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Letters of intent in modern commercial transactions. Looking at the past to improve the future

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**LETTERS OF INTENT IN MODERN
COMMERCIAL TRANSACTIONS. LOOKING AT
THE PAST TO IMPROVE THE FUTURE**

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Abstract

Based on comparative approaches and case studies, this paper analyzes the system of letters of intent (LOIs), underlining their advantages and potentialities but also their controversial elements, and to make suggestions to improve the future of this legal instrument.

In particular, it deals with the problem of defining a LOI as an enforceable and binding document. To this respect, the paper introduces a “three-tier test” composed of test on contract formation; test on “*de facto contract*”; and test on good faith. It demonstrates that a LOI can be considered enforceable as a contract if it satisfies at least one of these tests.

In conclusion, I will demonstrate the importance of the adoption of the concept of good faith in all countries; the problem of transnational LOIs and the impossibility to solve it completely with the “choice-of-law” mechanism; and the introduction of specific provisions on LOIs in every civil code and the unification of contract law at a regional level.

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Introduction

In 1984 Pennzoil, an American oil company, signed with Getty Oil a plan of merger through a document called “Memorandum of Agreement”. Few days after, Texaco publicly announced the signature of a “sale and purchase agreement” with Getty Oil. When Pennzoil threatened a lawsuit towards Getty Oil for breach of contract, Dave Copley, the general counsel of Getty Oil, commented: “*That is the most absurd thing I’ve ever heard*”.¹ According to him, it was simply ‘ridiculous (...) to think that Pennzoil could claim a breach of contract’.²

Copley’s comment, in my opinion, perfectly summarizes the problems this study will deal with. The cited “Memorandum of Agreement” is a particular kind of letter of intent, and letters of intent (hereinafter “LOIs”) are pre-contractual documents that in theory are aimed to provide clarity and security during big business transactions, but that in practice, because of extreme ambiguity in their nature and also in their drafting, have created – and keep on creating – enormous troubles. In *Pennzoil v. Texaco*, what had been agreed in the LOI was considered by the counterparty to have absolutely no legal value, at the point that the fact that Pennzoil threatened a lawsuit for breach of a contract was defined “absurd”, as if a LOI was not a legal document, but only a piece of paper.

But what is the correct interpretation? Can LOIs have the value of a contract? And how could they be improved in their structure and in their content to avoid the disastrous consequences faced in *Pennzoil v. Texaco*, where a bad drafting caused a lawsuit and enormous losses? These are the key questions I will attempt to answer in this study.

As we can learn from the cited case, managing a big business deal is sometimes a vital aspect for an enterprise and must be taken seriously, but, at the same time, superficiality in choosing and drafting the related legal documents can generate terrible outcomes. This is connected with a number of reasons: one of them, as we have seen, is the mere identification of the moment in which this transaction enters into force and starts existing.

Traditionally, the key element of a business deal is considered to be the contract: when drafting the contract, the parties agree on the aspects of their transaction and, by signing it, they make it enforceable and give it the power to establish legal obligations in case of breach.

However, in today’s globalized, complex and networked economic world, the existence of pre-contractual instruments that reflect preliminary agreements among parties before the future and definitive contract has become fundamental. Modern business transactions are characterized by increasing complexity and size, and the negotiation of such contracts can result in very long and elaborate procedures, often including third parties³ and a high uncertainty⁴, moreover, the details on which all the participants should agree can

¹ See T. PETZINGER, *Oil & Honor: The Texaco-Pennzoil Wars: Inside the \$11 Billion Battle for Getty Oil*, Beard Books, Washington, 1999, p. 240.

² *Ibid.*

³ See R. B. LAKE, U. DRAETTA, *Letters of Intent and Other Precontractual Documents. Comparative Analysis and Forms*, Second Ed., Butterworth Legal Publishers, USA, 1994, p. XX-XXI.

⁴ On the issue of uncertainty in contracting and negotiating, see J. KOSTRITSKY, *Uncertainty, Reliance, Preliminary Negotiations and the Hold Up Problem*, in Social Sciences Research Network Electronic Journal, Jan 2008.

be extremely numerous. In this intricate background, it is clear that the difficulty to reach definite agreements rises, and that the risk of non compliance and breach of *bona fide* commitments becomes higher. Therefore, the possibility to draft pre-contractual documents that help in the process of agreement and that preliminarily establish some basic obligations plays a crucial role.

The expression “letters of intent”, as we have already seen, is a wide term which denotes documents that are often specified by other names, such as “memorandum of understanding”, but also “head of agreement”, “protocol d’accord”, “protocol”, “letter of understanding”, “memorandum of intent” and “term sheet”,⁵ and that can have a surprising variety of contents and purposes (there are assurance letters of intent, framework letters of intent, publicity letters of intent, memorialisation letters of intent etc.).⁶ Generally speaking, letters of intent are often characterized by two elements. Firstly, they frequently delineate a contract that might be defined and signed in the future; secondly, they sometimes impose legal obligations.

However, the above-mentioned description does not highlight the key issue of LOIs, i.e. the fact that they can be extremely controversial. This is caused by three big problems: firstly by their peculiar nature, secondly by the dissimilarities among different legal traditions, and thirdly by the fact that LOIs are seldom drafted by lawyers, with all the disastrous effects that a bad drafted LOI can have on the future of a transaction or even of an enterprise. That is why my research question will focus not only on the importance of LOIs for modern commercial transactions, but also and especially on the way in which the system could be improved.

Sometimes, what is difficult to assess is the mere definition of the document we are dealing with, i.e. if it is a “contract” or a “letter of intent”. As we will see, the line between the “contractual” and “pre-contractual” spheres can be very subtle and ambiguous; however, it is at the same time fundamental to understand, because the existence of a proper contract has important legal consequences, which are not present in case of a “mere” letter of intent. These consequences are, for example, the rise of obligations to be fulfilled and of contractual liability in case of breach, the possibility to claim for contract’s performance and even the chance terminate the agreement.

To try to solve this issue, it is first of all useful to look at the general contract theory, according to which a contract is executed when an agreement is reached, i.e. when a party’s offer is accepted by the other party. However, which is the moment of acceptance? To this respect, each legal tradition offers its own answers, which collocate the moment of acceptance – and, as a consequence, the line between contractual and pre-contractual – at different stages. As I will fully analyze, the four major theories are the so-called “declaration theory”, the “mail box rule” (typical of common law countries), the “reception theory” (used, for example, in Germany) and the “information theory” (partly present in Italy). We will call this first analysis “*test on contract formation*”.

Once we have assessed – with all the above mentioned difficulties – that a certain document is not a contract, but a LOI, the problems are not over. In fact, even though we are facing a LOI, there could be the possibility that it has an intimate binding nature, and that it is substantially comparable to a contract: this depends mainly on the intention of the parties. In other words, we must understand if the parties had

⁵ See LAKE, DRAETTA, *Letters of Intent*, p. 5.

⁶ *Ibid.*, p. 12-17.

the intention to create binding obligations with that document (we will call this assessment “*test on the facta contract*”). Here we clearly fall in a grey area, with enormous margins of uncertainty: however, I will try to demonstrate that some kind of LOIs are generally susceptible of enforcement, and that some clauses of a LOI are more likely to be considered obligatory (depending – also here – on the legal tradition we are thinking about). Additionally, I will highlight the importance of being careful in the wording of the document and of assessing clearly, from the beginning, the obligatory or non obligatory nature of the entire LOI or of some of its provisions.

If, after the analysis described in the previous paragraph, a LOI is considered to possess the requisites of a contract, the parties can enforce it as such. But ‘if a contract is not found, the question arises whether one of the parties can be liable on a theory that does not require the existence of a contract or of a complete contract’,⁷ i.e. the good faith and pre-contractual liability theory (we will call this last step of the reasoning “*test on good faith*”). This pre-contractual liability, traditionally, occurs in cases such as unjustified withdrawal from negotiation, breach of information duties, misuse of negotiation etc.. What is very controversial – especially if we consider different legal traditions – is the nature of this concept. First of all, is it always applicable? We will see, for example, that the common law system is very reluctant towards the idea of good faith. Secondly, even if it is applicable, is it classifiable as a contractual liability (like in Germany), does it derive from tort law (like in France) or is it a “third kind” of liability (like, recently, in Italy)? This is not merely a matter of definition: in assigning the pre-contractual liability to a certain category, we find divergent consequences with regard, for example, to the burden of proof or to the limitation of the action.

To summarize what we have said until now, two fundamental concerns must be considered when analyzing the power and the implications of a LOI: its controversial nature (declined in the problems of contract formation, of the binding or not binding nature and of the good faith theory) and the substantial discrepancies that characterize different juridical systems: to this respect, I am not only talking about civil law and common law, but also about sub-categories within the civil law itself. The combination of the above-mentioned two concerns determines the conclusion that the system of LOIs still shows relevant gaps. This issue is not only a theoretical one, but – especially and more worryingly – a practical one. As we have already underlined, LOIs are very often used by enterprises to rule the negotiation of big deals and to start putting “black on white” some legal obligations before the final contract is signed; however, if this system lacks consistency and uniformity of interpretation, it results to be an extremely dangerous tool, capable of an incredible disruption in terms of legal consequences.

To prove that this is not at all an exaggeration, I will consider some jurisprudential cases in which the bad drafting of the document has created disastrous effects: to cite here two of the most relevant, the *Pennzoil v. Texaco* case and the *Buitoni S.p.A. v. Istituto per la Ricostruzione Industriale* case, better known as the *SME* case.

After this analysis, I expect to be ready to answer my research question and to draft some conclusions on the ways in which the system of LOIs could be improved. To reach this goal, my intention is to use a specific research method, which can be described through the following two points:

1) *Comparative approach*: I will compare different legal traditions and underline the main differences and similarities among them; through this operation, I will be able to discover the most relevant problems and

⁷ *Ibid.*, p. 171.

gaps in the system, especially under the transnational perspective. In particular, my research will focus on the comparison among English common law, France, Germany and Italy. I will make some quick references also to the most relevant extra-European systems (in particular, to U.S. law), but I will not extend much this kind of analysis: my choice is to concentrate my attention on few specific systems in a deepened way instead of considering many systems and facing in this way the risk of superficiality.

2) *Case-study*: as I have already mentioned, I will take into consideration not only the good examples of drafting, but also the unsuccessful cases, trying to use these experiences as sources of suggestion for the future and instruments of development.

This research method is combined with a specific choice in terms of sources and tools for carrying out the analysis. Because of the practical approach that characterizes the study and because of the case-study method, I consider primarily important two kind of sources: real successful and unsuccessful cases and articles written by lawyers and professionals; especially for the most theoretical issues, then, I will also consult academic works

To find out these instruments, I will rely on library's resources, online databases, institutional websites and official lawyers' web pages.

What I believe is important to underline here is the fact that, on this specific issue, it is at the moment quite difficult to find works that are at the same time recent and complete.⁸ Some of them – especially the articles written by professionals – are recent, but focus only on specific aspects of the problem, while others – I am thinking mainly about the academic books – are complete, but quite old. Therefore, one of the purposes of this study is to offer a new instrument that satisfies contemporarily both these requisites.

In light of the contents, the important aspects, the goals and the methods that I have explained in the previous paragraphs, the study is organized as follows:

1) The first chapter will address the controversial nature of LOIs: after a general overview on these instruments, containing possible definitions and an explanation of their importance and their different uses, I will describe the three most important concerns arising from the system, i.e. the contract formation, the binding or not binding nature of LOIs and the issue of good faith and pre-contractual liability, and the related “three-tier test”.

2) In the second chapter, starting from the issues described in the previous one, I will make a comparison on LOIs in different juridical systems, with particular attention for English common law, France, Italy and Germany, making reference to the way in which each system solves the above-mentioned crucial and problematic areas. At the end of the chapter, I will demonstrate which countries are the most open towards the LOIs system and which are the most reluctant.

3) In the third chapter I will analyze some real cases of letters of intent. I will consider particularly relevant to focus on cases in which the bad drafting has created disastrous consequences (*Pennzoil v. Texaco*, *SME* etc), firstly to show the practical importance of the issue, and secondly to be able to delineate a sort of

⁸ One of the reasons is the fact that the juridical analysis of LOIs is still seen by many as an “exploration of new lands”, which is particularly difficult because the principles underlying it vary consistently from a juridical system to another (see R. M. MORRESI, *Le lettere d'intenti*, 2009, p. 3).

“check-list” to apply while preparing this kind of documents (this last point will be introduced here and then fully analyzed in the conclusions).

Conclusions: After a summary on the most important findings of the study, I will comment on the “hot topics” arising from it (the importance of the adoption of the concept of good faith, the problem of transnational LOIs and the unification of contract law) and, finally, I will propose a sort of “check-list” which could be observed while drafting these documents. In light of these conclusions, I will list the most relevant points which could improve the future of the system of letters of intent.

CHAPTER I: THE CONTROVERSIAL NATURE OF LOIS

I.1 Overview on LOIs

I.1.1 Definition

A LOI can be defined ‘as a pre-contractual written instrument that reflects preliminary agreements or understandings of one or more parties to a future contract’.⁹ This definition itself gives the idea of the importance of the LOI system, especially in complex business transactions:

‘In other words, letters of intent allow parties to a business deal to structure their negotiations in stages. Letters of intent allow both sides to move ahead in a cautious manner without, in most cases, unconditionally binding each to the other. Step by step, the parties can conduct the necessary due diligence and agree on all the terms of their relationship before locking into a binding agreement to consummate the transaction.’¹⁰

Sometimes we are facing a LOI even if it is not called like this in its title. As I have anticipated in the introduction, the term “letter of intent” refers to a big category including in itself many different kind of documents, such as the “head of agreement”, the “memorandum of understanding”, the “letter of understanding”, the “term sheet” etc.. ‘All are used regularly, but “letter of intent” seems to be used more frequently, and to an extent is replacing the others’,¹¹ maybe also because of its historical tradition.¹²

Finally, it must be added that, even if theoretically all the cited terms are mere synonyms of the same concept, sometimes the chosen “title” has been considered fundamental for the decision of the case: for example, in the *SME* case the fact that the document was called “*intesa*” (“understanding”) leads to the conclusion that it was not intended to be obligatory.

From a linguistic point of view, the term “letter of intent” is of course more used in the English-speaking areas, and has many equivalents according to the country of reference. We find the term “*lettre d’intention*” in French, “*lettera d’intenti*” in Italian and “*carta de intencion*” in Spanish; in German areas, they seem to prefer the English term instead of the German word (“*Absichtserklärung*”).

I.1.2 Content and use

LOIs show a big variety not only in the ways in which they are called: they can also be extremely different also with regard to their style and to their content. LOIs can ‘vary from simple declarations to elaborate,

⁹ LAKE, DRAETTA, *Letters of Intent*, p. 5-6.

