



Using Letters of Intent in Commercial Real Estate Negotiations

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BEFORE EXECUTING A COMMERCIAL PROPERTY LEASE OR SALES CONTRACT, the parties may prepare a letter of intent or an agreement in principle. The letter of intent (or a similar document) generally signals that the parties have agreed on the outline of a deal, but not on all of its provisions or details. For ease of reference, this article refers to letters of intent, agreements in principle, term sheets, and similar preliminary agreements as “LOIs.”

LOIs serve several purposes. One is the “elimination of future misunderstandings arising out of [the parties’] negotiations.”¹ For example, an LOI, by stating the terms on which agreement has been reached, may narrow the areas for future negotiation. Similarly, an LOI may limit future misunderstandings by stipulating that a formal signed writing, separate from the LOI itself, is required before either party is bound to the transaction.

Another typical purpose of an LOI is to secure the parties’ *exclusive* efforts toward concluding the transaction:

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.²

While LOIs can serve these and other helpful purposes in real estate transactions, they should be used thoughtfully and prepared carefully. Indeed, the use of an LOI in a real estate negotiation can raise the question of just what the parties actually intended by preparing and signing the LOI.

For example, did the real estate LOI commit the parties to *perform* its substantive terms, say, to lease space on terms set forth in the LOI? For convenience, the enforceability of a real estate LOI as a substantive real estate contract is called “substantive enforceability” in this article.

Where a real estate LOI is not substantively enforceable, other questions may arise about what the parties intended through their LOI. For example, did the real estate LOI require

1. *Feldman v. Allegheny International, Inc.*, 850 F.2d 1217, 1221 (7th Cir. 1988).
2. *Id.*

When you're negotiating commercial real estate transactions, letters of intent can help define significant points of agreement before a formal contract is signed. But use them with care to avoid raising questions about whether and to what extent their terms are binding on the parties.

the parties to negotiate further toward a final binding contract? If so, did it limit the positions the parties could adopt in those future negotiations?

The existence and scope of a duty to negotiate toward a final contract pose difficult questions for real estate lawyers and deal-makers alike. A well-crafted real estate LOI will address and resolve such questions in clear terms.

These and related issues about using LOIs in Illinois real estate transactions are the subject of this article.

When are real estate LOIs substantively enforceable?

There are three requirements under Illinois law for a real estate LOI to be substantively enforceable:

1. The LOI must set forth the essential terms of the property purchase and sale agreement ("sale agreement"), lease, or other real estate transaction;

2. If the property interest to be conveyed is to last longer than one year, the Illinois statute of frauds applies and the LOI must be in writing and signed by the party against whom it is sought to be enforced; and

3. The parties must *intend* that the LOI bind them.³

These three prerequisites to making the LOI substantively enforceable are discussed in turn below.

Essential elements. The essential terms of a property sale agreement or lease under Illinois law are well established. A sale agreement must contain the names of the vendor and vendee, the price, the central terms and conditions of sale, and a property description. A lease must specify the space, the lease term, the rent amount, and the time and manner of payment.⁴

Statute of frauds. The statute of frauds applies to essentially all contracts conveying an interest in Illinois real estate that is to last

longer than one year. In pertinent part, the statute provides:

No action shall be brought to charge any person upon any contract for the sale of lands, tenements or hereditaments or any interest in or concerning them, for a longer term than one year, unless such contract or some memorandum or note thereof shall be in writing, and signed by the party to be charged therewith, or some other person thereunto by him lawfully authorized in writing, signed by such party.⁵

Although the subject is beyond the scope of this article, there are several well-recognized exceptions to the statute of frauds that can render a real estate agreement enforceable even though it is not expressed in a signed writing.

