculation and conjecture what the final terms of the deal would have been.

In *Logan*, for example, the court emphasized that "the parties were at pains in their letter of intent to identify what they were *not* agreeing to do: Defendant was not agreeing to sell, or even to negotiate in good faith toward selling, and plaintiff was not agreeing to buy, or even to negotiate in good faith toward buying, the property in question." The court also correctly noted that "each party remained free to sit on its hands and do nothing," and that "each party also might hope that the other would not behave in that way, but such a party had nothing beyond that—hope on which to risk its financial circumstances." In view of the "narrow and specific bargain struck by the parties," the court concluded that the plaintiff could only recover its reliance damages, "[b]ut because defendant never agreed to sell or even to negotiate in good faith toward the sale of the property to plaintiff (and, in fact, explicitly disclaimed any such agreement when it signed the letter of intent), plaintiff cannot . . . charge defendant with losses that flowed from her inability to finally purchase it."

Similarly, in *Vestar Development II, LLC v. General Dynamics Corp.*, 249 F.3d 958 (9th Cir. 2001), the Ninth Circuit considered a binding exclusivity provision contained in an expressly non-binding letter of intent and held that the plaintiff could recover its reliance damages, but not its expectation damages, for a breach of the exclusivity provision. The court found that the plaintiff's claim for expectation damages could not satisfy the requirement under California law "that damages not be speculative or, conversely, that they be proved to a reasonable certainty." The court explained that "satisfactory proof" of the plaintiff's expectation damages was impossible because, since the preliminary agreement was expressly non-binding, "[t]here [was] no way to know what the terms of the eventual sale would have been—or even if a deal would have been reached."

The reasons for denying recovery of expectation damages for breaches of binding provisions contained in the expressly non-binding preliminary agreement in *Logan* and *Vestar* are present in every case involving the breach of a binding provision in a non-binding preliminary agreement. Specifically, the plaintiffs in such cases will be put to the task of establishing that the parties' express intent not to be bound by the terms set forth in the letter of intent should be set aside in favor of a finding that the breach of the limited binding provision precluded a final deal from being reached. This "proof" necessarily involves speculation that a deal would have been done absent the breach.

Even if it could be assumed that a final deal would have been reached without a breach, plaintiffs face the further challenge of proving what the terms of the deal would have been. No doubt, they will point to the terms outlined in the preliminary agreement as a guidepost for what the terms of a final deal would have been, but since those terms are expressly non-binding, the court must once again necessarily resort to speculation: either that the preliminary terms would have been the final terms, despite the parties' expressed intent not to be bound by those terms, or that some other set of terms would ultimately have been agreed to by the parties.

Steps to Avoid Application of the *Venture* "Rule"

Of course, as with most things, an ounce of prevention is worth a pound of cure: parties can take certain proactive steps to avoid ending up in litigation regarding the proper measure of damages recoverable for the breach of a binding provision of an expressly non-binding preliminary agreement.

To avoid an argument that there is a binding obligation to negotiate in good faith, thus bringing the provision within the purview of *Venture*, parties should expressly state that there is no such duty. In addition, proper care should be taken to avoid "contract-like" language in letters of intent. Words matter. For example, the non-binding provisions should refer to the "potential transaction" or the "possible deal," or other terms or conditions that "would" be applicable. Within any non-binding provision, care should be taken to avoid the use of words such as "shall," "will," or "must." In contrast, any provisions intended by the parties to be binding, to the extent they are to be included, should use these types of words to indicate contractual formality. Being precise in choosing what language to include in a letter of intent provides an additional layer

of protection from a court imposing a duty to negotiate in good faith. The cumulative effect of such precision is to draft a preliminary agreement that expressly states it is not an agreement to negotiate in good faith, and that does not contain any language capable of being interpreted as creating a binding obligation to negotiate in good faith, rendering the rationale from *Venture* inapplicable.

Parties should also include language that expressly limits recovery for the breach of the binding provision to the non-breaching party's reliance damages, or, alternatively, provide for a specific break-up fee. In light of such a limitation, a plaintiff would be hard-pressed to argue that an award of expectation damages was within the contemplation of the parties at the time the letter of intent was executed. Such language may be included in conjunction with a provision expressly stating that no liability will attach for the breach of any of a letter of intent's expressly non-binding provisions.

Conclusion

In today's complex business world, negotiating parties routinely enter into preliminary agreements, which often contain binding and non-binding provisions, prior to executing a final contract. When entering into such preliminary agreements, parties should be wary of the *Venture* "rule" that leaves open the door to the possibility of expectation damages being awarded for the breach of a non-binding preliminary agreement. Parties should also be aware, however, of the case law that holds that expectation damages are not recoverable for the breach of a binding provision of a non-binding preliminary agreement and the practical steps they can take to avoid finding themselves embroiled in messy, expensive litigation. If parties structure their preliminary agreements consistent with the case law discussed above and take the proper precautions in drafting their preliminary agreements, they may significantly reduce the risk of having to pay expectation damages for the breach of a preliminary agreement to which they never intended to be bound.

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