Letters of Intent—Defining "Good Faith"

by Rosaria A. Suriano and Matthew P. Dolan

A common practice among business clients prior to or during the negotiation of a commercial transaction is to enter into a letter of intent. The letter functions exactly how it sounds—it serves to express a mutual interest of negotiating together toward a final agreement in good faith. The document is executed by the parties in order to provide a foundation of agreed-upon terms for ongoing negotiations.

In a general sense, letters of intent can be advisable as they offer the parties the ability to agree on important issues and costs involved in the due diligence/negotiation process. For example, the parties may devise how expenses will be divided when inspections, audits, environmental costs, or other contingencies are involved. The letter of intent in a commercial transaction also can provide a buyer with peace of mind through the inclusion of an exclusivity provision prohibiting the seller from negotiating with other parties for some specified period of time. These letters can be drafted in a manner to be as specific (or ambiguous) as the parties' desire.

However, despite the many benefits a letter of intent can offer, the parties must carefully consider the value of a letter of intent that is not meant to function as the parties' 'final' agreement and how the oft-included contractual obligation to negotiate in good faith is defined. Although a party may have a contractual and/or implied obligation to act in good faith during the negotiation process, this obligation does not require the other party to ultimately consummate the deal. In fact, New Jersey courts have taken a seemingly hands-off approach to alleged good faith violations in the negotiation process between business entities, refusing to find a breach of the duty of good faith even in instances where the parties concede that the contractual good faith provision in their jointly negotiated letter of intent was meant to be binding.

Self-Interest Alone is Not Bad Faith

In *W. Palm Beach Hotel, L.L.C. v. Atlanta Underground, L.L.C.*, the Federal District Court for the District of New Jersey considered whether the plaintiff's increase in the purchase price of commercial property by $500,000 after over a year of negotiations and the existence of a letter of intent constituted "bad faith."[1] In its analysis, the court quoted favorably from the Seventh Circuit, stating 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 and the free market. And 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 in negotiations.[2]

The court thus held that the requested price increase, in that case, was not bad faith. This approach follows similar New Jersey state court precedent, which has refused to find bad faith in the negotiations of business entities even where the obligation to negotiate in good faith is expressly included within the letter of intent, the parties are close to reaching an agreement and one party refuses to continue with the negotiations.

In *Sun Pharm. Indus., Inc. v. Core Tech Solutions, Inc.*, Sun Pharmaceuticals, Inc. appealed the dismissal of its claims against a New Jersey medical research firm, Core Tech Solutions, Inc., arguing, in part, that the trial court erroneously failed to find bad faith during the negotiations over a contract to produce a skin patch that administers the drug Fentanyl (the FTDS).[3]

Preceding the negotiation process, the parties had entered into a letter of intent (LOI) setting forth certain understandings between Sun and Core Tech for the commercialization of the FTDS. The LOI provided much in the way of non-binding language stating, in part, that the terms and conditions represented the parties "non-binding intention and shall only be binding upon execution of a definitive Agreement between [Sun and Core Tech]."[4]

However, the LOI also included certain provisions the court found were necessarily binding, including Sun's agreement to pay Core Tech $150,000 upon consummation of the LOI for due diligence testing, the parties' agreement to negotiate exclusively with one another for a period of 90 days and that that the "[p]arties agree[d] to…discuss and negotiate in good faith to reach an Agreement…."[5]

Ultimately, as the contract deadline swiftly approached, the parties exchanged a flurry of emails and draft contracts. Recognizing the need for more time, about one week before the deadline, Sun sought an extension of the agreement and to meet with Core Tech representatives in person. Core Tech refused both requests and the email correspondence continued. Then, two days before the negotiation period was set to lapse, Sun sent a purportedly 'final' agreement to Core Tech for review. Core Tech had several remaining questions and points of concern. After reviewing the final draft on the day before the LOI lapsed, Core Tech sent 19 separate emails to Sun outlining the outstanding issues.

The answers to many of Core Tech's questions revealed the parties were not yet in agreement. Consequently, the parties failed to reach a deal within the 90-day negotiation period, and Core Tech informed Sun that the LOI had "self-terminated" according to its terms and Core Tech would not be moving forward with additional negotiations. In response, Sun asserted that the parties were close to an agreement and the failure to continue negotiations to arrive at a contract was a failure by Core Tech to negotiate in good faith. Sun also claimed that the 19 emails concerned immaterial issues and were merely a tactic by Core Tech to back out of reaching a deal. Accordingly, Sun filed suit alleging that Core Tech breached its duty to negotiate in good faith pursuant to the LOI.

Ultimately, the trial court dismissed Sun's claims relying, in part, on a Seventh Circuit Court of Appeals case, *A/S Apothekernes Laboratorium for Specialpraeparater v. I.M.C. Chem. Group, Inc.*, which involved a letter of intent obligating the parties to negotiate in good faith.[6] The trial court opinion quoted from *Apothekernes* stated:

> The obligation to negotiate in good faith has been generally described as preventing one party from 'renouncing the deal, abandoning the negotiations, or insisting on conditions that do not conform to the preliminary agreement.' *Teachers [Ins. and Annuity Ass'n. v. Tribune Co.*, 670 F. Supp. 491, 498 (S.D.N.Y.1987)]. For instance, a party might breach its obligation to bargain in good faith by unreasonably insisting on a condition outside the scope of the parties' preliminary agreement, especially where such insistence is a thinly disguised pretext for scotching the deal because of an unfavorable change in market conditions. *Id.* at 506.[7]

On appeal, Sun argued that the trial court should have adopted a wider definition of culpable conduct as set out by the New Jersey Supreme Court in *Brunswick Hills Racquet Club, Inc. v. Route 18 Shopping Center Associates*,[8] where the court held that "subterfuges and evasions" in the performance of a contract are a violation of the implied covenant of good faith and fair dealing.[9] Sun argued that Core Tech's remaining issues with the proposed agreement represented the type of subterfuges and evasions discussed in *Brunswick Hills*.