Intent to be bound. Most of the reported judicial decisions concerning whether or not a real estate LOI is substantively enforceable turn on the third essential requirement: that the parties intended it to be binding. As an initial but fundamental matter, whether the parties intended an LOI to be binding is determined *objectively* from their words and conduct – not from what either party says it subjectively intended or understood. For example, one party's belief that a contract was formed is not enough to render an LOI substantively enforceable.⁶

Moreover, the parties' intent to be bound by an LOI must be determined solely from its language, unless that language is ambiguous. Not surprisingly, statements in a real estate LOI that it is "firm and binding" or that there is an "intent to lease" support substantive enforceability.⁷

3. 740 ILCS 80/2; see, e.g., *Peoria Associates L.P. v. Best Buy Co.*, 995 F. Supp. 823, 824 (N.D. Ill. 1997).

4. See *Citadel Group Ltd. v. Washington Regional Medical Center*, 692 F.3d 580, 589 (7th Cir. 2012); *Ocean Atlantic Development Corp. v. Aurora Christian Schools*, 322 F.3d 983, 1002 (7th Cir. 2003).

5. 740 ILCS 80/2.

6. See, e.g., *Borg-Warner Corp. v. Anchor Coupling Co.*, 16 Ill. 2d 234, 243 (1958).

7. *Id.*; *Evans v. Tiffany & Co.*, 416 F. Supp. 224, 239 (N.D. Ill. 1976).

TAKEAWAYS >>

- If you want to draft a substantively enforceable letter of intent (LOI) for a real estate transaction, it should: (1) be in writing; (2) be signed by both parties; (3) set forth all essential elements of a property sale agreement or lease; and (4) state clearly that while the parties anticipate preparing a more formal final written agreement, the LOI itself is intended to be, and is, a binding sale agreement or lease -- even if a final agreement is never prepared or executed.

- If you want to draft an LOI that is not substantively enforceable, then the LOI should state that it is not a binding sale agreement or lease and the existence of a binding agreement is "subject to" and "conditioned upon" execution of a formal written agreement separate from the LOI.

- If your LOI is not intended to be substantively enforceable, you should further consider whether you want it to bind the parties to conduct negotiations toward a final contract, and whether any such negotiations must be exclusive, concluded within a set period of time, conducted in "good faith," and/or subject to any other standards or restrictions.

TO MAKE YOUR LOI ENFORCEABLE, PUT IT IN WRITING, MAKE SURE IT'S SIGNED BY BOTH PARTIES, SET FORTH ALL ESSENTIAL ELEMENTS, AND STATE CLEARLY THAT IT IS A BINDING SALE AGREEMENT OR LEASE.

If a real estate LOI is ambiguous about the parties' intent to be bound, then a court will admit evidence relevant to intent from outside of the LOI (e.g., evidence of the parties' negotiations). Thus, if the parties' intent to be bound is expressed ambiguously in an LOI, then the ambiguity may create a disputed issue that prevents a court from deciding substantive enforceability based solely on the LOI's language and without holding a trial. For example, where an LOI stated that "the contract alone shall be binding" but also that when the contract is signed "this letter [the LOI] shall be null and void," the LOI was ambiguous and substantive

enforceability could not be determined from the face of the document.⁸

Criteria relevant to deciding whether the parties intended the LOI to be enforceable include the complexity of the agreement, the amount of money involved, whether a formal writing is required to fully express the agreement's terms, and whether negotiations indicate that a formal writing is anticipated. The LOI itself often will reflect on these criteria, as may extrinsic evidence.⁹

In an illustrative decision, a real estate LOI was found enforceable based on evidence outside the LOI itself where 1) corporate formalities were followed in executing the LOI, 2) the transaction was publicly announced based on the LOI, and 3) the custom and usage in the real estate industry is to expressly disclaim enforceability when the parties do not intend to be bound, but the LOI did not disclaim enforceability.¹⁰

When are LOIs *not* enforceable?

Under Illinois law, parties can reach an agreement in stages, without running the risk that a court will enforce a bargain that one of the parties would have rejected as incomplete. On the other hand, where a formal written contract will be based on the same terms as an LOI, the mere

fact that the parties anticipate preparing a final contract does not render the LOI unenforceable. So how can the parties ensure that the LOI is not held enforceable?