¹⁰ T. C. HOMBURGER, J. R. SCHUELLER, *Letters of Intent – A Trap for the Unwary*, in *Real Property, Probate and Trust Journal*, vol. 37, No 3, published by the American Bar Association, 2002, p. 511.

¹¹ LAKE, DRAETTA *Letters of Intent*, p. 5.

¹² The term “letter of intent” has a particular historical tradition, in fact it was originally used on the United States stock market (see M. FURMSTON, T. NORISADA J. POOLE, *Contract Formation and Letters of Intent*, John Wiley & Sons Ltd, Chichester, 1998, p. 143).

lengthy documents that are signed by all parties and resemble to contracts'.¹³ It has been said that the term "letter of intent" describes the kind of legal document, not its content, which can therefore be extremely various.¹⁴ Here I will propose a classification, that is not to be considered totally exhaustive and comprehensive, and – more importantly – that must not be interpreted as "rigid", because in the practice many of the listed functions overlap in the same LOI. However, it could be helpful in understanding the frequency and generality in the use of LOIs:¹⁵

- 1) *Assurance LOIs*: they are used mainly to show seriousness of intention, and as an indication that a negotiation is proceeding;
- 2) *Framework LOIs*: they represent frameworks for future negotiations, and are used especially in complex transactions;
- 3) *Publicity LOIs*: in this case, LOIs are adopted as instruments that justify or suggest the publicity of the negotiation;
- 4) *Memorialization LOIs*: 'the most important use of letters of intent is to record preliminary agreements, partial agreements, and even areas that are not agreed during the process of a negotiation';¹⁶
- 5) *Contracts*: sometimes, LOIs are formally called like this but in the practice they are not mere pre-contractual documents, but proper contracts.

LOIs demonstrate a big variety also in the contexts in which they are used: they show their presence especially in deals involving the sale of goods and services,¹⁷ finance,¹⁸ real estate¹⁹ etc., but, as their aim is to help in the process of negotiation, they are generally chosen also when the transaction is very big and

¹³ LAKE, DRAETTA *Letters of Intent*, p. 6.

¹⁴ See R. SPECIALE, *Contratti Preliminari e Intese Precontrattuali*, in *Annali della Facoltà di Giurisprudenza di Genova – Collana di Monografie*, n. 63, Giuffrè, Milano, 1990, p. 215-2016.

¹⁵ The same classification is also contained in LAKE, DRAETTA *Letters of Intent*, p. 12 and following. Other classifications have been proposed; for example, in 1977 the Working Group on International Contracts led by Prof. M. Fontaine produced a Report on Letters of Intent and divided them in four broad categories (definitive contracts with particular variations; stages in the negotiation; letters without binding effect and clauses excluding liability; documents indicating firm agreement about certain particular aspects of the negotiation): see M. FONTAINE, F. DE LY, *La redazione dei contratti internazionali a partire dall'analisi delle clausole*, in *Contratti & Commercio Internazionale*, Giuffrè, Milano, 2008.

¹⁶ LAKE, DRAETTA *Letters of Intent*, p. 16.

¹⁷ For an understanding of the most common problems in the use of LOIs in contracts of sale, see J. A.GOODMAN, *Legal Ramifications of a Letter of Intent*, in *The Legal Edge*, 2004, and S. GELLERSTEIN, *Crafting Letters of Intent in Purchase Contracts*, in *Mid Atlantic Real Estate Journal*, 2009. For a general comment on the use of LOIs in sale and purchase agreements, see also J. FERIANCEK, *What Did You Agree to in Your Letter of Intent?*, in *Natural Resources & Environment*, vol. 23, No 1, 2008, p. 42-44.

¹⁸ See M. FURMSTON, T. NORISADA, J. POOLE, *Contract Formation*, p. 143: 'In financial circles a letter of intent is referred to as a 'commitment letter' in which the essential terms for the loan agreement, such as the amount of the loan, the interest rate and a description of any security, are recorder together with the assurance that the loan will be granted'.

¹⁹ See K. S. FIELDS, *Letters of Intent May Be Binding*, 2004: 'Most real estate transactions begin with a letter of intent ("and LOI") which outlines the parties' general understanding of a proposed transaction'. See also FURMSTON, NORISADA, POOLE, *Contract Formation*, p. 143: 'in some jurisdictions a document called a 'binder' may be used in real estate transactions. This document contains such basic terms as a description of the property and the price together with a provision stating that the purchaser's obligation to purchase is subject to obtaining finance'.

complex, like in corporate acquisitions and mergers²⁰: in other words, they are mainly applied in the area that could be defined as ‘contracts with high economic content’.²¹ Additionally, they are employed not only in the private sector, but also in the public one: in particular, they are often ‘used in transactions among states and international organizations and by municipal government authorities’.²²

1.1.3 Advantages and disadvantages

In conclusion, we can affirm that the system of LOIs is absolutely widespread and is adopted in many situations and contexts, being flexible and adaptable to different purposes and goals.

Additionally, ‘the fact that so many sophisticated business transactions involve the use of letters of intent is alone evidence of their importance. Conducting business transactions without them can be both less efficient and more dangerous’,²³ because they inject a degree of certainty in the negotiation process.

A direct consequence of this is the fact that LOIs have an extraordinary potential to save time and money: ‘if the parties can agree on essential terms quickly, confirming those terms in a letter of intent encourages the parties to expend the resources necessary to close the deal, and the time and expense of due diligence and final negotiations become more palatable’.²⁴

Moreover, LOIs are often used with regards to their “moral” and “ethical” aspects: ‘another common explanation for why LOIs are effective is that business professionals who sign them feel a moral obligation to comply with their terms, and this moral obligation is sufficient to deter noncompliance’,²⁵ also the reputational consequences of non-compliance are often taken into account and feared by business professionals.²⁶

However, as Professor Allan Farnsworth has flatly said, ‘it would be difficult to find a less predictable area of contract law’.²⁷ In spite of all the above mentioned advantages, in fact, pre-contractual instruments show a big ambiguity: this is surely to be seen as a disadvantage in the system, even though businessmen express sometimes a different opinion.²⁸ This ambiguity is caused mainly by the reasons that I have already mentioned in the introduction: firstly because of the controversial nature of LOIs, secondly because of the dissimilarities among different legal traditions, and thirdly because of the fact that LOIs are seldom drafted

²⁰ See FURMSTON, NORISADA, POOLE, *Contract Formation*, p. 143: ‘In the lengthy transactions for merger and acquisition and sale of assets, a document called ‘memorandum of intent’ or ‘agreement in principle’ is frequently drafted to make it clear that some fundamental terms have been agreed upon, that a proposal to sell will not be made to a third party and that a formal contract is to be executed later’.

²¹ See SPECIALE, *Contratti Preliminari*, p. 218.

²² LAKE, DRAETTA *Letters of Intent*, p. 3.

²³ HOMBURGER, SCHUELLER, *Letters of Intent*, p. 511-512.

²⁴ M. D. WILLIAMSON, *Letters of Intent: Their Use in Minnesota Business Transactions*, in *Bench & Bar of Minnesota*, vol. 64, No 10, 2007. See also E. KORN, S. MEISENZAHN, *Contracting Still Matters! Or: How (and Why) to Design a Letter of Intent*, in 2009, p. 28: ‘Letters of intent themselves contribute to solving the underinvestment problem by turning unverifiable information into verifiable one’. On the economic impact of LOIs and on the related costs, see also A. SCHWARTZ, R. SCOTT, *Precontractual Liability and Preliminary Agreements*, in *Harvard Law Review*, vol. 120, No. 3, 2007, p. 661-707.

²⁵ J. A. HOLTEN, *Letters of Intent in Corporate Negotiations: Using Hostage Exchanges and Legal Uncertainty to Promote Compliance*, in *University of Pennsylvania Law Review*, vol. 162, issue 5, 2014, p. 1250.

²⁶ *Ibid.*, p. 1249.

²⁷ A. FARNSWORTH, *Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations*, in *Columbia Law Review*, vol. 87, No. 2, 1987, p. 259-260.

²⁸ See HOLTEN, *Letters of Intent in Corporate Negotiations*, p. 1240: ‘Business professionals value vagueness as a positive attribute of LOIs, and ambiguity is often intended’.

by lawyers. In this first chapter, I will focus my attention on the issue of the controversial nature of LOIs, describing the three elements that cause this ambiguity: the problem of contract formation, the binding or not binding nature of LOIs and the issue of good faith and pre-contractual liability.

What must be preliminarily highlighted is that the general “obscurity” which characterizes the system of LOIs is of course undesirable for business communities, and that the fact that they are used in many big and important cases and transactions increases the gravity of this problem: therefore, the aim of this study, as I have already mentioned, is not only to describe the problems, but also to provide tools to improve the system, to delete this controversial nature and to collocate LOIs out of what has been defined an ‘unclear grey zone’.²⁹

I.2 The most important problems arising from the system of LOIs

I.2.1 Contract formation

The first element determining the controversial nature of LOIs is, as we said, the problem of contract formation: in other words, when looking at a legal document, it is sometimes very difficult to identify the “line” between the pre-contractual area and the contractual moment and to classify it as a pre-contractual document or a proper contract.

This issue is surely interesting from a theoretical point of view, but in a practical perspective it is not only interesting; it is crucial. A contract is a very specific legal instrument, with a peculiar definition and precise outcomes, such as the rise of obligations and, consequently, of contractual liability in case of breach; moreover, a contract gives the possibility to claim for its performance and even the chance terminate it. These are only examples of the legal effects of a proper contract, but they render the idea of the power of this instrument; power which is undoubtedly lower and less clear in case of a “mere” pre-contractual document like a LOI. Therefore, it is fundamental to have criteria and tools to operate this distinction.

Therefore, the first thing to do when analyzing the legal value of a LOI is trying to understand if it can be considered a contract because it was formed like a contract (“*test on contract formation*”). In spite of the relevant differences among countries, a general principle seems to be common:

‘The classic distinction between contract law and other sources of legal obligation is that contract is grounded in voluntary agreement. The fundamental principle of contract formation, it follows, is that there must be mutual assent in order to establish a binding contractual obligation’.³⁰

Therefore, the existence of an exhaustive agreement is essential for the formation of a contract. This identifies the first big difference between contracts and LOIs: LOIs generally do not contain full commitments, giving to the parties the chance to complete them in detail in the future, and leaving open

²⁹ See M. LUTTER, *Der Letter of Intent: zur rechtlichen Bedeutung von Absichtserklärungen*, Heymanns, München, 1983, p. 3.

³⁰ B. E. HERMALIN, A. W. KATZ, R. CRASWELL, *Chapter on the Law and Economics of Contracts*, forthcoming in *The Handbook of Law & Economics* (final draft: June 2006), p. 58.

some margins of uncertainty on the juridical character of the agreement;³¹ contracts, on the other hand, are complete documents considered enforceable by both parties.

But when is a proper “agreement” reached? Generally speaking, an agreement is formed, and therefore a contract is executed, when the proposal of one party (the offeror) is accepted by the other party (the offeree):³² this is the key rule that draws the line between ‘what is and what is not a contract’.³³ This rule could apparently seem very easy to put into practice, but, if we consider it more carefully, we face an enormous interpretative problem: what do “offer” and “acceptance” really mean?

The notion of “offer” is usually identified as an expression of willingness to contract made with the mutual intention that the agreement in object shall become binding. This “intention to be bound” is a fundamental element to define a contract and to distinguish it from a “mere” LOI.

What about the “acceptance”? Is it sufficient to say “yes” or is the relevant moment another one?

To answer these questions, we must necessarily enter into the contract theory. In particular, we find four main theories that give different interpretations to the issue of “acceptance”:

- 1) *The “declaration theory”*: this theory identifies the acceptance when the offeree produces some external manifestation of his intent to accept the offer, even if this is not known by the offeror;
- 2) *The “mail box rule”*: according to this theory, a proposal is accepted when the offeree dispatches the acceptance of the offer;
- 3) *The “reception theory”*: as the name suggests, in this case an offer is to be considered accepted when the acceptance reaches the offeror’s address;
- 4) *The “information theory”*: the receipt of an offer is not sufficient: the offeror must have actual knowledge of the acceptance.

As we will see in detail in chapter II, each country has adopted one of these theories, or a mixture of two; for example, the “mail box rule” characterizes most common law countries, while the “reception theory” is extensively used in civil law countries (with remarkable differences among them).

International law, in any case, establishes a common trend which denotes a privilege for the “reception theory”, partially weakened by the residual criterion of the “declaration theory”: art. 18.2 of the United Nations Convention on Contracts for the International Sale of Goods (CISG) states that “*an acceptance of an offer becomes effective at the moment the indication of assent reaches the offeror*”, while art. 18.3 continues: “*However, if, by virtue of the offer or as a result of practices which the parties have established between themselves or of usage, the offeree may indicate assent by performing an act, such as one relating to the dispatch of the goods or payment of the price, without notice to the offeror, the acceptance is effective at the moment the act is performed, provided that the act is performed within the period of time fixed by the offeror or within a reasonable time*”.

³¹ See A. LISI, *Lettere di intenti e documenti precontrattuali nel commercio internazionale*, 2003;

³² See HERMALIN, KATZ, CRASWELL, *Chapter on the Law*, p. 58: Lawyers often say that to form an agreement there must be an offer (which evidences one party’s assent) and also an acceptance (which evidences the counterparty’s assent); and thus this body of doctrine is often referred to as the law of offer and acceptance’.

³³ S.A. SMITH, *Contract theory*, in *Clarendon Law Series*, Oxford University Press, Oxford, 2004, p. 167.

The UNIDROIT Principles 2010 of International Commercial Contracts adopt the same criteria (art. 2.1.6.2 and 2.1.6.3).

According to this analysis, the issue of contract formation seems to be quite easy and straight-forward: the key element of contract formation is the agreement, the agreement exists when an offer is accepted and the four theories explains the relevant moment to define the “acceptance”.

This reasoning surely works for simple transactions; however, the more the transaction is complex,³⁴ the more the mechanism shows gaps and problems. Additionally, it fails to consider the negotiation phase as a moment when a contract, and therefore legal obligations, could potentially arise:

‘the doctrine of offer and acceptance still perceives complex transactions as simple dealings. It therefore fails to take into account the process whereby parties shape their agreements. Consequently, if a contract is formed in negotiations, the courts often ‘reason backwards’ declaring that a contract exists, and then look for ‘something that resembles offer and acceptance.’³⁵

In conclusion, the system of offer and acceptance as the key mechanism to understand the line between pre-contractual and contractual documents shows at least two kind of inconveniences:

- 1) the high numbers of theories could create problems in case of transnational transactions: in one country (adopting, e.g., the “mail box rule”) a contract could be considered executed, while in the other one (adopting, e.g., the “reception theory”) the answer could be negative; in this case, a choice-of-law clause could be a good tool to insert clarity in the relationship, even though, as we will see in chapter III, interpretative problems are in any case likely to arise;
- 2) the mechanism is not tailored for complex transactions and for the negotiation phase, forcing Courts to adopt alternative interpretations.

