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Practice Points for Term Sheets, Letters of Intent, and Undertakings to Negotiate in Good Faith—Based on Delaware Supreme Court's SIGA *Decision*

We discussed in a recent Fried Frank M&A Briefing that the Delaware Supreme Court's decision in *SIGA v. PharmAthene* (Dec. 23, 2015 and May 23, 2013) has meaningfully increased the legal risk, at least in Delaware, associated with utilizing a term sheet or letter of intent. As discussed in that Briefing, in *SIGA*, the Supreme Court (i) enforced a contractual obligation to negotiate in good faith a definitive license agreement consistent with the terms set forth in a term sheet—even though the term sheet was labeled as "non-binding" and there had been a dramatic change in the underlying economic circumstances of the deal; and (ii) *e*stablished that there is a now a real potential in Delaware (unlike most other jurisdictions) for the recovery of expectation damages (*i.e.*, damages based on lost profits) for breach of a binding obligation to negotiate in good faith. (See Fried Frank M&A Briefing, *A Change in Delaware in the Consequences of Willful Breach of an Obligation to Negotiate an Agreement in Good Faith,* dated Jan. 19, 2016, available on the Fried Frank website.)

SIGA underscores—and we discuss in this Fried Frank Private Equity Briefing—the importance of clarity in a term sheet or letter of intent with respect to whether there is a binding obligation to negotiate in good faith and what the scope of that obligation is.

Key Points

- **Increased risk when relying on term sheets and letters of intent.** Recently, there has been a clear trend in proprietary opportunities to negotiate a detailed term sheet or letter of intent (each referred to here as an "LOI") prior to drafting and negotiating definitive documentation. Parties negotiating an LOI sometimes intend that there will be a binding obligation to negotiate in good faith a definitive agreement consistent with the terms set forth on the LOI, and sometimes intend instead that the LOI will not create a binding obligation to negotiate but will simply be a "jumping off point" for the parties to negotiate in the future if they choose to do so. The risk associated with using an LOI is that a party's intentions as to the binding nature of the LOI or of an obligation to negotiate will not be clear and ultimately will be misinterpreted by a court. The negative consequences of the risk have increased in Delaware, with the real potential, based on *SIGA*, for expectation damages if a court finds that there was a binding obligation to negotiate and that it was breached.

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Consider whether to utilize an LOI. Parties should consider carefully, based on the legal risk and the particular business and other circumstances, whether to:

- **proceed with an LOI, together with an express good faith obligation to negotiate** a definitive agreement;
- **proceed with an LOI, and specifically disclaim any obligation to negotiate** a definitive agreement, specifying that the LOI is not binding and is subject to the negotiation and execution of a definitive agreement; or
- **dispense with an LOI**, and proceed directly to negotiation of a definitive agreement.

Generally, the greatest advantage to proceeding with an LOI is that the parties can determine whether they have a meeting of the minds on the material terms of a deal before proceeding with the more detailed, prolonged, and costly effort of definitive documentation. As a rule, including a binding obligation to negotiate a definitive agreement in good faith will be more of an advantage to a party: the more certain the party is that it will want to proceed with a deal; the less certain it is that the other party will want to proceed with a deal; the more likely it is that the underlying economic or other circumstances may change over time to be less favorable to the party; and the more that deal certainty at the earliest possible point is desired (including, say, for regulatory purposes or market reaction).

- **Need for clarity.** If the parties determine to proceed with an LOI, they should ensure that they have clearly set forth whether, and to what extent, there is a binding obligation to negotiate a definitive agreement in good faith based on the LOI. This apparently self-evident and uncomplicated objective is surprisingly often ignored or executed imperfectly (as discussed below in "Practice Points").

Background

At a time that SIGA was in dire financial straits and could not afford to continue to develop its early-stage drug, SIGA discussed a merger with PharmAthene. Because SIGA had walked away from previous merger discussions with PharmAthene, PharmAthene insisted that the parties negotiate a license agreement term sheet ("LATS") so that, if SIGA again backed away from the merger, at least the license agreement would be in place. The merger agreement and the bridge loan both expressly provided that, if SIGA exercised any of its rights to terminate the merger agreement, the parties would negotiate in good faith a definitive license agreement consistent with the terms set forth in the LATS. The LATS was labeled as "non-binding" and was attached to both the merger agreement and the bridge loan.