Illinois law is clear that a real estate LOI will not be substantively enforced if it provides that a binding contract is "conditioned upon" or "subject to" execution of a formal agreement. Including such a clause in an Illinois real estate LOI is the simplest way to prevent enforcement.¹¹

But "magic words" are not required to defeat substantive enforcement – any statement to the effect that the LOI is not binding can suffice, including the following provisions:

- Words expressing that a binding agreement depends on the occurrence of a contingency, subsequent event, or agreed upon element;¹²
- Language that anticipates the possibility of a stalemate;¹³ and
- Where an LOI set forth only "some of the parameters for an offer," omitted "terms one would expect to find in a multi-million dollar contract for the sale of real property" (e.g., a closing date and property tax allocations), made execution of a sale agreement trigger the property inspection period, and made that inspection period trigger other pre-closing obligations.¹⁴

And again, under the Illinois statute of frauds, a real estate LOI lasting longer than one year should not be substantively enforceable unless it is in writing. But, the best practice is *not* to depend on the absence of a signature to avoid enforcement. The statute of frauds is subject to exceptions that may permit enforcing the contract despite there being no signed writing.

8. *Bradley Real Estate Trust v. Dolan Associates Ltd.*, 266 Ill. App. 3d 709, 712 (1st Dist. 1994).

9. See, e.g., *Citadel Group*, 692 F.3d at 588.

10. *Evans*, 416 F. Supp. at 239.

11. *Magnus v. Lutheran General Health Care System*, 235 Ill. App. 3d 173, 180-82 (1st Dist. 1992).

12. See, e.g., *Citadel Group*, 692 F.3d at 587-88 (holding preliminary term sheet not binding which said it is subject to change for unspecified "other conditions").

13. *Feldman v. Allegheny International, Inc.*, 850 F.2d 1217, 1223 (7th Cir. 1988).

14. *Ocean Atlantic Development Corp. v. Aurora Christian Schools, Inc.*, 322 F.3d 983, 997-99 (7th Cir. 2003).

ISBA RESOURCES ON REAL ESTATE TRANSACTIONS >>

- ISBA Free CLE, *Be Careful What You Ask For: Tips for Real Estate Practitioners in Buying and Selling Condominium or Community Association Properties* (Oct. 3, 2013), <http://onlinecle.isba.org/store/seminar/seminar.php?seminar=24749>.
- Joseph R. Fortunato, *Is the Real Estate Lawyer an Endangered Species?*, 100 Ill. B.J. 556 (Oct. 2012), <http://www.isba.org/ibj/2012/10/istherealestatelawyeranendangeredspecies>.
- Steven B. Bashaw & Joseph R. Fortunato, *Case Law Update: Real Estate Contracts*, Real Property (Jan. 2011), <http://www.isba.org/sections/realestate/newsletter/2011/01/caselawupdate realestatecontracts>.
- Helen W. Gunnarsson, *Beyond "Deed and Green": The Strange Truth About Lawyers' Roles in Illinois Real Estate Sales*, 94 Ill. B.J. 408 (Aug. 2006), <http://www.isba.org/ibj/2006/08/beyonddeedandgreenthestrangetruthab>.

When does an LOI impose a duty to negotiate?

Where a real estate LOI is not substantively enforceable – e.g., no binding sale agreement or lease is created – it still could establish a more limited contract. Specifically, it might obligate the parties to *negotiate* with each other to form a property sale agreement, lease, or other real estate contract.¹⁵

Here again, the existence and scope of a contractual duty to negotiate are determined first by the LOI's terms. For example, where an LOI stated that the parties intended to enter into formal leases embodying its terms and conditions “within reasonable limitations,” the court held that the reasonable-limitations clause obligated the parties to negotiate in good faith to agree on any disputed lease terms.¹⁶

Under Illinois law, an agreement to negotiate toward a final contract does not require that the negotiations lead to a binding contract. Indeed, it has been said that LOIs preserve a party's ability to change its mind.¹⁷

Still, an agreement to negotiate does impose some binding contractual obligations. For example, the LOI might commit the parties to negotiate toward a final agreement *exclusively* with one another for a set period.¹⁸

An LOI also may require that the parties' subsequent negotiations be conducted in good faith. A good faith duty generally limits the parties' ability to change their minds about terms on which they have already agreed.