1.2.2 Could LOIs be considered legally binding as “de facto” contracts?

Let’s assume that, following the analysis explained in the previous paragraph, our conclusion is that the legal document we are dealing with is not a contract, but a “mere” LOI. In this case, we have unfortunately fallen into the most difficult situation: when we have a contract, we are more or less able to predict its legal effects and its implications, but when we are facing a pre-contractual document, there are not clear and rigid rules. This peculiarity is exacerbated by the fact that LOIs are often very vague and ambiguous in terms of their legal effect, and rarely state clearly if they are binding or not.³⁶

³⁴ Consider, for example, the complexity of the transaction through the Internet, where the offer and acceptance mechanism shows all its weakness (see A. RAWLS, *Contract Formation in an Internet Age*, in *The Columbia Science and Technology Law Review*, vol. X, 2009).

³⁵ E. PANNEBAKKER, *Offer and Acceptance and the Dynamics of Negotiations: Arguments for Contract Theory from Negotiation Studies*, in *Erasmus Law Review – University of Rotterdam*, vol. 6, n. 2, 2013, p. 136.

³⁶ See FURMSTON, NORISADA, POOLE, *Contract Formation*, p. 147: ‘This vagueness in expressing the legal effect of a document can also be attributed to the fact that a letter of intent may be an ‘un-gentlemen’s agreement’ which is intended to bind one party while giving the other a free hand’.

Consequently, there could be the possibility that the LOI we are considering is a LOI from a formal and theoretical point of view, but that in its intimate nature, it is binding like a contract: I would say that the LOI in this case is a contract not by definition, but “*de facto*” (“*test on de facto contract*”).

The first step to demonstrate that a LOI is a “*de facto contract*”, and therefore binding and enforceable, is to understand if the parties had the intention to create binding obligations with that document. This intention, as we said, is an essential element of a contract: ‘absent a manifestation of an intent to be bound (...) negotiations concerning the terms of a possible future contract do not result in an enforceable agreement’.³⁷

However, this assessment requires an analysis which of course shows big margins of uncertainty: which is the meaning of “intention” and which are the rules to delineate it in a scientific and objective way? An answer could be the following:

‘Whether a party intended to be bound by the LOI will be determined by assessing what an objective observer would reasonably believe the party intended, based upon the words (written or not) or the actions (and, in a limited number of scenarios, the inactions) of the party’.³⁸

That is clearly a grey area which does not offer satisfactory answers from a theoretical point of view: the only way to interpret the “intention” of the parties from the perspective of an “objective observer” and to conclude that the document is a *de facto contract*, is to focus the attention on the practical side and to see from a concrete point of view based on doctrine and jurisprudence:

- 1) which are the kind of LOIs that are generally considered binding;
- 2) which are the individual clauses of a LOIs that are more likely to be seen as obligatory.³⁹

In this paragraph, I will describe these two points in general, leaving to chapter II the illustration of the differences among juridical systems: here I will explain the overall tendency, but we will see that in some countries some LOIs or some clauses are considered binding more frequently than in others.

1) *The kind of LOIs that are generally considered binding*

a. ‘The most frequently enforced letter of intent is a document that, notwithstanding its “letter of intent” title, embodies all the material terms of a transaction and indicates the agreement of the parties regarding them’.⁴⁰ in other words, a document that in practice contains all the elements of a complete contract must be treated as such, regardless of the “formal” name. This is a direct application of the general principle of international law stating the irrelevance of the *nomen iuris* of a document in favour of its concrete content;

³⁷ *Philmar Mid-Atlantic, Inc. v. York Street Associates II*, 566 A.2d 1253 (Pa. Super. Ct. 1989).

³⁸ I. MEISLIK, *A Letter of Intent is Enforceable. A Letter of Intent is not Enforceable*, 2012, p. 1;

³⁹ The list I will provide relies on the classification offered in LAKE, DRAETTA *Letters of Intent*, and confirmed also in more recent works, such as D. NAYLOR, M. GREEN, *Recent Developments in Letters of Intent*, , 2007.

⁴⁰ LAKE, DRAETTA *Letters of Intent*, p. 92. See also B. JEFFRIES, *Preliminary Negotiations or Binding Obligations? A Framework for Determining the Intent of the Parties*, in *Gonzaga Law Review* (forthcoming), 2014, and K. SHELLEY, J. TORONTO, *Preliminary Agreements: How To Avoid Unintended Contractual Obligations*, in *Franchise Law Journal*, vol. 25, No 2, 2005, p. 47: ‘Indefiniteness may show a lack of finality and a corresponding lack of intention to be bound. Conversely, definiteness of terms may demonstrate finality and reasonably imply such an intention’.

b. Some LOIs contain the specific request from a party to the other to initiate the performance of the obligations under negotiation (an “instruction to proceed” or “authority to proceed”): for this peculiar connection with the performance of a contract, they are commonly considered binding;⁴¹

c. The documents that ‘contain provisions relating to supplies of goods or services subdivided into “lots”’⁴² are also considered contracts, especially with respect to the delivery of the first lot (while ‘the legal implications of the remaining part of the letter of intent, that is, the part relating to future lots, are more questionable’;⁴³

d. Some LOIs are, from a factual point of view, proper contracts not yet operative. This is the case of an agreement on all the terms of a contract, but with the provision ‘that it becomes operative only when one or both parties have performed one of their contractual obligations’;⁴⁴

e. Another relevant category of LOIs that are commonly considered binding is the one of documents that grant the right of first refusal.

2) *The individual clauses of a LOI that are more likely to be seen as obligatory*

This group contains all those clauses that doctrine and jurisprudence usually consider binding even though the LOI as a whole is not.⁴⁵ ‘Such provisions do not generally refer to the material terms of the transaction under negotiation, but to some ancillary understandings that are related to, or necessary for, the negotiation’.⁴⁶

a. Confidentiality agreements and secrecy obligations are always considered binding. They are fundamental in the drafting of a good LOI, establishing a mutual obligation to keep confidential and not to disclose to any third party or to disseminate any confidential information connected with the LOI and generally subjecting all press releases to agreement between the parties⁴⁷;

b. Good faith obligations and “best efforts” clauses are also key points in LOIs and are generally considered enforceable. These two notions are often confused, but they are not the same: in particular, the

⁴¹ See LAKE, DRAETTA *Letters of Intent*, p. 108: “A typical example is that of negotiations concerning the sale of aircraft, where a buyer wants to purchase immediately a given number of aircraft, at the same time expressing its intention to buy an additional number later”.

⁴² *Ibid.*, p. 118.

⁴³ *Ibid.*, p. 119.

⁴⁴ *Ibid.*, p. 120.

⁴⁵ A LOI can be totally enforceable or totally not enforceable, but there is a zone in the middle where some parts are, and others are not. See MEISLIK, *A Letter of Intent is Enforceable*, p. 1: “Is a letter of intent enforceable? (...) It could be: (A) yes; (B) no, not at all; (C) some parts yes, and some parts no”.

⁴⁶ LAKE, DRAETTA *Letters of Intent*, p. 124.

⁴⁷ On the importance of confidentiality agreements in an acquisition agreement, see G. A. PIETRAFESA, *The Importance of Confidentiality Agreements and Letters of Intent*, in *New Jersey Lawyer – The Magazine*, No. 20, 2002.

best efforts standard is more demanding than the good faith one, requiring the parties to be diligent in reaching a result;⁴⁸

c. Of course, clauses referring to future contracts to negotiate are considered enforceable in the sense that on one hand they clearly make the entire LOI not binding, but on the other hand they oblige the parties to conclude a future contract within a certain period of time. This kind of clause identifies the so-called contract “preliminary only in form”;⁴⁹

d. Clauses concerning the sharing of expenses have also a binding nature.

If the LOI or the clause we are considering does not fall into these lists, which are generally recognized by doctrine and jurisprudence, it is in any case possible to give evidence that the real intention of the parties was to be bound by the document, as we said at the beginning of this paragraph. In particular, courts will look at the actual wording of the document, at trade practices and conducts,⁵⁰ at the context of the negotiations and at all the circumstances of the case⁵¹, in this way trying to characterize the purpose of the letter either as:

‘ (1) a mere gesture showing interest in the possibility of a transaction (...); (2) a serious commitment to negotiate toward agreement upon a possible transaction (...); (3) an orderly collection of the necessary contractual terms ready to be binding, but missing the key ingredient – the intent to be bound (...); and (4) a patently enforceable contract, albeit in an abbreviated or informal format’.⁵²

However, as we have already mentioned, the margins of uncertainty are very high and this analysis is sometimes extremely complex; ‘unfortunately for courts called upon to weigh these competing interests, there are no bright-line rules for how to determine the parties’ intent to be bound by either a preliminary written agreement or by an oral agreement’.⁵³ Consequently, courts do not show an homogeneous way to interpret the intention of the parties, relying in some cases on a “subjective” approach, and in others on a more strict and “objective” one.⁵⁴

Therefore, one of the “golden rules” of the drafting of LOIs, in my opinion should be – as we will see more deeply in chapter III – to state clearly if, and to which extent, the entire document or some of its parts are to be considered binding or not binding. In this way, every interpretative problem is overcome and, through a simple clause, the issue of the LOI as a “*de facto* contract” and of its enforcement is solved.

1.2.3 Good faith and pre-contractual liability

Let’s imagine that our document has failed both the tests explained in the previous two paragraphs, and that it cannot be classified as a contract either from a formal point of view or from a factual one. Is that

⁴⁸ See LAKE, DRAETTA *Letters of Intent*, p. 130.

⁴⁹ See SHELLEY, TORONTO, *Preliminary Agreements*, p. 48.

⁵⁰ See FURMSTON, NORISADA, POOLE, *Contract Formation*, p. 174.

⁵¹ See WILLIAMSON, *Letters of Intent: Their Use*, p. 5.

⁵² G. G. GOSFIELD, *Real Estate Law – The Structure and Use of Letters of Intent*, in *GPSolo Magazine*, 2004.

⁵³ B. JEFFRIES, *Preliminary Negotiations or Binding Obligations?*

⁵⁴ See HOMBURGER, SCHUELLER, *Letters of Intent*, p. 518-525, and WILLIAMSON, *Letters of Intent: Their Use*, p. 4.

“the end of the game” or is it possible to find a third way to consider the LOI binding and enforceable? In other words, ‘if a contract is not found, the question arises whether one of the parties can be liable on a theory that does not require the existence of a contract or of a complete contract’.⁵⁵

This theory is the theory of good faith and pre-contractual liability, according to which a party is considered liable not because the document underpinning the relationship is necessarily a proper contract, but because that document contained a duty of good faith that the party has breached.⁵⁶ Therefore, I will call this third step “*test on good faith*”.

As we can understand, the definition of good faith is difficult and almost impossible, being strongly connected with the concrete case and with the sensitivity of the judge. Some authors have described it as a ‘nebulous doctrine’⁵⁷, an ‘elusive idea’⁵⁸ created with the aim ‘to provide a corrective approach in situations where the strict application of the law has unacceptable results’,⁵⁹ and hiding in itself the danger of interpretative subjectivity. Others have defined good faith as a ‘general clause’ potentially susceptible of any kind of content, and have highlighted the risk to transform it in a sort of “Pandora vase” and to extrapolate from it the most disparate solutions.⁶⁰

What we can delineate with some grade of certainty is first of all a distinction between “subjective good faith” (‘requiring honesty in fact’)⁶¹ and “objective good faith” (‘requiring compliance with standards of fair dealing’).⁶² But objective good faith creates many interpretative problems: which are these standards and which is the authority that should impose them? According to the doctrine of the “normative version of good faith”, the legislator has the duty to draft and to bind contractors with these standards, while the “contextual version of good faith” makes reference to the standards already accepted by a particular group of contractors.⁶³ In my view, although the first theory is more general and apparently gives more certainty to the issue of good faith, the second one reflects better the specificity of the case and is therefore more realistic and tailored to the concrete situation.

Being so difficult to define the notion of good faith, there are not rigid characterizations of the behaviours highlighting its breach: they are usually identified on a case-by-case basis. To make some examples, pre-contractual liability may arise in cases such as conduction of parallel negotiations, unjustified withdrawal from negotiations, bad faith revocation of an offer,⁶⁴ conclusion of an invalid contract knowing about this invalidity, breach of information duty (the so-called “duty of disclosure”)⁶⁵, disclosure of confidential

⁵⁵ LAKE, DRAETTA *Letters of Intent*, p. 171.

⁵⁶ See on this point R. E. TESTANI, K. E. LENTZ, *Avoiding “Benefit of the Bargain” Damages in Letters of Intent*, in *Business Law Today – The ABA Business Law Section’s Online Resource*, 2010, p. 1: ‘Is “breach” even the right word? Or is the proper rubric “bad faith”?’.

⁵⁷ See M. SORNARAJAH, *Introduction*, in *Good Faith and International Economic Law*, edited by A. D. Mitchell, M. Sornarajah, T. Voon, Oxford University Press, 2015, p. 1.

⁵⁸ R. BROWNSWORD, N. J. HIRD, G. HOWELLS, *Good Faith in Contract: Concept and Context*, in *Good Faith in Contract. Concept and Context*, edited by R. Brownsword, N. J. Hird, G. Howells, Ashgate Publishing Company, Aldershot, 1999, p. 3.

⁵⁹ *Ibid.*

⁶⁰ See P. GALLO, *Contratto e buona fede: buona fede in senso oggettivo e trasformazioni del contratto*, UTET Giuridica, Torino, 2014, p. 605-606.

⁶¹ BROWNSWORD, HIRD, HOWELLS, *Good Faith in Contract*, p. 4.

⁶² *Ibid.*

⁶³ *Ibid.*

⁶⁴ See SMITH, *Contract theory*, p. 198.

⁶⁵ See T. WILHELMSSON, *Good Faith and the Duty of Disclosure in Commercial Contracting – the Nordic Experience*, in *Good Faith in Contract. Concept and Context*, edited by R. Brownsword, N. J. Hird, J. Howells, Ashgate Publishing Company, Aldershot, 1999, p. 166.

information and misuse of negotiation (e.g. negotiating without intending to conclude a contract or preventing the other party from negotiating competing deals). Therefore, even if there is not a specific clause establishing a good faith obligation, pre-contractual liability is often found as implied in the contract itself according to the interpretation of the concrete case and of the behaviours of the parties.

