

LETTERS OF INTENT:

Their Use, Content, and Legal Issues

**THE HAMILTON LAW ASSOCIATION
CORPORATE COMMERCIAL LAW SEMINAR**

“Practical Advice for Business Lawyers”

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LETTERS OF INTENT

“...Love Letters in the Sand?...”

Introduction: A Letter of Intent usually is not intended to be a contract. However, the Courts have construed Letters of Intent as contracts in circumstances where the wording of the Letter of Intent and the conduct of the parties leads to the conclusion that the ingredients of a contract exist.

1. What is a Contract?

In order to understand the fine line between a non-binding Letter of Intent and a binding contract, it makes sense to revisit the key requirements to form a contract. A contract is a promise or set of promises constituting an agreement between two or more parties that gives each a legal duty to the other(s), and also gives the right to seek a remedy for the breach of those duties. The essentials for a contract are competent parties, subject matter, a legal consideration, mutuality of agreement, and mutuality of obligation. Unless specifically required by law, a contract does not have to be in writing, and oral contracts may be enforceable. In fact, the Ontario Court of Appeal recently found that an individual had a contractual right to become a shareholder of certain corporations by virtue of oral agreement with another individual who was found to be the governing mind of such corporations: *UBS Securities Canada Inc. v. Sands Brothers Canada Ltd.*, 95 O.R. (3d) part 2. Most parties who are intending to enter into a complex commercial transaction prefer to reduce the terms of the agreement to writing, and the preliminary discussions of the parties may lead to a written “proposal”.

2. **What is a Letter of Intent:**

When parties contemplate entering into a commercial transaction, often they will consider using a device known as a “Letter of Intent”. A Letter of Intent is a letter or memorandum from one negotiating party to the other, setting out the state of negotiations regarding a particular proposed transaction, including the proposed consideration, a description of the subject matter of the proposed transaction, how the purchase price would be paid, the proposed closing date, and any other conditions or provisos relating to the proposed transaction, such as due diligence, financing and employment contracts for principals. The Letter of Intent normally has a termination date by which time the other party must sign the Letter acknowledging that the Letter correctly sets out the status of the negotiations. Most Letters of Intent are intended to be non-binding and specifically state that they are expressions of the state of negotiations only, and that the obligations of the parties will only become binding upon execution of the contemplated agreements. However, problems often arise after significant negotiation, including considerable legal and accounting work, when the parties fail to reach final agreement and one party desires to abandon the negotiation, and the other party wishes to enforce the Letter of Intent as a binding agreement on the basis that all significant terms of the transactions have been agreed upon. There are many cases dealing with such disputes and they invariably turn on the specific facts of each case.

3. **Case Law:**

Recently, the Ontario Court of Appeal considered an appeal in *Wallace v. Allen*, 93 O.R.(3d)723, which was an appeal from a decision of Eberhard J. of the Ontario Superior Court of Justice. An excellent paper prepared for a LSUC program by Craig R. Carter (see

bibliography, post) discusses the *Wallace* decision in detail and definitely is recommended reading. The matter at issue in the case was a share purchase agreement regarding the shares of several corporations. The parties had negotiated a Letter of Intent and had spent considerable time negotiating the formal agreements before the intended transaction collapsed, primarily due to the conduct of the vendor and purchaser. Although the Letter of Intent which was negotiated contained many terms normally found in a contract, including reference to “agreement” and “acceptance” of the terms of the Letter of Intent, it also stated that: “...*the wording in this Agreement may alter somewhat...*” and that: “...*the Letter of Intent must be reduced into a binding agreement of Purchase and Sale by the Parties within the next 40 days...*” In her judgment, Eberhard J. stated that:

“The Courts will not enforce an agreement to agree, but whether or not the parties have reached agreement intending to be bound is to be assessed from the perspective of the objective reasonable observer considering the circumstances giving rise to the Letter of Intent, the wording of the document, and the conduct of the parties.” (85 O.R. 3d) 88 paragraph [96]

Eberhard J. also quoted a statement from G.H.L. Fridman, *The Law of Contract in Canada*, 4th ed., pp. 16-17, in her decision, as follows:

“Constantly reiterated in the judgments is the idea that the test of agreement for legal purposes is whether parties have indicated to the outside world, in the form of the objective reasonable bystander, their intention to contract and the terms of such contract. The law is

concerned not with the parties' intentions but with their manifested intentions. It is not what an individual party believed or understood was the meaning of what the other party said or did that is the criterion of agreement; it is whether a reasonable man in the situation of that party would have believed and understood that the other party was consenting to the identical terms. The common law embraced this attitude of objectivity in the determination of contractual relations. However, equitable ideas have infiltrated the law of contract to the extent of permitting a more subjective assessment of the circumstances. In some situations, therefore, the existence of a contract and the nature and content of its terms may be determined by reference to the actual belief and understanding of an individual party rather than by reference to the belief and understanding of a reasonable man hypothetically in the position of such party."