After noting the limited New Jersey precedent for the definition of good faith in the context of a letter of intent, the Appellate Division disagreed with Sun and failed to find the two cases at odds. The court recognized that "[g]ood faith is a concept that defies precise definition" and that "'[s]ubterfuges and evasions 'in the performance of a contract' are not significantly different than the culpable conduct as defined in *Apothekernes*."[10]

The appellate court found no issue with Core Tech sending 19 last-minute emails outlining issues Core Tech had with the proposed agreement. Moreover, the court found no obligation on the part of Core Tech to continue negotiations at all, despite how close to an agreement the parties may have been. Ultimately, the appellate court held that "these 'experienced commercial parties,' who only agreed to negotiate an agreement if mutually beneficial, can be safely left to 'fend for themselves.'"[11]

Crafting the Letter of Intent to Meet Your Needs

With these cases in mind, during the letter of intent stage business parties should remain cognizant of what their expectations are should the negotiation process go sour. The limited New Jersey case law on the subject suggests that New Jersey courts will remain hesitant to find bad faith absent particularly egregious conduct during the negotiation process itself. Indeed, the courts have on more than one occasion recognized an aversion

to "impose a set of morals on the marketplace."[12] Thus, even where the parties concede that they were bound by a duty to negotiate in good faith, that duty does not mean the parties are required to continue negotiations past the period defined within the letter of intent, no matter how close they are to a final agreement.

Yet, New Jersey courts also have held that the concept of good faith "defies precise definition" and the issue is a "fact-sensitive" one depending on the facts of each case.[13] Therefore, uncertainty will continue to persist. To alleviate this uncertainty, parties considering using a letter of intent in a negotiated transaction should consider including terms that contemplate the consequences of a deal that ultimately goes downhill.

For example, the parties could consider including language expressly disclaiming any obligation to negotiate in good faith. Although this may seem counterintuitive to the spirit of the deal, the ambiguity of the term clearly leaves too much uncertainty at play. Moreover, with New Jersey's ostensibly *laissez-faire* approach to business entities' self-interests in negotiated transactions, this may be enough ammunition to dissuade a court from imposing even an implicit obligation on the parties that could, in turn, discourage a party from later pursuing litigation.

The parties also can work to define the scope of damages for which either party may be liable in the event certain pre-conceived events come to fruition. This approach will work to expressly limit the amount sought at a later date from parties claiming bad faith, and should particularly be considered where the stakes are high.[14]

Ultimately, as with any contractual transaction, it remains imperative that parties entering into a letter of intent strive to address in advance as many possibilities related to the negotiation process as they can conceive. By so doing, the potential for later liability (or loss incurred in anticipation of a deal) can be significantly curtailed. ■

Rose Suriano is a partner with Meyner and Landis, LLP, and represents companies in business disputes, commercial litigation, non-compete agreements and business-related claims. Matt Dolan is an associate with Meyner and Landis, LLP, and formerly a law clerk to the Honorable Edward M. Coleman, Presiding Judge, Chancery Division-General Equity for the Somerset/Hunterdon/Warren Vicinage.

Endnotes

1. *W. Palm Beach Hotel, L.L.C. v. Atlanta Underground, L.L.C.*, No. CIV. 14-1063, 2014 WL 4662318, at *5 (D.N.J. Sept. 18, 2014).
2. *W. Palm Beach Hotel, L.L.C.*, 2014 WL 4662318 at *6 (*quoting Feldman v. Allegheny Int'l, Inc.*, 850 F.2d 1217, 1222–23 (7th Cir. 1988)).
3. *Sun Pharm. Indus., Inc. v. Core Tech Solutions, Inc.*, A–0646–11 T4, 2013 WL 1942619 at *1 (N.J. Super. Ct. App. Div. May 13, 2013).
4. *Id.* at 2.
5. *Ibid.*
6. *A/S Apothekernes Laboratorium for Specialpraeparater v. I.M.C. Chem. Group, Inc.*, 873 F.2d 155 (7th Cir. 1989).
7. *Apothekernes*, 873 F.2d at 158.
8. 182 N.J. 210, 225 (2005)
9. *Sun Pharmaceutical Industries, Inc.*, 2013 WL 1942619 at *7.
10. *Ibid.*
11. *Id.* at *8 (*quoting Brunswick Hills*, 182 N.J. at 230).
12. *Ibid.*
13. *Brunswick Hills, supra*, 182 N.J. at 224.
14. *See SIGA Technologies, Inc. v. PharmAthene, Inc.*, 67 A.3d 330, 351 (Del. 2013) (Delaware Supreme Court upholding recovery of both reliance and expectation damages [later determined by the chancery court on remand to be $194 million] where factual finding was made that the parties would have reached an agreement but for the defendant's breach of the duty of good faith).