Historical legal consequences of the breach of the duty of good faith are the cancellation of the contract and the compensation of damages. The latter, according to recent case law, are not only the actual damages – like the expenses –, but also the consequential damages⁶⁶ if they were ‘in the contemplation of the parties at the time the contract was made’.⁶⁷

Good faith is one of the areas where the differences among legal traditions are more evident: common law imposes no general duty of good faith, while ‘European states (...) have been somewhat more receptive to the idea, often referred to as *culpa in contrahendo*’.⁶⁸ We will fully analyze these aspects in chapter II; here it is useful to start having a look at what international law says. UNIDROIT Principles 2010, for example, contain a list of provisions on good faith. Artt. 2.1.15.1-2-3 state: “*A party is free to negotiate and is not liable for failure to reach an agreement (...) However, a party who negotiates or breaks off negotiations in bad faith is liable for the losses caused to the other party (...) It is bad faith, in particular, for a party to enter into or continue negotiations when intending not to reach an agreement with the other party*”.

Artt. 5.1.4.1.-2 continue: “*To the extent that an obligation of a party involves a duty to achieve a specific result, that party is bound to achieve that result (...) To the extent that an obligation of a party involves a duty of best efforts in the performance of an activity, the party is bound to make such efforts as would be made by a reasonable person of the same kind in the same circumstances*”.⁶⁹

A complicated aspect is the nature of good faith and pre-contractual liability. This is not merely a matter of definition: if the pre-contractual liability is assigned to a certain legal category, this means that it has some specific consequences that can be very different from those belonging to another category: for example, in jurisdictions like Italy the rules on the burden of proof or on the limitation of action vary considerably if we look at the “tort law” sphere or at the “contractual” area. Here we will address the issue from a theoretical point of view, leaving to chapter II the detailed analysis of the aptitudes of the countries and of the differences among them.

Generally speaking, pre-contractual liability can be alternatively defined as:

1) *liability in tort*

⁶⁶ See for example *Venture Associates Corp. v. Zenith Data Systems Corp.*, 96 F. 3d 275 (7th Circ. 1996) and the words of judge Posner: ‘Damages for breach of an agreement to negotiate may be (...) the same as the damages for breach of the final contract that the parties would have signed had it not been for the defendant’s bad faith (...) But if the plaintiff can prove that had it not been for the defendant’s bad faith the parties would have made a final contract, then the loss of the benefit of the contract is a consequence of the defendant’s bad faith and, provided that it is a foreseeable consequence, the defendant is liable for that loss – liable, that is, for the plaintiff’s consequential damages’.

⁶⁷ TESTANI, LENTZ, *Avoiding “Benefit of the Bargain”*, p. 2.

⁶⁸ S. J. BURTON, E. G. ANDERSEN, *Contractual Good Faith. Formation, Performance, Breach, Enforcement*, Little, Brown and Company, Toronto, 1995, p. 330.

⁶⁹ For a comment on the concept of good faith in UNIDROIT Principles, see N. NEDZEL, *A Comparative Study of Good Faith, Fair Dealing, and Precontractual Liability*, in *Tulane European & Civil Law Forum*, vol. 12, 1997, p. 151 and following.

Many jurisdictions, such as for example the French one, connect bad faith to tort law instead of contract law, even if the liability materially derives from a contract.⁷⁰

2) *contractual liability*

This theory considers good faith as a condition connected directly to the contract, and has its theoretical grounds in the German legal tradition.

3) *a third kind of liability*

This residual category generally suggests a “mixture” between the first two; in chapter II we will see that recent Italian case law classifies the pre-contractual liability nor as a liability in tort nor as a proper contractual liability, but as a sort of “middle way” called “liability for social contact”.

In conclusion, it must be said that it is quite rare that a breach of a LOI is found to be completely without consequences: to obtain this result, the interested party should be able to give a negative answer to all of the three tests we have described. The document should not be a contract either from a formal point of view or from a factual one and, additionally, it should not give rise to pre-contractual liability. According to me, this third test is the most difficult to pass, because, as we said, a breach of good faith can be found and taken into account by the court even if the document is silent, i.e. even if there is not a clause specifically imposing the duty of good faith (but it is in any case highly suggested to insert this clause, to avoid any kind of confusion).⁷¹ One of the few ways to avoid the application of this kind of liability is to explicitly declare that it is excluded: in other words, ‘to avoid an argument that there is a binding obligation to negotiate in good faith (...) parties should expressly state that there is no such duty. In addition, proper care should be taken to avoid “contract-like” language in letters of intent’.⁷²

⁷⁰ See TESTANI, LENTZ, *Avoiding “Benefit of the Bargain”*, p. 1: ‘Could the duty of good faith negotiation that a letter of intent creates be a tort duty rather than contract duty, even though created by a contract?’

⁷¹ See for example HOMBURGER SCHUELLER, *Letters of Intent*, p. 531.

⁷² TESTANI, LENTZ, *Avoiding “Benefit of the Bargain”*, p. 3.

CHAPTER II – LOIs IN COMPARATIVE PERSPECTIVE

II.1 A short introduction: how to read this chapter

Before starting with the second chapter, it is necessary to make a short introduction and to explain the way in which to study it.

In reading the titles of the paragraphs, it could seem that section II.2 merely repeats the contents of the previous chapter (in particular, of section I.2). The themes are undoubtedly the same: contract formation, the legally binding nature of LOIs and the issue of good faith and pre-contractual liability (in short, the “three-tier test”). Moreover, they are treated in the same order as in chapter I.

What substantially differs is the perspective in which these topics are developed. In chapter I we have seen how each of these issues could be controversial in the context of LOIs and which are, generally speaking, the main concerns arising from it: we have analyzed the problems from a “theoretical” point of view, without explaining the ways in which each legal tradition deals with them.

That is exactly the purpose of this second chapter. Starting from the “theoretical grounds” established in the first chapter, we will now move from the general to the particular, from the theory to the practice, to see how the “three-tier” test presented in chapter I is interpreted and solved in different juridical systems (which, as I have already explained in the introduction, are English common law, France, Italy and Germany).

We will learn in this way that the same document can pass one test in one country and fail it in another one, and we will demonstrate that the same LOI could have completely different destinies according to the country of reference. We will see very different kind of results, from the most obvious to the most surprising.

II.2 The problematic areas of LOIs in a comparative perspective: English common law, France, Italy and Germany

II.2.1 Contract formation in comparative perspective

In paragraph I.2.1 we have said that a contract exists only in presence of some conditions. In particular, there must be an “agreement”, and therefore:

- 1) a mutual intention of the parties to be legally bound by the document,
- 2) a proper offer expressing this intention, and
- 3) a proper acceptance to the offer made by the offeror (to this respect, we have seen four possible theories defining the moment of acceptance).

In this paragraph we will see how these three points are developed in the surveyed legal traditions.

English common law

‘In common law countries there are no codes that define “contract”, although scholars in England and the United States generally agree that a contract is merely a “legally binding agreement”¹. Even if this definition has been criticized for many reasons (for example, for ignoring the element of consideration),² it is considered one of the most reliable in common law environments. It is very important to stress the fact that, to be legally binding, an agreement must necessarily satisfy some requirements, such as the completeness and the presence of consideration.

Consequently, an offer is the expression of willingness to contract made with the intention that it becomes binding. This definition is peculiar of many legal traditions, but what characterizes English common law in particular is the fact that

‘offers must contain enough details of the proposed contract so that acceptance can result in a complete agreement (...) The common law is generally more reluctant than the civil law to classify offers to the public, advertising, displays in shop windows, and other commercial communications as offers, as opposed to mere invitation to treat’.³

To this respect, therefore, English law seems to be quite strict in distinguishing between the pre-contractual and the contractual moments,⁴ and ‘the concept of offer (...) becomes rather technical under English law and limited to a relatively closed range of proposals’.⁵

An offer can be revoked by the offeror at any time prior to acceptance.

For what concerns acceptance, common law countries generally adopt the ‘mail box rule’, according to which a contract is concluded when the offeree simply dispatches the acceptance.⁶

The main requisite for an acceptance is that it exactly conforms to the offer: if it does not, we are in presence of a counter-offer which needs an acceptance from the original offeror. This is the so-called

¹ LAKE, DRAETTA, *Letters of Intent*, p. 26.

² See P. S. ATIYAH, *An Introduction to the Law of Contract*, in Clarendon Law Series, Clarendon Press, Oxford, 1995, p. 37 and following.

³ LAKE, DRAETTA, *Letters of Intent*, p. 29.

⁴ Pre-contractual negotiations are also generally excluded from the interpretation of the terms of the contract, even if some doctrine argues that, when appropriate, this exclusionary rule should be waived (see F. BOTCHWAY, K. CHOONG, *Not ready for Change? The English Courts and Pre-Contractual Negotiations*, in *The International Lawyer*, vol. 45, No 2, 2011, p. 625-645).

⁵ P. OWSIA, *Formation of Contract. A Comparative Study under English, French, Islamic and Iranian Law*, Graham & Trotman Limited, London, 1994, p. 409. See also P. GILIKER, *Role for Tort in Pre-Contractual Negotiations? An Examination of English, French, and Canadian Law*, in *The International and Comparative Law Quarterly*, Vol. 52, No. 4, 2003, p. 969: ‘The common law has traditionally regarded the question of pre-contractual liability as a matter of contract formation. Where the claimant is able to satisfy the rules of offer and acceptance, consideration, an intention to be bound, and certainty, contract law possesses a number of tools capable of resolving disputes arising prior to contract’.

⁶ Some authors are very critical towards this doctrine. See K. ZWEIGERT, H. KÖTZ, *An Introduction to Comparative Law*, Clarendon Press, Oxford, 1998, p. 358: ‘The ‘mailbox’ theory was originally attributed to the view that the offeror implicitly authorized the Post Office to act as his agent for the receipt of acceptances (...) The real reason for the rule was the need to minimize the period during which the offeror could withdraw his offer’.

“mirror-image rule”, which some doctrine has critically defined as an ‘arcane and colourfully named mechanical rule’.⁷

Acceptance by silence is generally not considered valid, even if courts have been wrestling with the matter for a long time, in the waves of the “movement against formality” that characterizes some common law doctrine.⁸

France

Similarly to English common law, ‘in the French legal system a binding contract is defined as an agreement by two or more parties intending to create legally enforceable obligations among themselves’.⁹ However, France is part of the civil law system, and therefore the issue of consideration as fundamental part of a contract is not contemplated.

Also in France, like in common law, an offer is a declaration of willingness to contract made unilaterally by one party, but here proposals like a display of articles in a shop are usually considered offers: ‘the general tendency is to characterize as an offer any proposal that does not clearly indicate its contrary intent, provided it contains the essential elements of the contract contemplated’.¹⁰ French case law demonstrates to this respect wide margins of flexibility, defining as an offer the mere presence of a taxi at a taxi stand, and declaring liable for breach of transport contract the taxi driver that starts moving the vehicle before the passenger is in.¹¹

In spite of this big difference with common law, the French system shows the same rule with regards to the withdrawal prior to acceptance. However, it adds some exceptions to this general freedom, such as the respect of the period of time necessary to the offeree to duly examine the offer.

The moment of acceptance is in France very disputed; in particular, both the “mail box rule” and the “receipt rule” have their supporters. Also the French Court de Cassation is not constant in the interpretation: in particular, it ‘has constantly held that the time of effective acceptance depends on the circumstances of the individual case’.¹² However, ‘the doctrine of the receipt of acceptance, according to which the contract is formed when the acceptance is received by the offeror, seems (...) to be the one prevailing’.¹³

In France, like in common law, the “mirror-image rule” requires the conformity of the acceptance to the offer, even though some case-law does not show an excessive rigidity to this respect, allowing, in certain situations, the court to interpret the real intention of the parties.

Acceptance by silence is generally not considered valid.

⁷ HERMALIN, KATZ, CRASWELL, *Chapter on the Law*, p. 58.

⁸ See in particular A. W. KATZ, *The strategic Structure of Offer and Acceptance: Game Theory and the Law of Contract Formation*, in *Michigan Law Review*, vol. 89, No. 2, 1990, p. 215-295.

⁹ LAKE, DRAETTA, *Letters of Intent*, p. 44.

¹⁰ *Ibid.*, p. 45-46.

¹¹ See COUR DE CASSATION [Cass. Civ.], Dec. 2, 1969, D. 197 O.J. 104

¹² ZWEIGERT, KÖTZ, *An Introduction to Comparative Law*, p. 361.

¹³ LAKE, DRAETTA, *Letters of intent*, p. 48.

Italy

Art. 1321 of the Italian civil code (Italian Royal Decree 16.3.1942 n. 262) defines a contract as the agreement of two or more parties to establish, regulate, or extinguish a legal relationship among themselves, having an economic content.

‘Similar to its French definition, an “offer” in Italian law is defined as a unilateral declaration of will, expressed by an offeror having legal capacity to make a contract to an offeree having legal capacity to make a contract’;¹⁴ additionally, there is a general *favor* towards the definition of a proposal as an offer. That means that, like in France, a price exposed in a shop is usually interpreted as an offer and not as a mere invitation to treat, like in English common law.¹⁵

Also in Italy an offer can be withdrawn at any time prior to the formation of contract; like in France, however, there are some exceptions, for example situations in which ‘an offeror has agreed not to revoke the offer for a certain period of time and options’.¹⁶

Differently from English common law and French law, in Italy the rule of acceptance is based on the so-called “information theory”, according to which a contract can be considered concluded only when the offeror has knowledge of the acceptance. That is clearly the strictest rule, very far from the “mail box theory” typical of common law countries. However, the Italian system offers a presumption according to which an offer is considered accepted once the acceptance reaches the address of the offeror: in other words, we are in presence of an “information theory” weakened by a presumption based on the “reception theory”.

Finally, the “mirror-image” rule is present also in Italy, but, like in France,

‘even if there was no agreement on certain points, parties may produce evidence that these points were not such as to prevent the formation of a valid contract covering the points agreed upon. Courts may determine the intent of the parties’.¹⁷

We find another correspondence with the French system in the rule according to which acceptance by silence is generally considered invalid.

Germany

In Germany – one of the countries where contract theory sees its historical origins – ‘a contract consists of the agreement by two or more parties on a matter having legal relevance’.¹⁸

Like in the above-examined systems, an offer in Germany is a unilateral declaration of will through which the offeror express his intention to be bound by the contract after the simple acceptance of the same.

However, in spite of this similarity, Germany shows a relevant difference for what concerns the possibility to revoke the offer. We have seen that in English common law, France and Italy this is admitted with the

¹⁴ *Ibid.*, p. 49.

¹⁵ See A. TORRENTE, P. SCHLESINGER, *Manuale di Diritto Privato*, Giappichelli, Torino, 2013, p. 498-499.

¹⁶ LAKE, DRAETTA, *Letters of intent*, p. 50.