Ultimately, after an exhaustive review of the facts of the case, and of the applicable case law, Eberhard J. concluded that the Letter of Intent was not an enforceable contract, and that the Plaintiff purchaser did not have a remedy in specific performance or damages. The judgment in *Wallace v. Allen* prepared by Eberhard J. is recommended reading for any lawyer who is preparing a Letter of Intent, since it is an excellent overview of the law and the criteria that are applied in determining whether a Letter of Intent is enforceable.

The decision in *Wallace v. Allen* was appealed to the Ontario Court of Appeal, (93 O.R.(3d)723) and the decision was delivered by MacFarland J.A. (with the agreement of Laskin J.A. and Armstrong J.A.). The Court concluded that the Trial Judge had erred in law in determining that the parties did not intend a binding Letter of Intent, and the Court stated that:

“It is submitted that the Trial Judge failed to apply the presumption in law that one who executes a commercial document intends to be bound thereby, and that her construction of the Letter of Intent defeated the expectations of the parties and was contrary to the overwhelming weight of the evidence.” (93 O.R. (3d) 723 para. 6.)

MacFarland J.A. went on to state that

“The language of the document itself speaks to an intention to be bound upon the signing of the document.” (93 O.R. (3d) 723 para.30.).

The Court of Appeal also dealt with the matter of damages in the case, and indicated that it was not a case for specific performance, but doubled the damages which the Trial Court had determined in the trial judgment. Although the Court of Appeal seized on the wording in the document as the critical factor, the reasons of Eberhard J. demonstrate that conduct of the parties can strongly influence the Court.

4. **Business Functions of a Letter of Intent:**

The Letter of Intent is primarily a “business” document which when used appropriately

identifies the major components of an intended transaction, and permits the parties to determine whether they have common ground to proceed with the transaction. The business functions of a Letter of Intent include the following:

- a. signaling commitment to making a deal;
- b. minimizing legal/accounting costs until it is known that both parties have such commitment;
- c. confirming whether the parties are “on the same page” by setting out the key ingredients of the proposed deal;
- d. commitment to a time line with specific dates by which certain components of the negotiations would be concluded (e.g. Letter of Intent; due diligence; settle documents; confirm financing; closing);
- e. agreement not to negotiate with other parties and to keep the negotiation confidential;
- f. any other terms specific or peculiar to the proposed transaction.

5. Ingredients of a Letter of Intent:

Drafting a Letter of Intent can be risky business. In some cases clients prepare the Letter of Intent without any advice from legal counsel, and such documents often contain contract language or omit essential terms. In such cases it is wise to recommend a supplementary memorandum to the Letter of Intent, to rectify any serious deficiencies in the original document. And of course, some Letters of Intent are intended to be enforceable by the parties, with the understanding that the details of the deal must be negotiated.

A review of the *Wallace v. Allen* case will confirm that if the Letter of Intent is not to be

binding, the language used in the document is critical. The letter should not include contract words such as “*agrees*”; “*it is agreed*”; “*the agreement*”; or “*upon acceptance*”, unless the reference is to the clauses intended by the parties to be enforceable, such as confidentiality/non-disclosure; exclusive dealing; due diligence; payment of costs; and public announcements. Arguably, some or all of the “enforceable” clauses found in a Letter of Intent should be in a separate intentionally binding confidentiality agreement signed by the parties before any material disclosure is made prior to the Letter of Intent being negotiated and signed.

The parties must be identified, and often the purchasing party is acting on behalf of a proposed corporation, or a trustee or a representative of a group of purchasers. Certainty of who the purchaser is or will be is preferable, but often is determined in the context of settling the terms of the formal agreement. The Letter of Intent must consistently indicate that it is referencing a “proposed” transaction and that it is not a contract. The subject matter of the proposed deal must be set out with some particularity, but every detail is not required for the Letter of Intent. Remember, it is a statement of the general terms of the transaction being negotiated.

Often the exact purchase price is not yet known, but it is essential that the Letter of Intent at least sets out a method or formula that will be used to determine or calculate the purchase price. Lack of such provisions often result in negotiations breaking down due to significantly different expectations of the vendor and purchaser with respect to the purchase price.

The Letter of Intent sometimes contemplates that a deposit will be paid by the purchaser if and when the purchase agreement is settled and signed. The parties often expect that the purchase agreement will be signed in advance of the closing date, and if that happens, the deposit is a good idea. However, most purchase agreements, although settled prior to closing, often are signed at closing.

Most Letters of Intent set out the terms of payment of the purchase price and, if any part of the payment is to be deferred, the terms of the promissory note and any proposed security must be described. The Letter of Intent may provide for the purchaser being allowed to commence due diligence and there also must be a provision requiring return of any information or materials which have been delivered to the purchaser if the negotiations are terminated.

