

Letters of Intent in the Commercial Real Estate Setting

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Negotiating a commercial real estate contract can be lengthy and expensive. It can also be a waste of time and money if the parties ultimately disagree over key terms of the deal. To assure agreement over important terms, parties sometimes use a preliminary agreement known as a letter of intent. This article addresses the benefits and pitfalls of letters of intent and provides practical guidance for interpreting and using letters of intent in a commercial real estate transaction.

What is the benefit of a letter of intent?

In its simplest form, a letter of intent outlines the basic terms of a transaction, similar to a term sheet. Agreement on the basic terms tends to facilitate agreement on the remaining terms. A signed letter of intent lends a certain level of gravitas to your negotiations. Whether you are the seller or the buyer, you and the other party are more likely to feel committed to finalizing a deal when you have already formalized a preliminary agreement. When you sign a letter of intent, you are signaling to the other party that you are serious about making the transaction happen. Negotiating a letter of intent can also identify casual or uncommitted parties prior to incurring the expense of a final contract.

Letters of intent may be used for any contract negotiation in which you and another party have agreed to the economic terms of the transaction. For example, a letter of intent may be useful in the sale of a restaurant after both parties have agreed on the purchase price, deposit amount, closing date, and responsibility for closing costs but have yet to agree on the allocation of liabilities.

When are letters of intent binding upon parties?

As is true with any written document, the legal effect of a letter of intent depends on its language. Letters of intent can bind parties to particular terms, to negotiate in good faith, or to nothing at all. Often letters of intent expressly state that the parties are not contractually bound unless they sign a subsequent formal contract. Generally, language to this effect is desirable because it precludes litigation over a transaction in which the parties have not yet agreed on all terms.

When a letter of intent does not explicitly state the extent to which you and another party agree to be bound, the legal effect of the letter of intent is uncertain and the risk of litigation heightened. If, for example, you claim the letter of intent represents binding promises of the other party and that party sees it differently, resolution of the dispute may depend on a court ruling.

An “agreement to agree” is not an enforceable contract in any circumstance. If a letter of intent is construed as simply an agreement to agree, the letter of intent is not enforceable. However, specific provisions of a letter of intent may be enforceable even if the letter of intent as a whole is not an enforceable contract. For example, if you are the seller of property, you may agree in a letter of intent not to sell the property for a period of time pending negotiation of the final contract, or you and the prospective buyer may agree to negotiate in good faith. These provisions are enforceable to the same extent as other contractual promises.

To ensure that a letter of intent is not construed as an enforceable contract, language such as the following should be included: “Neither delivery to you of this letter of intent nor your acceptance of it represents a binding obligation on either party to consummate the purchase and sale of the property, and neither party will have any legal obligation until a formal contract is entered into between the parties. Delivery to you, and your acceptance, of this letter of intent, however, will represent our mutual desire to proceed with the transaction and the preparation of the contract consistent with the provisions outlined above. It is understood that the specific terms of the contract are subject to negotiation and that if the parties are unable to reach agreement on such terms, the transaction will not be consummated.”

What does it mean to negotiate in good faith?

General principles of contract formation allow parties to terminate negotiations at any time for any reason unless they have previously agreed otherwise. A letter of intent can obligate parties to negotiate in good faith. Negotiating in good faith means that parties will negotiate until a final contract is formed or a stalemate based upon a genuine disagreement of terms is reached, at which point the deal is dead. In other words, these parties are obligated in a procedural manner but are not bound by the substantive terms like a party to a binding letter of intent. Being obligated to negotiate in good faith generally prevents one party from breaking off negotiations to accept a more favorable opportunity. The extent to which a party is obligated to negotiate in good faith is determined by the terms of the letter of intent. You should be aware of this kind of obligation because it is becoming increasingly popular in commercial real estate negotiations, and a failure to adhere could result in a claim against you for monetary damages or even the forced sale of your property.

How should you analyze a letter of intent?

There is no “one size fits all” letter of intent, and each letter of intent should be analyzed with this in mind. While it is not advisable for you to sign a letter of intent without the assistance of an attorney, you should feel empowered to take a first look.

Step 1: Give the entire document a broad look. Instead of focusing on the specific terms, get a general impression of the document. Make sure all pages are present, including any exhibits or attachments; take note of the title at the top (while also remembering it does not control the legal effect of the document); look for dates and signatures; and ensure the parties are accurately referenced. Make note of the different sections of the document. For example, is there a section outlining financing terms or describing the property? Is there a section on confidentiality?

Step 2: Review the terms. Check the terms of the document for clarity and accuracy. If there is a discrepancy in the terms, communicate the discrepancy to the opposing party as soon as possible. If the meaning of particular language is unclear, seek legal advice. Do not sign a document containing language you do not understand.

Step 3: Look for “binding” language. A letter of intent can be binding in whole or in part, or it may obligate the parties to negotiate in good faith. Look for particular phrases signaling a legal effect, such as:

- “This binding letter of intent is contingent on the following terms and conditions...”
- “With the exceptions of paragraphs 3, 4, and 12, this letter of intent does not create a binding contract and will not be enforceable...”
- “This letter of intent creates a duty and obligation to negotiate in good faith...”
- “This Agreement is enforceable as to the sale of the property.”

What are some particular terms to include in letters of intent?

Letters of intent may address the following matters:

Economic terms. Besides the purchase price and earnest money deposit, a letter of intent may outline how the transaction is to be financed and who pays title insurance, survey, and other closing expenses.

Inspection period. Purchasers typically desire a time period during which they may inspect the property and determine its acceptability. They generally have the option of cancelling the purchase agreement if the property is not determined to be acceptable.

Closing. A letter of intent may specify a date for closing, sometimes expressed as a certain number of days after the occurrence of a stated event, such as expiration of the inspection period.

Brokers. If real estate brokers are involved in the transaction, the letter of intent may identify the brokers and confirm how the brokers are to be paid.

Confidentiality. A letter of intent may require the parties to keep negotiations confidential. This term should not preclude seeking professional assistance from an advisor, such as an attorney or accountant, or discussions with prospective lenders.

Good faith negotiations. A letter of intent may require the parties to act honestly and diligently in the negotiation of the final contract.

Exclusive opportunity. A purchaser may require that the seller not negotiate with any other party after execution of the letter of intent.

Nonbinding provision. A letter of intent may state that it only expresses a preliminary understanding and is not binding on the parties.

Should you sign a letter of intent?

A letter of intent is a cost-efficient means of assuring agreement on critical elements of a transaction before undertaking preparation of a comprehensive commercial contract. It is especially useful whenever there is substantial uncertainty over the likelihood of reaching agreement on the economic terms of a deal. Except for limited obligations, such as a seller's agreement not to negotiate with others during preparation of a final contract, letters of intent should expressly state that they are not binding agreements. In these circumstances, a letter of intent may be an excellent vehicle to reach agreement on final contract terms.



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