¹⁷ *Ibid.*, p. 51.

¹⁸ *Ibid.*, p. 52.

condition that it is done before the acceptance; in German law, instead, ‘the offeror is ‘bound’ by his offer (...) in the sense that he cannot withdraw it (...): rather than giving rise to liability in damages, a purported withdrawal simply has no legal effect at all’.¹⁹

Moreover, differently from Italian and French law and similarly to English common law, a mere proposal is generally considered to be an invitation to treat and not a proper offer.

Speaking about acceptance, Germany adopts the “reception theory”, integrated with the above-mentioned “mirror-image rule”.

Differently from all the other systems object of this analysis, there are some cases in which Courts have attributed some significance to silence, especially in the field of commercial letters of confirmation.²⁰

II.2.2 Could LOIs be considered legally binding as “de facto contracts”? Different answers in different legal traditions

In paragraph I.2.2 we have seen that, when a document cannot be formally considered a contract, there could be the possibility to define it as a “*de facto*” contract and to consequently enforce it as a proper contract.

The essential requisite allowing this interpretative operation is the existence, among the parties, of a mutual intent to be bound by the document. As we said, it is not simple to define what “mutual intent” is, but there are some LOIs and some clauses that, for their structure and their content, are more likely to be considered binding.

In this paragraph we will see the way in which English common law, France, Italy and Germany approach to these points and the different conclusions deriving from it.

English common law

Although the idea of “intention of the parties” is more or less the same in all the surveyed countries, English common law seems to dedicate a particular attention to it. In this system, the concept plays a crucial role because, together with consideration, it is one of the “indicia of seriousness”²¹ required to enforce a legal document and, therefore, it is generally considered one of the essential elements of a contract.²²

English courts, also in light of the case-by-case approach typical of common law, show an extremely practical and concrete way of interpretation which does not allow a theoretical categorization of what they generally consider “intention”. They evaluate the present situation and establish if there was intention or not considering elements such as the actual wording of the document, trade usages and customs, the

¹⁹ K. ZWEIGERT, H. KÖTZ, *An Introduction to Comparative Law*, p. 361.

²⁰ See N. HORN, H. KÖTZ, H. G. LESER, *German Private and Commercial Law. An Introduction*, Clarendon Press, Oxford, 1982, p. 78.

²¹ See ZWEIGERT, KÖTZ, *An Introduction to Comparative Law*, p. 397.

²² See LAKE, DRAETTA, *Letters of intent*, p. 37-38: ‘The common law rule as to intention as a contract element may be summarized as it relates to classes of contracts. There does not seem to be a general requirement that parties affirmatively intend to create a contractual relationship. If a promise is of a type not normally intended to be legally enforceable, the law will not enforce it unless the parties express a strong intention that it be enforceable’.

concrete context and all the circumstances of the case:²³ it is ‘a factual, all-things considered inquiry into the parties’ manifest intent’.²⁴

Therefore, it is not possible to give a general definition of what is “intention” according to English courts. However, examining English case-law, we can in any case discover which LOIs – or which specific clauses – are more likely to be considered binding. We will follow here and in the following paragraphs the classification proposed in chapter I:

1) *The kind of LOIs that are generally considered binding*

a. LOIs that contain all the material terms of a contract: in paragraph II.2.1 we said that one of the essential elements for contract formation in English law is the completeness of the agreement; moreover, the “mirror-image rule” is applied with particular rigidity. Consequently, a LOI containing elements of the final contract can be considered comparable to the latter only if it shows all the relevant components of the contract itself, and not only some of them;²⁵

b. LOIs containing “instructions to proceed” or “authority to proceed”: as we said, intention of the parties is considered crucial in English common law and sometimes regarded as an essential element of a contract. Therefore, LOIs whose performance is partially commenced are considered binding only if this intention exists:

‘the general rule in such cases is that in the absence of express language in which the parties manifest their intent to create or not to create a contract through a letter of intent, English courts will attempt to determine the intent of the parties by looking at the totality of circumstances’.²⁶

But the mutual intention is not the only requisite to be fulfilled; the element of completeness, i.e. of the presence of all the material terms of the contract, is in fact fundamental and it seems to overcome the presence of partial performance of the obligations. For example, in the case *British Steel Corp. v. Cleveland Bridge & Engineering Co.*²⁷ there was evidence of an extensive performance by British Steel, but the fact that negotiations were not complete was sufficient for the court to conclude that the LOI did not constitute a contract. To make a quick reference to US common law, the difference is significant: ‘in the United States partial performance is a major contributing factor toward determination that parties to a letter of intent intended that it be a contract’,²⁸ and sometimes it is considered relevant even if the document did not

²³ See J. KLASS, *Intent to Contract*, in *Virginia Law Review*, vol. 95, 2009, p.1454: ‘These circumstances can include the type of agreement, the completeness and specificity of the terms, the nature of the parties’ relationship, as well as more general consideration of the parties’ reasonable background beliefs’.

²⁴ *Ibid.*

²⁵ See the case *Charles Church Developments Ltd. v. Pacific Western Oil Corp.*, 1980 Q.B. 914 (C.A.): ‘a preliminary arrangement which contemplates a formal contract may itself constitute a binding agreement. Alternatively, such a preliminary arrangement may, whether the parties are conscious of the result or not, merely record some terms which the parties have agreed and reflect their confidence that they will reach agreement on other terms. In that event the preliminary arrangement, though expressed to be an agreement, is not binding because the parties have not yet reached agreement on all the terms of the contract which they are negotiating’.

²⁶ LAKE, DRAETTA, *Letters of intent*, p. 109; see also the case *British Steel Corp. v. Cleveland Bridge & Engineering Co.* [1984] 1 All E.R. 504 [1982] Comm. L.R. 55: ‘There can be no hard and fast answer to the question whether a letter of intent will give rise to a binding agreement: everything must depend on the circumstances of the particular case’.

²⁷ See footnote n. 77.

²⁸ LAKE, DRAETTA, *Letters of intent*, p. 112.

contain a specific clause establishing the instruction to proceed, because it is partial evidence of a complete agreement;

c. LOIs regarding future lots: similarly to point b., English courts will check if the document is characterized by completeness and mutual intent to be bound; ‘in short, contracts by lots would be considered in a manner similar to other cases involving the commencement of performance’;²⁹

d. LOIs that are contracts not yet operative, i. e. LOIs containing a right of first refusal: in English common law they can be considered contracts, provided that they contain all the necessary elements – in particular, completeness and intent to be bound.

2) *The individual clauses of a LOI that are more likely to be seen as obligatory*

a. Confidentiality agreements and secrecy obligations: like in the other surveyed systems, these clauses are often included in LOIs and are generally considered binding. In common law, in particular, they are frequently embodied in freestanding pre-contractual agreements;³⁰

b. Good faith obligations and “best efforts” requirements: common law is traditionally very reluctant in recognizing the role of good faith in pre-contractual relationships: consequently, it would be quite improbable that this aspect is taken into consideration and considered enforceable.

“Best effort” clauses are better known as “best endeavours” clauses in England; they are in theory enforceable, but the application in case law varies from situation to situation,³¹ also because of their evident connection with good faith;

c. Clauses referring to future contracts to negotiate, d. clauses concerning the sharing of expenses: they are generally considered binding.

France, Italy, Germany and other civil law countries

In this paragraph we will analyze these countries together and not separately, because civil law shows a substantially unitary approach towards the enforceability of LOIs.

The intent to be bound, like in common law, is an essential element to define a document as a contract; in light of the already mentioned difficulties that this notion causes, however, it is useful also here to analyze which kind of LOIs and of specific clauses are more frequently considered binding by case law.

1) *The kind of LOIs that are generally considered binding*

a. LOIs that contain all the material terms of a contract: in the previous paragraph we have learned that, differently from English common law, all the surveyed civil law countries demonstrate to weaken the “mirror-image” rule through exceptions: in particular, courts show the tendency to consider enforceable also LOIs which do not contain an agreement on all the contents of the final contract, if the test on the

²⁹ *Ibid.*, p. 120.

³⁰ *Ibid.*, p. 126.

³¹ *Ibid.*, p. 129.

mutual intent to be bound has a positive outcome. The inclusion of the essential elements is considered in any case necessary, but ‘a lack of agreement on secondary terms would not preclude contract formation (...) when there is sufficient evidence that neither party intended to condition contract formation on the final agreement on all of its terms, including the secondary ones’;³²

b. LOIs containing “instructions to proceed” or “authority to proceed”: we have seen that, under English common law, these LOIs are not considered binding *per se*: the crucial requisite is not the presence of an instruction to proceed, but the existence of a real intention to be bound and of an absolute completeness of the agreement. To the opposite, under US law also a mere factual performance, independently from the clauses contained in the LOI, is likely to make the LOI enforceable. Civil law countries collocate themselves in a sort of “middle way” between English common law and US common law: when an express clause in the document establishes an instruction to proceed, the LOI is likely to be considered binding because of the “reliance interest” arising from this situation, but, if there is not such a clause and one party merely starts performing, this is not considered sufficient for the enforceability of the document. Additionally, civil law countries, differently from common law, do not require – as we said under point a. – a complete agreement;

c. LOIs regarding future lots;

d. LOIs that are contracts not yet operative: they are generally considered binding in civil law countries, without the need of additional requisites;

e. LOIs containing a right of first refusal: in civil law countries they are normally regarded as enforceable if the refusal does not occur.

2) *The individual clauses of a LOI that are more likely to be seen as obligatory*

a. Confidentiality agreements and secrecy obligations: like in common law, these clauses are normally considered binding also in civil law countries. In particular, under civil law ‘violations of confidentiality obligations expose the breaching party to liability for full damages and not merely to reliance damages’;³³

b. Good faith obligations and “best efforts”: differently from common law, in civil law an express clause is not essential for the good faith obligation to be taken into account by courts, because good faith is a general principle of both contractual and pre-contractual stages. In practice, however, it is in any case very common also in civil law LOIs, to avoid any interpretative doubt;

c. Clauses referring to future contracts to negotiate;

d. clauses concerning the sharing of expenses: they are generally considered binding, like in common law.

II.2.3 Good faith and pre-contractual liability from a comparative point of view

³² *Ibid.*, p. 107.

³³ *Ibid.*, p. 126.

We have seen that, if a contract cannot be found in any way, the “escape rule” consists in establishing liability for breach of good faith obligations, theory that does not necessarily require the presence of a contract.

As we have anticipated, good faith in an extremely vague concept and is interpreted and applied very differently in each country.

English common law

Traditionally, English courts are very loath in recognising a general obligation of good faith. For the contractual stage, it seems that some duties comparable to good faith are actually taken into consideration by case law, although ‘English judges prefer concrete solutions and do not normally resort to the term “good faith”’.³⁴

This reluctance is obviously amplified when we are not considering a proper contract, but a pre-contractual moment. In this case, English law does not recognise the existence of any good faith obligation: in other words ‘unless a letter of intent is found to be a complete contract, English courts do not impose liability’,³⁵ sometimes even if in the document there is a precise clause contemplating good faith.

The rationale under this inflexible refusal is customarily the vagueness and the uncertainty of the concept of good faith and, consequently, the difficulty in establishing damages.³⁶

English doctrine and jurisprudence have always asserted, as a justification, that the same goal reached by other countries with the notion of good faith is any case achieved also by English law through other legal figures, such as tort or unjust enrichment.³⁷ However, this clearly

‘does not show that bad faith is an unnecessary concept. If English law subverts the proper scope of contract, tort, or unjust enrichment to achieve such results, then English law may indeed need a bad faith concept in order to explain its own rules’;³⁸

moreover, a distinct principle of good faith could potentially create ‘new’ rules of good faith and evolve in this way the system.³⁹

Others have also pointed out the fact that the theory of “promissory estoppel”, typical of common law, could replace the absence of a good faith theory. According to the promissory estoppel, the promise of

³⁴ *Ibid.*, p. 171. See also R. BROWNSWORD, *Positive, Negative, Neutral: the Reception of Good Faith in English Contract Law*, in *Good Faith in Contract. Concept and Context*, edited by R. Brownsword, N. J. Hird, G. Howells, Ashgate Publishing Company, Aldershot, 1999, p. 13: ‘English contract lawyers have long been familiar with the concept of (subjective) good faith in the sense of honesty in fact or a clear conscience (...) However, until very recently, the idea of a general doctrine of good faith, in the sense of an overriding (and objective) requirement of fair dealing, has not been part of the lexicon of English contract law’.

³⁵ LAKE, DRAETTA, *Letters of intent*, p. 172.

³⁶ *Ibid.*, p. 172.

³⁷ See R. GOODE, *The Concept of “Good Faith” in English Law*, in *Saggi, Conferenze e Seminari* of the “Centro di studi e ricerche di diritto comparato e straniero” directed by M. J. Bonell, n. 2, Tipografia Don Bosco, Roma, 1992, p. 9: ‘In many cases we arrive at the same answers but by a different route. Thus there are numerous situations in which we do not find it necessary to require good faith because we impose a duty which does not depend on good faith’. See also A. MUSY, *The Good Faith Principle in Contract Law and the Precontractual Duty to Disclose: Comparative Analysis of New Differences in Legal Cultures*, in 2000, p. 7. Specifically on the use of the principle of unjust enrichment, see the case *B. P. Exploration Co. (Lybia) Ltd v. Hunt*, [1979], 1 W.L.R., 783.

³⁸ SMITH, *Contract theory*, p. 199.

³⁹ See F. O’CONNOR, *Good Faith in English Law*, Dartmouth Publishing Company Limited, Aldershot, 1990, p. 100.

one party, upon which the other party justifiably and detrimentally relied on, may become judicially enforceable.⁴⁰ However, this principle is habitually used only with respect to existing contracts, and not to the negotiation stage.⁴¹

The above-mentioned unwillingness towards good faith is peculiar in English law. U.S. courts, in fact, are generally more flexible and willing to impose this kind of liability. English law has therefore been critically accused by some authors to be old-fashioned⁴² and ‘behind the continent’.⁴³

This ‘all or nothing approach’⁴⁴, however, has not been constant during the years. During the eighties, for example, English courts seemed to be more open to this kind of liability, at least in some circumstances,⁴⁵ but in the nineties they newly changed their aptitude, going back to the traditional rigidity.⁴⁶

In recent years, the influence of European Union law – which specifically establishes obligations of good faith – and the need of unification have induced commentators to insist more and more for the inclusion of the principle in English law. Nowadays, therefore, we can witness a strong aptitude towards the recognition of an implied duty of good faith, both in doctrine and in jurisprudence. In the 2013 case *Yam Seng Pte Limited v International Trade Corporation Limited*⁴⁷ the High Court judge Leggatt so expressed: ‘I respectfully suggest that the traditional English hostility towards a doctrine of good faith (...), to the extent it still persists, is misplaced’. This approach was then followed in other cases,⁴⁸ and it seems to prepare the grounds for a ‘new era’ in English law. However, this tendency is still at its initial stages and, therefore, it must be taken with particular cautiousness,⁴⁹ especially considering the negotiating stage of a transaction, which was not specifically taken into account by the mentioned cases.