Thereafter, the research study results for the drug showed that the drug was highly effective; SIGA received significant grants (putting it in a position that it could develop and market the drug on its own, without further financial assistance); and a substantial order for the drug was received. According to the court, SIGA's value increased to at least $3 to $5 billion; and the evidence indicated that SIGA regretted having entered into the merger agreement (at a much lower valuation) and did not want to proceed with the license agreement. At the drop dead date provided in the merger agreement, the SEC still had not cleared the proxy materials for the deal and SIGA exercised its right to terminate the merger agreement. Thereafter, SIGA refused to negotiate the license agreement on terms consistent with the LATS, seeking instead more favorable terms that would reflect the new economic circumstances.

The court held that SIGA had breached in bad faith the contractual obligation to negotiate the license agreement consistent with the terms set forth on the LATS. The court awarded PharmAthene $195 million in expectation damages.

Practice Points

- **Generally, parties utilizing an LOI should clearly express whether they do or do not intend there to be a binding obligation to negotiate a deal in good faith.** To determine if there is an obligation to negotiate a definitive agreement in good faith based on an LOI, a court will look first to the express terms of the LOI. An express obligation to negotiate, or an express *disclaimer* of any obligation to negotiate, set forth in the LOI (or, as in *SIGA*, in a definitive agreement that references the LOI) generally will be enforceable. Typically, the issue arises when the parties have been silent, or have been unclear, with respect to whether there is or is not an obligation to negotiate. In these situations, the court may seek to *infer* the parties' intentions. Generally, the more material, extensive, and specific the terms set forth in the LOI, the more that a court may be inclined to infer that the parties intended that there was an obligation to negotiate in good faith based on the LOI. In addition, the parties' communications and their actions (such as a purported future licensee having started to market the product based on the LOI) may be viewed by the court as supporting an inference that the parties intended to be bound to an obligation to negotiate. We note that there are sometimes circumstances under which, based on deal-risk considerations, a party may choose *not* to raise or clarify whether there is an obligation to negotiate; however, if the parties are silent or unclear as to an obligation to negotiate, there is the distinct risk that the court's conclusion could differ from what a party's actual intention was.

- **If there is an obligation to negotiate, the scope of the obligation should be clear.**

  - **LOI labeled as "non-binding" or "subject to negotiation and execution of a definitive agreement."** An LOI labeled as "non-binding" or "subject to negotiation and execution of a definitive agreement" should include clarification as to how that label relates to any obligation to negotiate an agreement. In *SIGA,* the term sheet was labeled "non-binding," but the merger and bridge loan agreements provided an obligation to negotiate in good faith consistent with the terms of the LOI. There was no explication as to the interrelationship of these provisions. An LOI that is labeled "non-binding" should clearly specify which, if any, provisions are nonetheless intended to be binding (such as those relating to expenses, confidentiality, and any obligation to negotiate). If an obligation to negotiate is specified as being carved out from the non-binding nature of the LOI, the parties should make clear whether the negotiations do or do not need to be consistent with the terms set forth in the LOI.

  - **LOI labeled as "subject to approval."** If an LOI is labeled as subject to approval by a board or an investment committee (or otherwise), there should be clarification as to how that provision relates to any obligation to negotiate a definitive agreement. If the LOI includes a binding obligation to negotiate a definitive agreement in good faith, a label that the LOI is subject to approval of the company's board would presumably lead to the same result as in *SIGA* where the term sheet was labeled "non-binding"—that is, the obligation to negotiate (in this case, to negotiate an agreement that would be presented to the board) would be enforceable. However, we expect that the court would not necessarily award expectation damages for a breach in this scenario because, in *SIGA*, the court noted that a premise of its decision to award expectation damages was its finding that, *but for* the bad faith breach by one party of the obligation to negotiate a definitive agreement, the parties would have reached a definitive agreement. That finding presumably could not be made if entering into a definitive agreement is subject to board

approval. Another issue would arise if, during the good faith negotiations, the board indicated that it would not approve the deal. In that case, we expect that the court could well find the obligation to negotiate no longer enforceable.

