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■ **Non-binding preliminary agreements: use ‘good faith’ with caution**

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Business negotiations often reach a stage at which one or more parties want what they have agreed to in principle to be recorded in writing. The parties may sign a term sheet, letter of intent or heads of agreement – all variations on a common theme. These preliminary agreements spell out, in summary fashion, the key terms of the proposed deal. These preliminary agreements are often stated to be non-binding, such as by the use of the words, ‘subject to contract’, or ‘subject to the execution of a definitive agreement’.

One party may request the inclusion of a mutual obligation to negotiate the definitive agreement ‘in good faith’. This request may be a difficult one to reject – why wouldn’t each party agree to negotiate in good faith to finalise the deal? It may be tempting for a party to conclude that such a statement is harmless, since the term sheet is non-binding.

If, for whatever reason, one party changes its mind, can it simply walk away from the non-binding arrangement? Does it make a difference if the term sheet includes a statement to ‘negotiate a definitive agreement in good faith’?

This article considers the differing impact of a provision to negotiate in good faith in the common law systems in the United Kingdom (no impact), Australia (some impact), and the United States (a significant impact). Although the common law in these three jurisdictions has many similar attributes, the ramifications of cavalierly using common business terms such as ‘good faith’ can be very different.

United Kingdom

Generally the English courts are reluctant to enforce obligations

to negotiate in good faith, whether implied or express, because such a concept is perceived to be irreconcilable with the parties’ freedom of contract. In addition, ‘good faith’ is considered vague, a type of ‘agreement to agree’ and therefore too uncertain to enforce. It is also difficult to say whether the termination of negotiations was brought about in good or bad faith. Moreover, since it is difficult to determine whether good faith negotiations would have produced a final agreement or what the terms of that agreement would have been, how can the loss for breach of any good faith obligation be determined? In the leading House of Lords case of *Walford v. Miles (1992)*, the court said: “While negotiations are in existence, either party is entitled to withdraw from these negotiations at any time and for any reason. There can be thus no obligation to continue to negotiate until there is a proper reason to withdraw. Accordingly a bare agreement to negotiate has no legal content.”

However, the inclusion of a provision to negotiate in good faith was considered more recently by the English Court of Appeal in the case of *Petromec v. Petroleo Brasileiro (2005)*. The court commented that it did not consider that *Walford v. Miles* was binding authority that an express obligation to negotiate in good faith would be completely without effect. It suggested that when the parties enter into a written contract that includes a provision for good faith negotiations, and in particular when legal advisers have been involved, then it may be appropriate for such a provision to be enforceable.

Thus, when it is clear that the term sheet is not binding and is only a ‘bare agreement to negotiate’, then *Petromec* would have no impact on the traditional position espoused in *Walford*. Under English law, there is no recognition of an

implied obligation to negotiate in good faith, and the inclusion of an express provision does not, in the absence of a binding agreement, limit a party's ability to walk away from the negotiations.

Australia

The existence and scope of an obligation to negotiate in good faith is not yet settled in Australia. Traditionally, Australia has followed the English courts and been reluctant to recognise an obligation to negotiate in good faith. However, Australian courts have recently appeared more willing to depart from this position. In *Coal Cliff Collieries v. Sijehama (1991)*, the validity of an express agreement to negotiate in good faith was considered. The court rejected the proposition that no promise to negotiate in good faith would ever be enforceable by a court. Subsequent cases in Australia have followed this approach.

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How does the current state of the law in Australia impact on our non-binding term sheet scenario? Although an implied contractual duty of good faith is recognised in Australia, both under common law and statute, it is not imposed on all contracts. While the courts may seek to imply a duty of good faith in the negotiation of contractual obligations, they will not override a contract's express language. The express non-binding nature of the term sheet makes it likely that the Australian courts would not imply an obligation to negotiate in good faith when there is a non-binding term sheet.

But what of the express obligation? It is generally accepted that parties may by contract bind themselves to negotiate in good faith. But there remain practical difficulties with this concept. Significantly, the courts have held that any express obligation to negotiate in good faith needs to be sufficiently specific as to the elements of the obligation. In our example, because no attempt has been made to define what is intended by the obligation, or what should happen if good faith negotiations break down, the courts are again unlikely to enforce the obligation.

If parties to a term sheet wish to bind themselves to negotiate in good faith in reaching a definitive agreement, because the concept of good faith is uncertain and evolving, they should define what it is that they mean by good faith. Even in the scenario of a binding obligation to negotiate in good faith, a party's obligations under Australian law are not onerous. Generally, the obligation can be fulfilled by simply taking part in the process of negotiations. Beyond this, there is no requirement that a party act for or on behalf of or in the interests of the other party, nor does it require a party to act otherwise than by pursuing its own interests.