France

France, Germany and Italy share a civil law background and therefore, differently from common law, generally recognise the principle of good faith. However, there are relevant discrepancies among them, especially for what concerns the specific provision of the institute in the civil code and its nature.

In France, art. 1134 n. 3 of the *code civil* requires that contracts are performed in good faith, but there is not an expressed obligation to do that in the negotiation stage. However, pre-contractual liability is traditionally recognised by courts, which collocate it not in contract law, but in tort law.⁵⁰ Consequently, this kind of liability does not derive from art. 1134, but from art. 1382 and 1383 of the French civil code, according to which a person acting in a way that causes damages to another person is obligated to rectify the harm.

⁴⁰ See BURTON, ANDERSEN, *Contractual Good Faith*, p. 343.

⁴¹ See LAKE, DRAETTA, *Letters of intent*, p. 176.

⁴² See M. FONTAINE, *Les lettres d'intention dans la négociation des contrats internationaux*, in *Droit et Pratique du Commerce International*, 1977, p. 105.

⁴³ LAKE, DRAETTA, *Letters of intent*, p. 176.

⁴⁴ *Ibid.*, p. 172. The same expression is used in R. SPECIALE, *Contratti Preliminari*, p. 223 (*‘tutto (contratto) o niente (semplici trattative)’*).

⁴⁵ See the cases *Esso Petroleum v Mardon*, [1976] Q.B. 801, and *English v. Dedham Vale*, [1978] 1 W.L.R. 93.

⁴⁶ See *Walford v Miles* [1992] All. E. R. 453. In particular, p. 461: ‘A duty to negotiate in good faith is as unworkable in practice as it is inherently inconsistent with a position of a negotiating party’.

⁴⁷ See *Yam Seng Pte Limited v International Trade Corporation Limited*, [2013] EWHC Q.B. 111.

⁴⁸ See in particular *Bristol Groundschool Limited v. Intelligent Data Capture and others*, [2014] EWHC CH 2145.

⁴⁹ See K. BURDEN, I. BOWLER, A. ASHBY, *Good Faith: a New Era for English Law?*, 2014.

⁵⁰ See LAKE, DRAETTA, *Letters of intent*, p. 198.

Germany

Art. 242 of German civil code (Bürgerliches Gesetzbuch, the “BGB”) provides that “an obligor has a duty to perform according to the requirements of good faith, taking customary practice into consideration”. Even if its formulation is surely broad, it apparently seems in any case to be connected only with the stage of the performance of the contract, and not to the pre-contractual moment.

Germany, however, is the country where the principle of *culpa in contrabendo* (then imported in other civil law systems) has historically and theoretically developed.⁵¹ According to this doctrine, ‘damages should be recoverable against the party whose blameworthy conduct invalidates a contract or prevents its completion’.⁵² Thanks to this theory, art. 242 of the German civil code ‘has grown a ‘super control norm’ for the whole BGB, and indeed for large parts of German law outside it’,⁵³ and, as a consequence, the general obligation to perform in good faith not only in the contractual stage, but also in the pre-contractual one, has found a relevant ground both in doctrine and in jurisprudence. Art. 242 has become one of the “general clauses” of the German system by means of which the so-called Germany’s “case law revolution” was effected,⁵⁴ and ‘German legal scholars define the relationship existing between the parties during the period of the formation of the contract as a trust relationship having a quasicontractual character (...) or as a relationship binding *extra legem*’.⁵⁵

For what concerns the nature of pre-contractual liability, in Germany, differently from France, it is based on contract law and not on tort law.

Italy

Italian law, unlike French and German law, contains a specific provisions regarding the obligation to conduct negotiations in good faith (art. 1337 of the *codice civile*).⁵⁶ This means that the German doctrine of *culpa in contrabendo* has had a big reception in Italy (even if, until the beginning of the seventies, ‘the main stream of the Supreme Court of Cassation held that the good faith provisions did not offer an autonomous ground for a legal action’).⁵⁷

Differently from Germany, this liability is based in tort (art. 2043 of the Italian civil code) and not in contract.⁵⁸ under Italian law, this means that the burden of proof is collocated on the damaged party, and that the limitation of action corresponds to five years.

However, doctrine and case law have recently shown a change in this approach, trying to qualify the breach of good faith in negotiations as a third kind of liability with a contractual basis. This seems to be possible through the so-called “qualified social contact theory” (*teoria del contatto sociale qualificato*), according to which some situations (including the negotiation phase), in spite of the absence of a proper “contract”,

⁵¹ The first to recognize the principle of *culpa in contrabendo* as a way to supply to the insufficiency of the theory of offer and acceptance was Rudolph von Jhering (see M. V. HESSELINK, *Precontractual Good Faith*, in *Casebooks on the Common Law of Europe. Cases, Materials and Text on Contract Law*, Hart Publishing, Oxford and Portland, Oregon, 2002, p. 237; see also N. NEDZEL, *A Comparative Study of Good Faith*, p. 112 and following).

⁵² LAKE, DRAETTA, *Letters of intent*, p. 203.

⁵³ HORN, KÖTZ, LESER, *German Private and Commercial Law*, p. 135.

⁵⁴ See J. P. DAWSON, *The Oracles of the Law*, Ann Arbor, Michigan, 1968, p. 432 and following.

⁵⁵ LAKE, DRAETTA, *Letters of intent*, p. 203.

⁵⁶ ‘The Italian Civil Code of 1942 was the first code to contain a specific provision on pre-contractual liability’ (HESSELINK, *Precontractual Good Faith*, p. 238).

⁵⁷ MUSY, *The Good Faith Principle in Contract Law*, p. 5-6.

⁵⁸ See LAKE, DRAETTA, *Letters of intent*, p. 201.

are substantially comparable to a contractual stage, because of the particular social relationships that exists between the parties.⁵⁹ This theory has been adopted by the courts starting from the “leading case” of 2011⁶⁰ and is currently seeing more and more consents, especially because, transferring the pre-contractual liability from the tort sphere to the contractual sphere, it puts the party harmed by the breach of good faith in a stronger position,⁶¹ collocating the burden of proof on the damaging party and extending the limitation of action to ten years (instead of five).

However, there are still recent decisions qualifying a breach of bad faith as a “tort liability”,⁶² but, in my opinion, this kind of opinion is too much connected with the past and unreasonably refuses an innovative interpretation which has been adopted also in other areas, such as the medical one.⁶³

II.2.4 Conclusive remarks

After discovering the aptitudes of the surveyed countries towards contract formation, “*de facto* contracts” and good faith, it is necessary to put all these findings together and to draft some conclusive remarks, aimed at understanding which laws are more favourable to the system of LOIs and which less.

English common law

1) *test on contract formation*: as we have seen, English law is particularly strict in terms of the requisites of offer and acceptance. Even if the ‘mail-box rule’ makes acceptance quite easy, English system qualifies the issues of full completeness and consideration as fundamental elements of a contract. As a consequence,

‘although the parties may have reached agreement in the sense that the requirements of offer and acceptance have been complied with, there may yet be no contract because the terms of the agreement are uncertain or because the agreement is qualified by reference to the need for a future agreement between them’;⁶⁴

2) *test on “de facto contract”*: as we said, English courts are very rigorous in determining the real intent of the parties and quite severe also in attributing the qualification of “contracts” to the kind of LOIs and of single clauses that are generally considered binding in other systems;

3) *test on good faith*: because of the traditional reluctance of English common law towards the recognition of good faith in the pre-contractual stage, it is very hard for a LOI to pass this third test. However, we have also seen that courts have recently started to be more open towards pre-contractual liability; therefore it is possible that, in the future, the test on good faith becomes easier to overcome.

⁵⁹ See G. LONGO, *Teoria del contatto sociale, responsabilità precontrattuale e mediazione tipica*, 2014, and D. RICCARDO, *La responsabilità precontrattuale*, 2013.

⁶⁰ Cass. civ., n. 27648 of December 20, 2011.

⁶¹ See G. LONGO, *Teoria del contatto sociale*, p. 2.

⁶² See Cass. civ., n. 21255 of September 17, 2013. The same opinion in M. CARCANO, *Sulla violazione della regola di buona fede in senso oggettivo* 2015.

⁶³ See G. LONGO, *Teoria del contatto sociale*, p. 2.

⁶⁴ A. G. GUEST, *Anson’s Law of Contract*, Clarendon Press, Oxford, 1984, p. 54.

France

1) *test on contract formation*: in my opinion, the French system shows a certain *favor* towards the qualification of a document as a contract. We have seen that, for example, an invitation to treat in doubtful cases is considered a proper offer, that there are exceptions to the “mirror-image” rule and that some consider the mere ‘mail-box rule’ as a proper way of acceptance;

2) *test on “de facto contract”*: the results of this test are common to the other civil law countries, and generally show an interpretation of the “intent of the parties” on a case-by-base basis and a tendency to consider enforceable as “*de facto contract*” some LOIs and some clauses that are normally excluded in common law;

3) *test on good faith*: the flexibility towards contract formation seems to be counterbalanced by a slight rigidity in the system of good faith. In fact, there is not a norm in the French civil code specifically establishing a duty of good faith in the pre-contractual stage; moreover, the doctrine is based not on contract law, but on tort law, usually more complicated in the procedural and evidentiary stage, and sometimes insufficient in covering all the unlawful behaviours which could characterize the pre-contractual moment.⁶⁵

Italy

1) *test on contract formation*: like in France, there is a sort of flexibility with respect to the formation of contract: invitations to treat are generally considered proper offers and there are exceptions to the “mirror-image” rule. The rule of acceptance (the “information theory”) may seem quite strict, but the presumption based on the “receipt theory” substantially weaken this apparent rigidity;

2) *test on “de facto contract”*: see France;

3) *test on good faith*: differently from all the other surveyed countries, the Italian civil code has a specific article regarding pre-contractual liability. Moreover, the recent theory of “social contact” tends to qualify it as contractual liability and not tort liability, with all the procedural advantages explained in the previous paragraph.

Germany

1) *test on contract formation*: the rigid distinction between invitation to treat and proper offer and the impossibility to revoke the offer renders the system quite inflexible. However, differently from other countries, silence is sometimes taken into consideration as a way of acceptance;

2) *test on “de facto contract”*: see France

3) *test on good faith*: the absence of a specific provision in the BGB regarding pre-contractual liability is fully compensated by the strong doctrine of *culpa in contrahendo*, which makes very easy in Germany to recognize

⁶⁵ See R. SPECIALE, *Contratti Preliminari*, p. 245.

a breach of good faith duties in the negotiation stage. Moreover, this liability is traditionally considered connected to the contract law area.

Starting from this scheme, it is possible to understand which countries are, theoretically and practically, more reluctant in recognising a legal value to LOIs and which are more open. English common law is undoubtedly the area where the recognition of the enforceability of a LOI is more rare and difficult to reach.⁶⁶

Then there is France (flexible in contract formation, but, in my opinion, still quite “rigid” in good faith). Italy and Germany seem to be more or less at the same level and appear to be the countries that, through their legal and interpretative tools, are more open towards the system of LOIs and more disposed in attributing to it a certain – and sometimes “contractual” – legal value.

⁶⁶ *Ibid.*, p. 220 and following.

CHAPTER III - AN ANALYSIS OF THE MOST RELEVANT CASE-LAW ABOUT LOIs

III.1 The aim of this chapter

In chapters I and II we have analyzed the system of LOIs and the possible problems that could arise from it. We have motivated this criticism basically with two reasons: firstly the intrinsic controversial nature of LOIs, and secondly the largely different approaches used by the surveyed legal traditions.

As we have stated in the introduction, this lack of consistency and uniformity of interpretation transforms LOIs from an agile and useful instrument to an extremely dangerous tool, capable of incredible disasters in terms of legal consequences.

In this chapter, with regards to the countries surveyed in chapter II, we will study some famous cases on unsuccessful and “catastrophic” LOIs: *Pennzoil v. Texaco* (common law), *SME* (Italian law), *Vittel* (French law) and *Oolitic Stones* (German law).

First of all, I would like to explain why I have chosen these cases and not others. They are undoubtedly a bit old: they all belong to the Eighties and to the early Nineties. However, I think that it is worth analyzing them at least for four reasons:

- 1) because they involve huge and famous transactions and, therefore, show very clearly the good and the bad potentialities of LOIs;
- 2) because the reasoning of the Courts establishes some key and crucial points that every enterprise should take into account before drafting or signing a LOI;
- 3) because the further jurisprudence on LOIs is still quite scarce.¹ This does not mean that LOIs do not create problems anymore: they do now even more than in the past, but in the large majority of cases these conflicts are settled through extra-judiciary transactions. Normally, we find Court decisions only for very big and crucial negotiations (which we will find in the surveyed cases);
- 4) because in the area of the (scarce) more recent jurisprudence, the problems of LOIs are the same as in our cases: lack of clarity, bad wording, ambiguous draft, absence of fundamental clauses etc.

The case-study delineates the first step of the “learning by mistake” approach that will be adopted for the conclusions: starting from the faults that characterize these cases, we will be able to draft a sort of “check-list” of elements to include in a LOI and to describe a system of “good practice”, to improve the future of the system itself.

III.2 *Pennzoil v. Texaco*: a common law case study

¹ For what concerns Italy, this “scarcity” of recent jurisprudence after the *SME* case is clearly asserted in MORRESI, *Le lettere d'intenti*, p. 1.

III.2.1 *The facts and the litigation*

The choice to analyze a US case like *Pennzoil v. Texaco*² could seem quite surprising in light of the previous chapter, where we have considered only the English side of common law and made only brief references to US law. However, I think that *Pennzoil v. Texaco* is extremely relevant for our analysis for at least two reasons: first of all, it shows the weakness of common law in general, without particular distinctions between England and USA, and secondly, it teaches broad and “universal” principles on the drafting of LOIs which are to be considered fundamental also for civil law countries.