For example, it has been held that an LOI requiring good faith negotiations prevents the parties from abandoning the negotiations, renouncing terms contained in the LOI, or demanding terms that do not conform to it. In short, where the parties agree to negotiate in good faith toward a final contract, those negotiations may fail – but not because either party seeks to avoid or change settled terms.¹⁹

However, not every LOI will be construed to require “good faith” negotiation. Again, the question will be resolved by the LOI's language. One court 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.”²⁰ The court reasoned that, “[a]n agreement to negotiate in good faith is a contract” and “[l]anguage in the relevant document must indicate that good faith negotiations were contemplated; [a court] should not read into the agreement terms that do not exist[.]”²¹

Put another way, “[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.”²² Applying Illinois law, the federal seventh circuit held that “good faith' is no guide” in enforcing a real estate LOI that expressly anticipated the parties could reach a stalemate.²³ The court found that the LOI did not require negotiations to be successful or in good faith, each side was acting in its own best interest, and doing so was not “bad faith.”²⁴

A real estate LOI that is not 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 sale agreement or lease is a contract “concerning” an interest in land within the meaning of the statute of frauds. Thus, a real estate LOI can require negotiations toward a final contract only if the LOI is in writing and signed by the party against whom enforcement is sought (unless an exception to the statute of frauds applies).²⁵

A summary

Let's review. If you expect that an LOI will help move your real estate transaction toward a desired conclusion, and you want it to be substantively enforceable – for example, as a sale agreement or lease – then

- Put it in writing;
- Make sure it's signed by both parties;
- Set forth all essential elements of a property sale agreement or lease; and
- State clearly that the parties anticipate preparing a more formal final written agreement, but the LOI itself is a binding sale agreement or lease – even if a final agreement is never prepared or executed.

IF YOU DO NOT WANT YOUR LOI TO BE ENFORCEABLE, PROVIDE THAT IT IS NOT A BINDING SALE AGREEMENT OR LEASE AND IS “SUBJECT TO” EXECUTION OF A FORMAL WRITTEN AGREEMENT.

By contrast, if you do not want the LOI to be substantively enforceable, then the LOI should state that it is not a binding sale agreement or lease and the existence of a binding agreement is “subject to” and “conditioned upon” execution of a formal written agreement separate from the LOI.

In addition, if you do not want the LOI to be substantively enforceable, you face a few further choices. Do you want it to bind the parties to conduct further negotiations toward a final contract? If so, must such negotiations be exclusive? For what period of time? Must they be conducted in “good faith” or subject to other restrictions? There is no right answer to any of these questions, but the LOI should clearly state the choices that you and your counterparty make.

A real estate LOI that is not clear on these fundamental points invites a lawsuit.

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15. See, e.g., *Citadel Group*, 692 F.3d at 592.

16. *Evans, Inc. v. Tiffany & Co.*, 416 F. Supp. 224, 239 (N.D. Ill. 1976).

17. *Feldman*, 850 F.2d at 1221, 1223 (holding LOI did not bar counterparty from refusing to sign proposed contract).

18. *Id.* at 1221-22 (“the letter of intent . . . bound [defendant] to exclusive negotiation with [plaintiff] while the sale was being pursued.”).

19. *Citadel Group*, 692 F.3d at 592 (citing *Milex Products, Inc. v. Alra Laboratories, Inc.*, 237 Ill. App. 3d 177 (2d Dist. 1992)).

20. *Id.* at 583.

21. *Id.* at 592 (citations omitted).

22. *Id.*

23. *Feldman*, 850 F.2d at 1223.

24. *Id.*

25. 740 ILCS 80/2; *Peoria Associates L.P. v. Best Buy Co.*, 995 F. Supp. 823, 824 (N.D. Ill. 1997) (“[A] letter of intent concerning an interest in land falls within the grasp of the Statute.”).

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Vol. 103 #10, October 2015.
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