USE OF LETTERS OF INTENT IN RETAIL LEASING: WHEN IS A NON-BINDING LETTER OF INTENT REALLY BINDING?

By Dana I. Schiffman and Ben Hirasawa

ABOUT THE AUTHOR

Dana I. Schiffman *is a partner in the San Diego office of Allen Matkins Leck Gamble & Mallory LLP, one of California's premier business and real estate law firms. He practices commercial real estate law with a special emphasis on shopping center development, expansion and redevelopment. An expert on acquisition, development, leasing and financing matters associated with regional malls, shopping centers and commercial mixed-use projects, Dana represents some of the nation's leading real estate and retail companies. He can be reached at (619) 233-1155 or dschiffman@allenmatkins.com.*

Ben Hirasawa *is an associate in the firm's real estate practice.*

New case law may add a new, unexpected twist to "non-binding" letters of intent. Landlords, tenants and brokers are well advised to consider the pitfalls created by Copeland v. Baskin Robbins, U.S.A., (96 Cal.App.4th 1251 (2002)) and to reexamine their use of letters of intent in light of such new law.

In Copeland, the California Court of Appeals imposed liability for the breach of an implied covenant of good faith and fair dealing on a party who terminated negotiations under a letter of intent. Even though the Court in Copeland recognized the letter of intent itself was not a binding expression of the transaction, it did hold that the letter of intent constituted a contract to negotiate. Copeland also recognized that where a contract to negotiate exists, California law will imply a covenant of good faith and fair dealing to the contract negotiations and the party who breaches such a covenant will be responsible for "reliance" damages. The Court reasoned that since business negotiations can be a slow, complex and expensive process, public policy favors protecting parties to a business negotiation from bad faith practices of the other party in terminating the negotiations or making capricious demands. This article analyzes this subject in the context of retail leasing and provides suggestions for both using and avoiding Copeland's perverse holding.

The Court reasoned that since business negotiations can be a slow, complex and expensive process, public policy favors protecting parties to a business negotiation from bad faith practices of the other party in terminating the negotiations or making capricious demands.

1. FINDING A CONTRACT TO NEGOTIATE IN GOOD FAITH IN THE LETTER OF INTENT.

In its Copeland opinion, the Court clearly stated that an implied covenant of good faith and fair dealing does not apply to all contract negotiations. Rather, in its view, such an implied covenant only applies if the parties have entered into an agreement to negotiate. Therefore, to avoid an implied obligation of good faith and fair dealing, letter of intent language expressing an agreement to negotiate should be avoided. However, even absent such express language, an agreement to negotiate might easily be implied from other language in the letter of intent or the very context of the letter of intent. For instance, language which falls short of an express agreement to negotiate could in fact be construed as an agreement to negotiate, e.g. "Upon Landlord's receipt of copy of this letter signed by Tenant, Landlord will arrange for its counsel to prepare a lease reflecting the terms and conditions contained herein" or "Landlord and Tenant agree that the terms set forth herein are intended as an outline for negotiation of terms to be documented by a formal written lease." Most letters of intent involve a phasing of negotiations by which an expression of primary terms in the letter of intent is followed by negotiation and documentation of full terms. This context and purpose implies that most letters of intent could probably be construed as contracts to negotiate notwithstanding the absence of explicit language so stating. This appears to be the view of the Court in Copeland. Although the Copeland case lacks discussion of what constitutes an agreement to negotiate absent express language to that effect, the only conclusion that can be drawn from Copeland is that letters of intent, by their very nature, normally contain an implied agreement to negotiate.

Regardless of whether a landlord, tenant or broker would characterize the letter of intent as an agreement to negotiate, they usually have the expectation that general "non-binding language" in a letter of intent is sufficient to negate any obligation to negotiate. This is where Copeland has the most potential for being inconsistent with the usual expectations of the parties who regularly utilize non-binding letters of intent. Unfortunately, the reasoning of the Copeland case strongly suggests the notion that the Court would construe general non-binding language (e.g., "this letter does not constitute a formal or binding agreement and the provisions hereof are not binding on either party," or words to similar effect) as only establishing that the letter of intent itself does not serve as the definitive documentation for the transaction . Therefore, safely avoiding the characterization of the letter of intent as a contract to negotiate to which an implied covenant of good faith and fair dealing attaches is best accomplished by adding specific language such as the following: "Notwithstanding any provision to the contrary contained herein, this letter shall not constitute an agreement to negotiate and solely constitutes an outline of certain key terms. Landlord and Tenant each acknowledge and agree that each party is proceeding with negotiations relating to the proposed lease at its sole cost and expense and that either party may terminate negotiations at any time and for any reason without any liability or obligation whatsoever."