This case shows a foolish mixture of naivety from one side and of bad faith from the other, which concentrated in the first week of year 1984. On 28 December 1983 Pennzoil Inc. commenced a tender offer for the purchase of a substantial portion of the shares of Getty Oil Company at a price of \$100 per share. On 2 January 1984, a document called “Memorandum of Agreement” was signed, according to which Pennzoil had the right to acquire the shares of Getty Oil at a price of \$ 110 per share (10% more than the tender offer). However, this document contained a clause imposing the express approval of Getty Oil’s board of directors as a condition; and this board of directors the day after approved the document, but changed the price from \$110 per share to \$115. On 4 January 1984 a press release publicly announced the transaction: ‘this referred to an “agreement in principle” and for the first time there was reference to the need for a further formal agreement’.³ A draft of a formal definitive agreement was ready by 6 January 1984. However, nobody knew that immediately after issuing of the press release Getty Oil secretly entered into negotiation with Texaco Inc. for the acquisition of the shares at a price of \$125 per share, later raised to \$128. On 6 January 1984 (the same day when the draft of the definitive agreement between Getty Oil and Pennzoil was prepared!), a second press release announced that Texaco had signed an agreement to take over the company.

Few days after, Pennzoil sued Getty Oil for specific performance of the “Memorandum of Agreement”, but the Delaware Chancery Court denied the motion. Consequently, Pennzoil moved its lawsuit to Texas and sued Texaco for intentional interference with contractual relations and inducement of breach of contract. The jury found – not without difficulty in reaching this conclusion – that Texaco had knowingly interfered with the previous agreement: therefore, Pennzoil was awarded a total of \$ 11,1 billion, including actual damages and punitive damages.

However, Texaco required and obtained a preliminary injunction restraining Pennzoil from taking actions to enforce the judgment, and then filed an appeal before the Court of Appeal for the First Supreme Judicial District of Texas. Here the judges were very sceptical towards the recognition of a proper contract between Pennzoil and Getty Oil, highlighting the inexistence of all the material terms of the contract itself. Therefore, the Court wondered if there could have been a “*de facto* contract” based on the mutual intention to be bound (the second “test” that we have explained in the previous chapters). To this respect, Texaco argued that the wording of the press release (“agreement in principle” and “subject to” a further agreement) was a clear index of the mutual intention not to be bound by the document. Nevertheless the Court, putting into practice a factual analysis and taking into account all the circumstances of the case,

² *Pennzoil, Inc. v Texaco, Inc.* No. 84-05905 (151st Dist. Ct., Harris County, Tex.) Nov. 15, 1985, *aff'd*, 729 S. W. 2d 768 (Tex. Ct. App. 1987)

³ FURMSTON, NORISADA, POOLE, *Contract Formation*, p. 159.

concluded that there was a mutual intention to be bound: therefore, the “*de facto* contract” test was finally considered satisfied.

Finally, the two parties settled for \$ 3 billion: this sum, if compared with what the courts had decided, is significantly lower and represents a great loss for Pennzoil.

III.2.2 *The mistakes*

This case is so complex that it would not be right to attribute all the reasons of the failure to the LOI itself: there were of course other elements which concretely contributed to the outcome, first of all agency problems.⁴

However, it is evident that this case ‘serves as a warning against loose drafting of letters of intent’⁵ and ‘provides a remarkable illustration of the potentially disastrous consequences of expressing intentions ambiguously in letters of intent’:⁶ the vague wording “Memorandum of Agreement” and the absence of clauses defining clearly the intention to be or not to be bound by the document or by part of it were the first elements that drove the situation to a complete failure.

Moreover, specific clauses imposing to operate in good faith and – more importantly – expressly forbidding to conduct parallel negotiations before the signature of the final agreement would have surely helped in the decision and, maybe, an appeal would not have been necessary at all. This is even more true if we consider that in common law, traditionally, there is not an implied duty of good faith. A case like this would have easily been solved in tort in France or Italy and in contract in Germany, and ‘there would have been no need to have characterized the memorandum of agreement as a complete and final contract’⁷ because the doctrine of good faith would have completely supplied to this situation (and the defendant might have been Getty Oil and not Texaco). In common law, however, this reasoning is not possible and, therefore, express clauses reminding the general obligation not to conduct parallel negotiations and to behave in good faith are particularly important.

Additionally, this case also teaches how the clause “subject to” (referred to “approval”, or to “contract”⁸) could be dangerous. First of all, it makes negotiations longer and more uncertain, and, more significantly, it could be used as a way to drive negotiations in favour of one party instead of another: in *Pennzoil v. Texaco*, for example, the board of directors subjected the destiny of all the negotiation to a rise in the price of the shares, and Pennzoil was obliged to accept this: if it had not, all the bargain would have expired.

Finally, we must highlight the negative impact of the press release. It was issued immediately, in a very delicate phase of the negotiation, and added elements which were not present in the original document: the wording “agreement in principle” and the reference to a future and definitive contract. This wording

⁴ On the agency problems which characterized *Pennzoil v. Texaco*, see S. BUNDY, *Commentary on “Understanding Pennzoil v. Texaco”: Rational Bargaining and Agency Problems*, in *Virginia Law Review*, vol. 75, No 2, Symposium on the Law and Economics of Bargaining, 1989, p. 335-365.

⁵ FURMSTON, NORISADA, POOLE, *Contract Formation*, p. 159.

⁶ LAKE, DRAETTA, *Letters of intent*, p. 135.

⁷ *Ibid.*, p. 148.

⁸ A case where the “subject to contract” clause, together with the expression “clarification needed”, lead the judge to consider the LOI as a simple document and not as a contract is *Empro v Ball-Co*. For a detailed comment on this case, see O. BEN-SHAHAR, *Pre-Closing Liability*, in *The University of Chicago Law Review*, 2010, p. 977-995.

substantially contributed to create confusion and was used during the trial by Texaco as an argument to prove that there was not a mutual intention to be bound. Therefore, the launching of press releases during negotiations is generally very dangerous and it is recommendable to insert in the LOI a clear confidentiality clause expressly prohibiting it.

For what concerns the mentioning, in the LOI itself, of a future and definitive agreement, this is not to be considered a mistake, but the terms must be rigid and clear: for example, there should be the definition of a precise date within which the final agreement must be signed, and the binding character of the LOI (or of part of it) until that day should be specifically stressed.

III.3 Buitoni S.p.A. v. Istituto per la Ricostruzione Industriale (SME): an Italian case study⁹

III.3.1 The facts and the litigation

On 29 April 1985, Mr. Romano Prodi, chairman of the large Italian state-owned holding company IRI (“Istituto per la Ricostruzione Industriale”), and Mr. Carlo De Benedetti, chairman of the privately owned Italian food company Buitoni S.p.A., signed a document through which Buitoni S.p.A. declared its availability to acquire the shares of SME, another food company owned by IRI. Mr. Prodi stated that he was of the opinion that this sale was advantageous for IRI, and therefore committed himself to submit the issue to the board of directors of IRI, whose approval was the first condition for the bargain to be concluded. The second condition was the approval of the Government Authorities: this authorization – according to the document – was requested by law.

While the board of directors unanimously approved the transaction, the ministry did not; consequently, IRI did not proceed with the acquisition. For this reason, in July 1985, Buitoni sued IRI for breach of contract.

The LOI signed by IRI and Buitoni – rather rudimentary and clearly not drafted by lawyers –¹⁰ was not named in a specific way: it only contained the term “*intesa*”, i.e. “understanding”. Moreover, it did not include words indicating agreement, such as “*obbligo*” or “*impegno*”. In any case, Buitoni maintained that, in its materiality, the LOI contained all the material terms of a proper contract or – at least – of a valid offer from Buitoni, regularly accepted by IRI after the board of directors’ approval.

‘IRI’s position was diametrically opposite’:¹¹ the document was not a contract, but only a way to put black on white the basic points of the negotiations, without any mutual intent to be bound; moreover, the board of directors’ approval could not be considered a proper acceptance of an offer. In IRI’s opinion, it was the lack of approval by the Government Authorities to have real weight and to justify IRI’s refusal to conclude the contract.

The Court of first instance found in favour of IRI. That document, because of its wording, could be considered a proper contract neither formally nor “materially”: there were no elements indicating the

⁹ *Buitoni S.p.A. v. Istituto per la Ricostruzione Industriale*. Trib. Rome, Foro Italiano I (Foro It. I) 2284 (1986); Court of Appeal, Foro I. 1260 (1987); Cass. Civ., Foro I. 2584 (1988).

¹⁰ See LAKE, DRAETTA, *Letters of intent*, p. 150-151.

¹¹ *Ibid.*, p. 152.

mutual intention to be bound. Additionally, the LOI could not be considered an offer, because that document was bilateral and not unilateral (and, in any case, the approval of the board of directors could not have been considered an acceptance). With regards to the governmental approval, the Court stated that there was not a specific legal provision establishing it as a condition; however, ‘the requirement of the approval was implied in the powers of supervision and control that the ministry had over IRI’s activity, particularly considering the importance of the divestiture of such a large subsidiary as SME’.¹²

The decision was appealed. The Court of Appeal reached the same conclusion as the Tribunal, but with a slightly different reasoning: according to the Court of Appeal, the LOI could be considered an offer (in particular, it was an ‘unilateral offer from Buitoni and, at the same time, a bilateral precontractual instrument’).¹³ However, the facts did not show a proper acceptance of this offer or a mutual intention to be bound: therefore, IRI could not be sued for breach of contract.

The Italian Court the Cassation confirmed this findings.¹⁴

III.3.2 *The mistakes*

As we have already seen in *Pennzoil v. Texaco*, conditioning a LOI to external approvals can be sometimes very dangerous. In *SME*, the approval by IRI’s board of directors created ambiguity in its legal value (was it the acceptance of an offer or not?); moreover, the approval by the Ministerial Authorities – which was declined – completely blocked the transaction and caused the lawsuit which, finally, was won by IRI – the party which immediately stopped the negotiations and refused to conclude the final contract. Moreover, the Court found that this Ministerial approval was not required by law as an essential circumstance: therefore, if the LOI were drafted without these two “barring” conditions, the outcomes would have surely been different, and maybe a lawsuit would not have been necessary.

The other enormous mistake that characterizes this case is the wording of the document. As we said, it was surely not drafted by lawyers (very dangerous choice!); therefore, the terminology used was vague and ambiguous, with no reference to any kind of commitment or intention to be bound. This is the best way to deprive the document of any legal value and to have no clue to make the judges declare it enforceable as a contract.

III.4 *Vittel: a French case study*¹⁵

¹² *Ibid.*, p. 154.

¹³ *Ibid.*

¹⁴ For a deeper understanding of the reasoning of the *Cassazione*, see V. CARBONE, *Primo intervento della Cassazione sull’ “affaire” Sme*, *Cassazione Civile Unite 25 Marzo 1986 n. 2091 Co.Fi.Ma – C. Buitoni S.P.A. E Altri Pres. Granata – Est. Tondo – P.M. Fabi*, in *Il Corriere Giuridico* N. 5/1986, p. 51, and G. LOMBARDI, *Caso Sme-Buitoni: la Cassazione dice l’ultima parola*, in *Il Corriere Giuridico* N. 8/1988, p. 829 and following.

¹⁵ Trib. Comm. Meaux, May 15, 1987; Cour d’Appel Paris, May 13, 1988.

III.4.1 *The facts and the litigation*

In 1985 the *Société Anonyme Etablissement Dubreuil* (“Dubreuil”), specialized in the distribution of mineral water, granted an option to the *Société Générale des Eaux Minérales de Vittel* (“Vittel”) for buying its shares. In November 1985 the two companies signed a document establishing the terms of the purchase of Dubreuil’s assets. However, in January 1986 Dubreuil and the company *Brasserie des Vosges* (“Brasserie”) signed a second document regarding the purchase of Dubreuil’s shares. As soon as Vittel became aware of the situation, it sent a telex to Dubreuil stating that the transfer of the shares to Brasserie would have constituted a violation of their previous agreement. However, Dubreuil decided to accept the transaction with Brasserie, completely excluding Vittel from the transaction.

In July 1986 Vittel sued Dubreuil and Brasserie before the Commercial Tribunal of Meaux, asking to declare the transfer of the shares null and void and to be awarded damages in the amount of 500.000,00 French Francs.

However, the Tribunal rejected these requests, and the main reason was the document signed between Vittel and Dubreuil in November 1985, which, according to the Tribunal, could not have any legal value because of its extreme incoherence and obscurity. It was not clear if Mr. Dubreuil, the man who materially signed it, had the authority to do that, and the text itself was extremely general and confuse: the Tribunal commented that ‘it was astonishing that a company of the calibre of Vittel had not relied on more clear and unequivocal documents’.¹⁶

This decision was appealed by Vittel in front of the Court of Appeal of Paris. In particular, Vittel alleged that it had relied on the document as it was a formal contract because Mr. Dubreuil had already behaved, in previous occasions, as he was authorized to take decision on behalf of his company, and, secondly, because Dubreuil did not inform Vittel of the parallel negotiation with Brasserie.

The defendants, on the other hand, sustained that the document contained too many ambiguities and obscurities to be considered enforceable as a contract. For example, it mentioned the word “assets” (in French, “*actifs*”), and not the term “shares” (in French, “*actions*”): so, literally, it did not concern Dubreuil’s shares. Moreover, they stated that Mr. Dubreuil did not have any legal authority to act on behalf of the other members of the family, who were shareholders of Dubreuil itself.

The Court of Appeal, for what concerns the value of the document, confirmed the position of the Tribunal: in particular,

‘it could not be positively established that the scope of the November 16, 1985 document was that of transferring the shares of Dubreuil to Vittel, considering that the words of the document itself, included in a few lines written on simple commercial paper, referred to the acquisition by Vittel of the assets’.¹⁷

However, the Court of Appeal recognized the existence of a reliance interest in the position of Vittel, which had to be protected: during many months Vittel was induced to believe that the bargain was proceeding and was not informed of the parallel negotiations between Dubreuil and Brasserie. This behaviour was, according to the Court, “close to” bad faith, ‘to the extent Mr. Dubreuil, by being reticent with Vittel about the real status of its discussions with Brasserie, deprived Vittel of the chance of

¹⁶ LAKE, DRAETTA, *Letters of intent*, p. 164.

¹⁷ *Ibid.*, p. 166.

intervening in such discussions to protect its interest'.¹⁸ As a consequence, the Court ordered Mr. Dubreuil to pay an amount of damages of 500.000,00 French Francs.

III.4.2 The mistakes

What should preliminary noted is that in this case, like in many others, the “good faith test” is the only way to obtain some satisfaction in a situation where a LOI was drafted in an inaccurate and superficial way. In *Vittel* the document was not considered a contract, but, through the principle of good faith, the reliance interest of the party was in any case protected and it obtained at least an amount of damages, even though the second agreement remained perfectly valid.

What can be learned from this case is the need of clarity and precision in drafting a LOI: writing “assets” instead of “shares” was a severe mistake which determined the destiny of the lawsuit.

Another point which must always be carefully considered is the legal authority of the person who materially signs the document. In our case, the fact that Mr. Dubreuil conducted the entire negotiation and decided to sign the document on behalf of the Dubreuil company was not sufficient to legally endorse him with this power, which must be always checked in advance to avoid the document to be declared null and void for this reason.