United States

Any general statement of the law in the US is fraught with problems. English courts have only to consider decisions of higher English courts. Australia, which also has a federal system, has state courts that tend to take notice of the developments in other states and a High Court that ultimately resolves questions of contract law for the whole of Australia. In contrast, in the US there is no effective review of state law by the US Supreme Court. As a result the common law of what it means to agree to negotiate in good faith develops independently in 50 jurisdictions. That being said, it is possible to extract some general guidance.

The obligation to negotiate in good faith arises from either an express or implied obligation in an agreement. When the obligation does not exist, the traditional theory of freedom of contract applies and a party is free to walk away from a deal and break off negotiations for any reason.

Does a term sheet that expressly states its non-binding status, as in our example, nevertheless imply a binding obligation to negotiate? The watershed case is *Teachers Insurance & Annuity Association of America v. Tribune Co. (1987)*, in which the applicable term sheet stated that it was non-binding but did not expressly contain any obligation of good faith. In this case the court identified a type of preliminary agreement between parties that, although not requiring that the final contract be concluded, created an obligation on the parties to negotiate in good faith, what the court called a 'binding preliminary agreement.' Although a number of cases have followed in Tribune's footsteps, it is rare that when the parties have expressly stated their intention that the preliminary agreement is non-binding pending the definitive agreement, a court will impose an obligation to continue good faith negotiations.

There is little doubt that US courts will recognise express obligations to negotiate in good faith. In *Itek Corp. v. Chicago Aerial Industries (1968)*, a letter of intent containing both a no binding effect clause and a provision stating that the parties "make every reasonable effort to agree upon and have prepared as quickly as possible a contract", was found by the Delaware

Supreme Court to impose an obligation to negotiate in good faith. Similarly, in the Massachusetts case of *Schwanbeck v. Federal Mogul Corp.* (1992), a statement that: "This Letter of Intent is not intended to create, nor do you or we presently have any binding legal obligation whatever..." but then went on to say: "...however, it is our intention, and we understand, your intention immediately to proceed in good faith in the negotiation of such binding definitive agreement", was held to be a contractual obligation independent of the prior disclaimer that the letter was non-binding.

Itek and *Schwanbeck* are examples of how otherwise non-binding letters of intent may impose a duty to negotiate in good faith. But what does this duty entail?

Good faith is defined in the Uniform Commercial Code as "honesty in fact in the conduct or transaction concerned". However, the UCC deals with the performance of already concluded contracts, and not with good faith obligations in the pre-contractual stage. What constitutes pre-contractual good faith is an open issue. Clearly, certain actions such as fraud or duress, or other 'bad faith' conduct, will violate any good faith standard. Additionally, some commentators suggest that under an agreement to negotiate, the good faith standard ordinarily requires: (i) actual negotiations with no imposition of conditions that were not contemplated by the parties; (ii) disclosure of enough about parallel negotiations to give a reasonable opportunity to match competing proposals; and (iii) continued negotiation until impasse has been reached unless there is another justification for breaking off the negotiations.

Commentators have also suggested conduct permitted by the good faith standard. For example, an obligation to negotiate in good faith should not require a party to negotiate exclusively, or for any specific length of time, or to continue negotiations if its counterpart is not acting in good faith, or if market conditions change, or indeed if the opportunity to conclude the deal with a third party comes along.

Finally, in the event of a breach of an obligation to negotiate in good faith, what are the likely consequences? The US courts

have a number of remedies available. However, since it is not possible to determine whether good faith negotiations would have produced an agreement at all, or what the terms of that agreement would have been, certain remedies such as specific performance, or 'expectation damages', i.e., damages based upon the expected profits that the aggrieved party would have received from the transaction, are inappropriate. The more likely result is for a court to award 'reliance damages'. The aggrieved party is compensated for any loss resulting from its reliance on the other party's agreement to negotiate in good faith. The purpose of this measure is to put the party in the same position in would have been in had the agreement to negotiate in good faith not been made. It is likely to cover out-of-pocket expenses, but not the lost profits that the initial term sheet contemplated or lost opportunity costs. That said, the more advanced the negotiations towards a definitive agreement, the more likely that an aggrieved party will seek to argue for lost opportunity costs or damages to its business that may have resulted from the impact on employees, suppliers and customers of the failed negotiations.

Conclusion

Cross-border deals are now the norm. The cavalier use of commonly used terms such as 'good faith' across different jurisdictions can have unexpected consequences. In the context of preliminary agreements, particular attention should be paid to any language that suggests that there is an obligation to continue negotiations, or otherwise negotiate in good faith. Consider including explicit disclaimers reserving each party's right to terminate negotiations at any time and for any reason. Resist the inclusion of a 'good faith' obligation to negotiate. Alternatively, spell out precisely what needs to be done to comply with this obligation, or set forth the consequences for breach of this obligation, such as a termination fee.

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