2. DAMAGES FOR BREACH OF THE "CONTRACT TO NEGOTIATE."

Copeland establishes that the party responsible for a bad faith termination of negotiations will be liable for the other party's injuries suffered in relying upon the negotiations being conducted in good faith. In Copeland, the Court labeled such damages as "reliance" damages. This measure encompasses the plaintiff's out-of-pocket costs in conducting the negotiations and "may or may not include loss of opportunity costs" but does not include any damages for the injured party's lost expectations under the prospective lease or contract (Copeland at 1259). In this context, opportunity costs could include indirect losses by reason of the transaction not occurring. In most situations, establishing indirect losses could be difficult and their recovery may be a function of whether or not such indirect losses were reasonably foreseeable by the other party to the "contract." In Copeland, the plaintiff did not allege or attempt to prove any reliance damages. Therefore, whether "loss of opportunity costs" could be recovered did not need to be decid-

ed by the Court in the Copeland case and is left open for future consideration.

Liability for the other party's out of pocket costs and expenses could be painful enough. More disturbing is the lost time, cost and expense of defending a claim for a breach of agreement to negotiate in good faith. The idea of a court or jury determining whether a party terminated negotiations in bad faith seems problematic. Given the inherent ambiguity of what constitutes a good faith termination of negotiations, the likely complexity of the parties' motivations and business considerations and the questionable qualifications of a judge or jury to appropriately assess all these issues, one must wonder how often the "right" result will be realized.

The notion that "loss of opportunity costs" may be recoverable is an even more serious concern. These damages could be many times greater than liability for out-of-pocket costs and expenses incurred in connection with the negotiation. Because of the speculative nature of such damages, a court may be unlikely to expand the measure of "reliance" damages to include loss of opportunity costs. In any event, the court would probably limit the damages to those that would be reasonably foreseeable to arise from a breach of the covenant to negotiate. Nevertheless, this potential exists and, given the right facts, could be a significant risk. For instance, in circumstances where the tenant has informed the landlord of a time requirement in order to avoid holdover rent and/or other costs relating to the transition of its business from its old premises to the proposed new premises, the tenant may be in a good position to successfully include such losses in its "reliance" damages.

3. IMPLICATIONS OF COPELAND FOR RETAIL LEASE LETTERS OF INTENT.

The proposition that a party may recover reliance damages for breach of an express or implied promise in a letter of intent to negotiate in good faith is now the law in California. Other jurisdictions often eventually follow theories of contract liability first developed in California. In Copeland, the Court cited New York, Pennsylvania and Illinois cases that also recognize a cause of action for breach of a contract to negotiate. Assuming the subject transaction is governed by the laws of these states, or that the law of the jurisdiction that governs the subject transaction could evolve to follow Copeland, landlords, tenants and brokers should consider the implications of this important legal development.

Ultimately, the Copeland decision requires that the parties to the letter of intent have a clear vision of their objectives in using a letter of intent and that they employ precise language to protect their interests. Failure to do so could result in unanticipated financial liability and defeated expectations.

Given the uncertainty of a proper determination by a court or jury and the significant expense and exposure to liability incident to litigating a contract to negotiate, the holding of Copeland could provide leverage for the party to a failed negotiation who considers itself to be aggrieved by bringing or threatening to bring a claim for the breach of the covenant to negotiate in good faith. Therefore, depending upon the strategic interests and leverage of the landlord and the tenant, they should each consider whether to use a letter of intent versus a minimal term sheet, whether to sign a letter of intent and, when it is appropriate to enter into a letter of intent, whether to expressly include or exclude each of the following concepts:

- Express language by which the parties agree to negotiate;
- Language disclaiming any agreement to negotiate and explicitly recognizing a right to terminate negotiations for any reason or no reason. Alternatively, a time limitation on negotiations after which either party may cease negotiations for any reason or for no reason may be appropriate;
- Language stating that the letter of intent is nonbinding in the sense of being ineffective to constitute an actual agreement on the subject lease transaction;
- Language specifically addressing each party's responsibility for costs and expenses incurred in the negotiation and other possible "reliance" damages. In some circumstances it may also be appropriate to address enforcement costs and to specify that the prevailing party is entitled to recover its enforcement costs; and
- Language in subsequent correspondence between the parties and their agents reiterating

that there is no agreement to negotiate.

A landlord who has properties subject to a large number of small leases with non-credit tenants has a strong incentive to avoid any argument that the landlord has entered into a contract to negotiate in good faith. A smaller lease with a non-credit tenant is a less complex and less time consuming transaction than a major lease transaction with a more sophisticated and creditworthy entity. As such, some of the reasons for implying a duty to negotiate may not exist or may not be as strong. In addition given landlord-favorable market conditions, several alternatives to a specific small tenant may be available. The landlord may quite literally wish to preserve its ability to cease negotiations in favor of a better offer.

The implications of Copeland may also be particularly important in lease transactions where the leverage of the parties might shift in a major way between the commencement and completion of negotiations. This could be the case when tenants who are direct competitors are attempting to secure the few suitable locations within a particular market area or where a tenant's objective is to secure a certain number of expansion sites within a specific market and timeframe.

4. CONCLUSION

Ultimately, the Copeland decision requires that the parties to the letter of intent have a clear vision of their objectives in using a letter of intent and that they employ precise language to protect their interests. Failure to do so could result in unanticipated financial liability and defeated expectations.