Moreover, as we have already said, the Court of Appeals bitterly criticized the document because he had been drafted “in a few lines written on simple commercial paper”. This seems to suggest that ‘some kinds of formality is needed for agreements transferring shares’,¹⁹ and, more in general, for all the kinds of agreements to which the parties intend to attribute a serious (and legal) value.

Finally, as we have already noted in the analysis of the previous cases, a specific clause concerning the prohibition of conducting parallel negotiations could be vital for the good development of a transaction.

III.5 *Oolitic Stones*: a German case study²⁰

III.5.1 The facts and the litigation

This case involved some German companies which, in the first years of 1992, entered into negotiations for the supply of stones for hydraulic structures in the context of a call of tenders promoted by the defendant. The invitation to tender explicitly required that the material was to be rubble consisting of basalt, greywacke or hard sandstone. The plaintiff submitted a tender for the supply of basalt at a certain price (offer A); another company contemporarily submitted a tender for the supply of oolitic stones (offer B), asking for a lower price and alleging an expert’s report certifying the suitability of this stones to the

¹⁸ *Ibid.*, p. 168.

¹⁹ *Ibid.*

²⁰ BGH, 25 November 1992, NJW 1993, 520. In the major casebooks it is known not through the names of the parties (like for example *Pennzoil v. Texaco*), but through the title “Oolitic Stones” (see for example the cited *Casebooks on the Common Law of Europe. Cases, Materials and Text on Contract Law*, p. 253): that is why I have adopted this name.

purpose of the tender. The defendant decided to award the contract to this last company, even though in the tender the possibility to supply oolitic stones was not mentioned.

Therefore, the plaintiff sued the respondent for breach of the invitation to tender. The Bundesgerichtshof found that the plaintiff was entitled to compensation in the measure of the positive interest, because he would definitely have won the contract had the procedure for awarding it been properly followed: in other words, this was a case of *culpa in contrahendo* based on an unjustified break-off of the negotiations.

III.5.2 The mistakes

This case is particularly interesting because it shows the problem of LOIs in a new perspective. In the previous cases we have focused our attention on situations in which a bad-drafted LOI does not have any legal value and, therefore, the party relying on its enforceability is damaged. Here we have exactly the opposite: one party drafts a document (in this case a tender offer, which we can consider as a kind of unilateral LOI) thinking that its clauses, in particular the one specifying the kind of material required, are not strictly binding. As a consequence, he feels free to refuse offer A (more costly, but containing the material required in the tender) and to accept offer B (less expensive, but containing different materials). Eventually, the judge found for the plaintiff, considering that document completely binding and enforceable and declaring the respondent liable for *culpa in contrahendo*. Therefore, this case teaches that, when one party does not want to give to the document or to a certain clause a specific legal value, he must carefully check if this aspect is sufficiently evident in the document itself (for example, drafting generic clauses or stating that they are not to be considered binding).

CONCLUSIONS: HOW TO IMPROVE THE FUTURE

1. A summary of the findings of the study

The key questions addressed in this study can be summarized as follows:

- 1) what are LOIs and which is their importance in modern commercial transactions?
- 2) why can LOIs be defined as “extremely controversial”?
- 3) how are LOIs legally considered in different juridical systems?
- 4) which are the main examples of “disastrous” LOIs?

To recap, in extreme synthesis, the answers I have found during my research, I can say that:

1) A LOI is ‘a pre-contractual written instrument that reflects preliminary agreements or understandings of one or more parties to a future contract’.¹⁵⁹ LOIs are frequently used for many kinds of transactions because of their flexibility and adaptability to different purposes and situations, and for the degree of certainty that they could inject in the negotiation process. They allow parties to put “black on white” the steps of their bargain, helping them in finding more easily a final agreement and, consequently, in saving time and money.

2) However, LOIs probably constitute the most controversial and least predictable area of contract law.¹⁶⁰ This is because they have not a plain legal definition, and it is still not clear if they can be considered “contracts” or not. Therefore, the only way to answer this question is to reason on a case-by-case basis: to this respect, I have proposed a three-tier test articulated as follows:

- *Test on contract formation*: first of all, to define a LOI as a real contract, we must check if it has been formed like a contract. A contract starts existing when an acceptance matches the connected offer; to understand this moment, there are four main theories (“declaration theory”, “mail box rule”, “reception theory” and “information theory”);
- *Test on “de facto contract”*: if the first test is not satisfied, we can see if our LOI could be considered comparable to a contract not from a formal point of view, but from a practical one: in other words, we should try to understand if the real intent of the parties was to create a document containing legally and mutually binding obligations;
- *Test on good faith*: the last way to attribute to a LOI a certain legal value is to understand if ‘one of the parties can be liable on a theory that does not require the existence of a contract or of a complete contract’,¹⁶¹ i.e. the theory of good faith and pre-contractual liability.

¹⁵⁹ LAKE, DRAETTA, *Letters of Intent*, p. 5-6.

¹⁶⁰ See FARNSWORTH, *Precontractual Liability and Preliminary Agreements*, p. 259-260.

¹⁶¹ LAKE, DRAETTA *Letters of Intent*, p. 171.

3) Being LOIs so ambiguous and unpredictable, it is not surprising that they are used and interpreted very differently in various countries. I have applied the above-mentioned three-tier test to English common law, France, Italy and Germany and I have concluded that:

- English common law is the area where the recognition of the enforceability of a LOI is more rare and difficult to reach, especially for the traditional absence of the concept of “good faith”;
- Then there is France, flexible in contract formation but still quite “rigid” in the qualification of good faith;
- Italy and Germany are more or less at the same level and, if compared with the other surveyed countries, they are the most open towards the recognition of a contractual legal value to LOIs.

4) Finally, following a “learning-by-mistake” approach, I have examined four cases of LOIs (each of which is connected to one of the surveyed areas) that, because of their bad drafting, have created enormous problems in the negotiations:

- *Pennzoil v. Texaco* (common law)
- *SME* (Italy)
- *Vittel* (France)
- *Oolitic Stones* (Germany)

2. Hot topics

This research has emphasized some interesting points which are worth underlining:

1) The importance of the adoption of the concept of good faith: what emerged from both the “three-tier” test and the comparative analysis of different legal traditions is the fact that the concept of good faith, in spite of its vagueness, is a fundamental tool in the case of LOIs. When a LOI can’t be considered enforceable as a contract both from a formal and from a “practical” point of view, the institute of good faith and pre-contractual liability is a clever “third way” to attribute to the document a certain legal value, deriving not from its qualification as a contract but from a different theory. The traditional reluctance towards good faith characterizing common law explains what we have concluded about England, i.e. that, among the surveyed countries, UK is the less favourable towards LOIs: this way of reasoning excludes *a priori* the third test, leaving only the first two which are deeply connected to the existence of a “contract”. Considering the fundamental role that the instrument of LOIs plays in modern commercial transactions, it is therefore advisable, in my opinion, to strongly encourage the most recent doctrinal and jurisprudential movement trying to bring the concept of good faith in all the areas of common law.¹⁶²

¹⁶² See p. 33 for details.

2) The problem of transnational LOIs: one of the most relevant consequences of the dissimilar approaches adopted by different countries is the difficulty to use and enforce transnational LOIs, i.e. LOIs concerning parties which are based in two or more countries. Provided that it does not exist a “common” understanding of the elements underpinning the system of LOIs (contract formation, pre-contractual liability etc) and of the value of these documents, which is the view or the interpretation that must be applied to the concrete case? The parties often try to answer this question drafting a “choice-of-law clause”, i.e. a provision establishing that all the issues arising from that document should be subject to the law of a certain country, or to a set of international principles (for example, the UNIDROIT Principles); in absence of this clause, the general rules of private international law identify the law of reference. It is highly advisable for the parties to agree on a choice-of-law clause, because the rules of private international law could lead to unpredicted results. However, even after the mutual choice of a certain law governing the transnational LOI, problems in the application of the LOI could arise as well. First of all, laws are often very ambiguous in themselves for what concerns pre-contractual documents, and consequently the choice of a certain law does not automatically mean that all the issues and the problems could be plainly solved. Secondly, there could be difficulties in the concrete enforcement of the document in another jurisdiction where the common attitude towards these documents is different from the one characterizing the chosen law. Therefore, I must conclude that the choice-of-law mechanism is surely helpful, but it does not solve completely the inconveniences of transnational LOIs.

3) Specific provisions on LOIs and unification of contract law: a possibility or an *utopia*? Strictly connected with what we have said in the previous point is the consideration that a system of domestic and transnational LOIs could really work only if one of this two conditions is fulfilled:

- The creation of clear and detailed provisions, *within the laws of the single countries*, about the pre-contractual stage and in particular about LOIs, establishing their legal value, the role of good faith and the enforcement in other jurisdictions: in this way domestic LOIs could have a specific collocation in the legal framework of the country and, speaking about transnational documents, the system of choice-of-law could be finally useful in practice, because, choosing a certain law, parties could be sure about the legal effect of their LOI and about all the related consequences;
- The unification, *at a regional level*, of the law of contracts, with specific reference to pre-contractual documents: I am thinking, for example, about an European law of contracts. In these way all the legislative barriers among the countries constituting the European Union would disappear and an unique law would rule all the contractual and pre-contractual issues.

These two solutions are undoubtedly very ambitious and in my opinion are, at the present moment, more *utopias* than concrete possibilities. The first one implies the change of relevant parts of the civil codes of all the countries, which at the moment do not contain articles about LOIs, and the second one requires the establishment of an European contract law applicable to all the Member States. Some steps have already been tried in the past towards this direction, but for the moment this result seems to be quite far. However, in my opinion these two are the paths to go through, because I think that they

are the most effective ways to solve definitely the problems connected to the legal definition and recognition of LOIs.

3. A “check-list” to draft helpful LOIs

As we have already stressed, all the inconveniences caused by the ambiguous nature of LOIs are exacerbated by the fact that the drafters of these documents are seldom lawyers and, therefore, rarely conscious of the connected problems. Therefore, a “check-list” to use while working on a LOI could surely be useful. To prepare it I have considered what academic books say about LOIs, but my first source of inspiration consists on the case-studies analyzed in the third section of the paper and, in particular, on the mistakes deriving from those cases.

1) *Be sure to be clear, i.e. to draft a document which exactly reflects the real intention of the parties*

This could seem taken for granted, but, as we have seen in the case-studies, it is the basic and common mistake which characterizes all of them. This clarity should focus on two elements:

If you want that you and the other party are bound by the LOI:¹⁶³ in this case, you should try to make it as similar to a contract as possible. There are many different strategies to reach this goal, for example:

- a. paying attention to the “offer and acceptance” mechanism
- b. using “contractual language” (e.g., the term “agreement”, and not generic and dangerous words such as, in *SME* case, “intesa”)
- c. stating clearly that the parties are fully bound by that document or by some clauses. This is a crucial point and, to avoid any confusion, it is advisable, in some situations, to draft two different agreements: one containing the LOI itself, and the other explaining its binding nature
- d. listing clearly all the consequences deriving from non-compliance with the terms of the LOI

If you do not want that you and the other party are bound by the LOI: this situation requires an opposite reasoning:

- a. ignoring the “offer and acceptance” mechanism
- b. being very careful in avoiding any “contractual language” and using vague and generic terms
- c. stating clearly that the parties are not to be considered bound by that documents or by some of its clauses

2) *Use intelligent clauses*

There are some clauses that it is highly recommended to insert in any LOI, irrespectively of its binding or not binding nature. As we can learn from the cases, these clauses are:

¹⁶³ It can be observed that, in this kind of situations, one party has often an interest on binding the other one, without imposing the same obligation on itself. See for example F. BORTOLOTTI, *Drafting and Negotiating International Commercial Contracts, A Practical Guide*, ICC Publication No. 743E, 2013 Edition.

- A clause requiring the parties to act in good faith;
- An exclusivity clause prohibiting the parties to conduct parallel negotiations;
- A confidentiality agreement clearly stating that the parties agree to keep confidential and in particular not to disclose to any third party or to disseminate any confidential information connected with the LOI;
- A clause imposing that all press releases will be subject to agreement between the parties (in *Pennzoil v. Texaco* we have commented on the severe consequences that a “free” press release could have on a negotiation);
- A clause declaring that the LOI constitutes the entire agreement between the parties and supersedes all prior agreements and communications, both oral and written, relating to that subject matter, and specifying that the LOI may be amended, modified or supplemented only in writing;
- The precise period of validity of the LOI, i.e. a date within which the definitive agreement shall be drafted and signed, and the consequences of termination;
- A clause establishing the responsibility for the expenses (“typically specified as having the buyer and the seller each bear their own expenses”);¹⁶⁴
- A final clause defining the law governing the LOI and the dispute resolution mechanism (for example, arbitration), with the indication of the language and the place of the dispute resolution procedure.

3) *Avoid dangerous clauses* such as:

- Clauses containing imprecise legal language (remember the confusion, in the *Vittel* case, between “shares” and “assets”);
- “Subject to approval” clauses (in *Pennzoil v. Texaco* and *SME* we have commented that subjecting the document and the negotiation to approvals by the board of directors or the government could be very risky and not so useful)

4) *Remember the formality*

The fact that a LOI is not a definitive contract does not mean that it could be drafted “in a few lines written on simple commercial paper”, as the Court of Appeal commented in the *Vittel* case. Some kind of formality is required and this element could be taken into consideration during a judgment to evaluate the importance and the value that document had for the parties.

Following this check-list, the risk of big mistakes in the drafting of LOIs should be reduced. However, their ambiguous nature and the complexity of the concrete situation could in any case lead to legal mistakes. That is why I think that enterprises should adopt the “best practice” of drafting LOIs with a combinations of two elements: the use of standard models tailored on the specific enterprise and on the specific case, and the advice of at least one lawyer during the drafting and negotiation of LOIs. These two aspects are not alternative: they must be adopted together. The standard models allow to remember all the essential clauses that a good LOI should contain; additionally, the more they are specifically tailored on particular cases, the more they are useful. However, the advice of one or more

¹⁶⁴ I. WICK, *Letters of Intent – A Buyer’s Perspective Investigation*, 2015.

lawyers during the drafting is essential as well,¹⁶⁵ because it helps to recognize the elements that are peculiar to that specific situation and, consequently, to change the standard model in the light of that legal peculiarity.

Conclusively, I think that the adoption of the concept of good faith in every country, the unification of contract law (either from an “internal” perspective or from a “regional” one), the application of the above-mentioned check-list, the use of standard models and the advice of lawyers during the drafting are elements that could substantially reduce the controversial nature of LOIs and improve the future of this extremely useful and powerful legal instrument.

¹⁶⁵ This opinion is expressed also in LAKE, DRAETTA, *Letters of intent*, p. 245.

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