- **LOI labeled as "subject to due diligence."** An LOI labeled as "subject to due diligence" should include clarification as to how that provision relates to any obligation to negotiate a definitive agreement. A party negotiating an LOI should consider whether it would want to specify (a) whether the effect of a party's dissatisfaction with the results of due diligence would be (i) termination of the obligation to negotiate in good faith or, instead, (ii) the obligation to negotiate would continue but the requirement that the terms must be consistent with the LOI would terminate, and (b) whether dissatisfaction with due diligence would be in the party's sole discretion or would be based on material inconsistency with information already provided (or some other standard).

- **A change in circumstances (even if material) generally will not provide a basis for re-negotiation of the terms.** If there is a binding obligation to negotiate an agreement consistent with the terms set forth in an LOI, a change in circumstances generally will not provide a basis for re-negotiation of the terms. We note that proposed terms that are "substantially similar" to the terms set forth should not constitute a breach. In addition, proposals relating to terms set forth in the LOI that are unclear or not sufficiently specific should not constitute a breach. If the parties expect that there will be material changes in the underlying economic circumstances of the proposed transaction between the negotiation of the LOI and of the definitive agreement (as in the case, for example, of an early-stage drug for which study results or regulatory approvals are imminent), the parties may wish to consider whether to specify future events or circumstances that would trigger a specified change in the terms of the LOI, a right to re-negotiate the terms of the LOI, or a right to terminate the obligation to negotiate.

- **Failure to reach a definitive agreement does not necessarily constitute a breach of an obligation to negotiate in good faith.** The obligation to negotiate in good faith consistent with the terms set forth in an LOI is *not* an obligation to reach a definitive agreement. Good faith differences in the negotiation of the open issues may prevent the parties from reaching a definitive agreement. However, renouncement of the obligation to negotiate, abandonment of the negotiations without good faith efforts to reach an agreement, or insistence on conditions or terms that are materially inconsistent with the term sheet will constitute a breach (unless there is a legally justifiable foundation for having done so).

- **Factors in determining whether there has been a bad faith breach of an obligation to negotiate.** A court will be least inclined to find a breach if there was a good faith disagreement with respect to a material term that was not set forth in the LOI or as to which the LOI was unclear or not sufficiently specific. Evidence that a party regrets having entered into the obligation to negotiate will, of course, tend to support a determination of a breach, whereas a party's plausible belief (even if mistaken) that there was not a binding obligation to negotiate (say, because the other party had not fulfilled its obligations, or when the obligation to negotiate was not clearly expressed) will tend to support a determination that there was not a breach or that, if there was a breach, that it was not in bad faith. Parties should keep in mind that a court will consider the content of communications between the parties, as well as internal emails and board presentations, when determining whether a party's refusal to negotiate was a willful breach.

- **Distinguishing *SIGA*.** We note that it is uncertain to what extent certain unusual facts drove the result in *SIGA* and whether the result might be different in other circumstances. For example, it is not apparent whether, if the economic circumstances had changed in the opposite direction (*i.e.*, the value of the drug had dramatically decreased rather than increased), the court would have enforced the obligation to negotiate, with the result that significant payments would have to be made for the right to license a worthless drug. We note that *SIGA* may be distinguishable from other situations based on the following:

  - *First*, unlike many situations in which the issue of the binding nature of an obligation to negotiate arises, in *SIGA* there was an express statement in a definitive agreement that the LOI was binding.

  - *Second*, in *SIGA*, there was evidence of an intention to be bound by the obligation to negotiate. The parties had been in merger discussions before, SIGA had backed away from those previous negotiations, and PharmAthene had then insisted on negotiation of the LOI so that, if SIGA backed out again, at least PharmAthene would have a license for SIGA's drug.

  - *Third*, at the time that SIGA refused to negotiate the definitive agreement, SIGA had already obtained almost the full benefit of the parties' bargain (*i.e.*, the bridge loan, which enabled it to continue to develop the drug, and credibility in the market as a result of the announcement of the merger). PharmAthene, however, had not received *any* benefit of the bargain—resulting in the equities as to enforcement of the obligation to negotiate the license agreement being in PharmAthene's favor.

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