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Effectively using letters of intent in real estate negotiations

Before agreeing to a real estate sales contract or lease, the parties may prepare a letter of intent, term sheet or other form of preliminary agreement (together, called here an "LOI"). Generally, an LOI may be signed or at least initialed and reflects that the parties have agreed on certain important terms of a deal, though not on all of its provisions or details.

LOIs serve useful purposes. One is to avoid misunderstandings arising out of complex negotiations. For example, by setting out those terms on which agreement has been reached, an LOI may narrow the areas for future negotiation. Similarly, an LOI may stipulate that certain formalities must be met, such as a final signed writing, before either party is bound to perform the transaction. Another common purpose of an LOI is to secure the parties' exclusive efforts toward concluding the transaction.

As a federal appeals court has explained, "When a deal necessarily is preceded by costly groundwork, a letter of intent may benefit both the purchaser and the seller.... [T]he buyer secures the seller's undivided attention as long as progress continues in ironing out the points of the transaction. Neither party has committed himself to the exchange. Both have agreed to work toward it."

Yet, the use of an LOI in a real estate transaction (called here, a "real estate LOI") can beg the question of just what the parties intended by preparing and signing the document. For example, did the parties intend the real estate LOI to bind them to perform its substantive terms, say, to lease space for the term and at the rental rate identified in the LOI? If not, did the parties intend that the LOI would require them to negotiate further toward a binding lease or sale contract? To negotiate exclusively with one another? For how long? Must they negotiate in good faith? In a commercially reasonable manner? Did they intend the LOI to fix or limit any of the positions they can take in the continuing negotiations?

A well-crafted real estate LOI should address the parties' intentions on such questions in clear terms. An LOI that is unclear as to what, if anything, it obligates the parties to do can invite uncertainty, disagreements and even litigation.

Enforceable terms

A first question is whether the parties intend the "substantive" terms of the real estate LOI—the property sale, lease or other transaction—to be enforceable even if no full and final signed agreement is concluded. Under Illinois law, a real estate LOI's terms are binding and enforceable if each of three kinds of requirements are met.

First, the elements essential to a binding real estate contract must be set out, even if briefly, including, for example, the parties' names, the rental rate or sale price, a property description and the lease term or intent to convey an interest in fee simple. Second, if the property interest to be conveyed is to last longer than one year, then the Illinois "statute of frauds" (740 ILCS 80/2) applies and the real estate LOI must be in a writing signed by the party against whom it is to be enforced. These first two requirements basically mean that the substantive terms of a real estate LOI won't be enforceable unless the LOI—even if brief in form—meets the standard legal requirements for entering into an enforceable real estate agreement.

Third, for a real estate LOI to be binding, an additional requirement must be satisfied: the LOI, viewed objectively, must reflect that the parties intended it to bind them. Courts look first to the LOI's language to determine the parties' intent. Not surprisingly, statements in a real estate LOI that it is "firm and binding" or reflects an "intent to lease" support enforcing the LOI as a binding real estate contract.

By contrast, if a real estate LOI provides that the existence of a binding contract is "conditioned upon" or "subject to" execution of a formal agreement, then under Illinois law the LOI's substantive terms will not be enforced. No specific "magic words" are required to avoid enforcement of an LOI's substantive terms. Any statement that an LOI is not binding may suffice.

Other indicators of the parties' intentions are of lesser significance. The fact that the parties anticipate signing a final contract will not, by itself, prevent a real estate LOI from being enforced. And one party's belief that a contract was formed is not enough, without more, to enforce a real estate LOI's substantive terms.

Duty to keep negotiating

Even where a real estate LOI creates no binding agreement to actually sell or lease the subject property it may establish a limited contract between the parties. Most commonly, a real estate LOI may obligate the parties to continue negotiating with each other toward the formation of a binding real estate contract, while not obligating them to conclude such an agreement.

Here again, whether or not a real estate LOI obligates the parties to negotiate toward a final contract is determined in the first instance from its language. For example, where an LOI stated that the parties intended to enter into formal leases embodying its terms and conditions "within reasonable limitations," a court applying Illinois law held that the "reasonable limitations" clause obligated the parties to negotiate in good faith and to make a bona fide effort to agree on any disputed lease terms.

Yet, an agreement to negotiate toward a final real estate contract does not require that those negotiations succeed. Indeed, such LOIs preserve a party's ability to change its mind. Still, it is common for an LOI to require that the parties' subsequent negotiations be conducted in good faith. Generally, such a good faith duty limits the parties' ability to change their minds about those terms on which the parties have already agreed in the LOI. For example, a real estate LOI that required good faith negotiations was held to bar the parties from either renouncing any of the terms stated in the LOI or demanding terms inconsistent with them. Thus, where the parties agree to negotiate in good faith toward a final real estate contract, those negotiations are permitted to fail—but not because either party sought to avoid or change terms that were settled in the LOI.

Not every real estate LOI will be construed to require that the parties negotiate toward a final contract in "good faith." One court applying Illinois law rejected a claim that the parties had a duty to negotiate in good faith where "no language in the parties' [LOI] required them to engage in good faith negotiations, nor did [the LOI] establish a framework for the negotiation process." Generally, "[i]n the absence of contract terms limiting the ability to act with self-interest, a party is not prohibited from bargaining to its own economic advantage." For example, a federal appellate court applying Illinois law has held that a real estate LOI that anticipated that the parties might reach a stalemate did not require that negotiations be successful or conducted in good faith.

The statute of frauds

Again, a real estate LOI whose substantive terms are intended to be enforceable generally will need to be in writing and signed by the party against whom enforcement is sought to satisfy the statute of frauds. Yet, even a real estate LOI that is not intended to be substantively enforceable may still be subject to the Illinois statute of frauds. This is because a real estate LOI that requires further negotiations toward a final property sale or lease is a contract "concerning" an interest in land within the meaning of the statute of frauds. As a result, for real estate LOIs to be effective even in merely requiring further negotiations toward a final contract the LOI must be in writing and signed by the party against whom enforcement is sought.

In a nutshell

If you expect that an LOI will help you successfully conclude a real estate transaction, and you want the real estate LOI to be binding so that the transaction it describes could be enforced on the stated terms, then the real estate LOI should abide by several guidelines.

The LOI should be in writing; it should be signed by the parties; it should state all needed terms of a property sale agreement or lease, like price or rent, party names and descriptions of the property and the interest conveyed and finally, it should state clearly that the parties may (or will) prepare a final written agreement but the LOI itself is intended to be, and is, binding—even if a final agreement is never prepared or executed.

By contrast, if you and your counterparty find it helpful to create a real estate LOI, but do not want its sale or lease terms to be enforceable like a contract unless a further, final agreement is reached, then the LOI should state that the LOI is not a binding sale agreement (or lease) and the existence of a binding agreement is "subject to" and "conditioned upon" execution of a final written agreement. But that does not end the matter. Even where a real estate LOI is not intended to be substantively enforceable, the parties should express their intentions clearly on such other matters as: whether they must negotiate further toward a final contract; if so, whether such negotiations must be exclusive or in "good faith" and for what length of time they must negotiate.

The parties' failure to clearly express whether and on what terms a real estate LOI is intended to be binding and enforceable can lead to disputes, litigation and unexpected outcomes.

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