It is a good idea to set out timelines for settling key formal documents and closing. The dates often change and the parties must acknowledge any extension of time in writing, with a clear disclaimer that there is no contract until the final formal agreements are settled and signed. Finally, the Letter of Intent should be “acknowledged” not “accepted” by the parties. A sample Letter of Intent is attached to this paper.

6. **Conduct of the Parties and Counsel**

Regardless of the content of the Letter of Intent, it is essential to recognize that the Courts look at the conduct of the parties and their respective counsel when considering whether a document is enforceable. In *Wallace v. Allen* Eberhard J. seemed to give considerable

weight to the conduct of the parties and their lawyers. The Court of Appeal seemed to give most weight to the use of contract language in the Letter of Intent.

If the parties signal that they are starting to “perform” the terms of the contract under negotiation, such as commencing to work in the business; relocating or recruiting personnel for the business; or sending press releases and letters to suppliers, the Court may construe such actions as indicating that the party or parties is/are assuming or confirming that there is an agreement. The language used by Counsel in communications also should be guarded. In his paper referred to above, Mr. Carter suggests that the lawyers acting for parties who have signed a Letter of Intent should confirm to each other that “Notwithstanding anything I have said or done, there is no contract until there is a contract”.

Perhaps more elegant language could be used, but Counsel must “refresh” the “no contract” intention until the formal agreements are signed, and Counsel must caution the client against any conduct during the negotiation of the formal agreement which may be construed as confirmation of an agreement.

Draft carefully, act cautiously, and the “love letter in the sand” will not be binding until the parties so intend.

Bibliography

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5. *Fridman, G.H.L., The Law of Contract in Canada*, 4th ed., (Scarborough: Carswell, 1999).

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6. Conduct of Parties and Counsel



WHAT IS A CONTRACT?

- ◆ Promises - competent Parties
- ◆ Agreement - subject matter
- ◆ Mutual Obligations
- ◆ Consideration



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WHAT IS A LETTER OF INTENT?

- ◆ Status of Negotiations (“Getting Engaged”)
- ◆ Proposed Transaction & Terms
- ◆ Conditions/Provisos
- ◆ Timelines/Closing
- ◆ Acknowledged By Parties
- ◆ Non-Binding Language



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CASE LAW

- ◆ *Wallace v. Allen*
 - Good Discussion of Law
 - Court of Appeal

BUSINESS FUNCTIONS OF A LETTER OF INTENT

- ◆ Commitment to Negotiations
- ◆ Minimize Costs (Legal/Accounting)
- ◆ Parties “on same page”?
- ◆ Timeline
- ◆ Exclusive Dealing and Non-Disclosure
(separate document?)

INGREDIENTS OF A LETTER OF INTENT

- ◆ Binding or Non-Binding?
- ◆ If non-binding, avoid contract words like “agrees”; “it is agreed”; “this agreement”; “upon acceptance”
- ◆ Payment of Deposit - only if Purchase Agreement signed



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INGREDIENTS OF A LETTER OF INTENT

BINDING CLAUSES:

- ◆ Exclusive Dealing Clause
- ◆ Confidentiality/Non-Disclosure
- ◆ Due Diligence
- ◆ Costs
- ◆ Announcements



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INGREDIENTS OF A LETTER OF INTENT

- ◆ Identification of Parties-who is Purchaser?
- ◆ Make Clear a “Proposed” Transaction
- ◆ Subject Matter of “Proposed” Transaction
- ◆ Due Diligence
- ◆ Timelines/Closing



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INGREDIENTS OF A LETTER OF INTENT

- ◆ Price often not determined in Letter of Intent
- ◆ If possible, set out formula or method to determine price
- ◆ Payment/Deferred Payment/Security



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INGREDIENTS OF A LETTER OF INTENT

- ◆ Financing
- ◆ Financial Statements
- ◆ Some Other Event/Closing (eg. Purchase of real estate)
- ◆ Employment Contract of Vendor(s)
- ◆ Employee Retention



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INGREDIENTS OF A LETTER OF INTENT

- ◆ “Acknowledgement” not “Acceptance”
- ◆ Clearly state not an agreement unless and until Parties settle all terms, conditions and provisos and sign and deliver all formal agreements and the consideration



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CONDUCT

- ◆ Conduct of the Parties:
 - Has either Party commenced performance?
- ◆ Conduct of the Lawyers:
 - Reaffirm no contract during negotiation of Letter of Intent and Purchase Agreement until all terms settled
 - Disclaimer in each letter with new drafts



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FINAL THOUGHT

- ◆ Remember – it's a *love letter*!
- ◆ The Letter of Intent is **NOT** the final Agreement – stay focused on major terms and then move on to the formal Agreement

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LETTER OF INTENT

TO: _____

RE: **Letter of Intent for the Proposed Purchase and Sale of the Shares of** _____

The purpose of this letter of intent (the "**Letter**") is to acknowledge the discussions to date between _____ (the "**Purchaser**") and _____ (the "**Vendor**"), collectively referred to herein as the "**Parties**" and individually as a "**Party**", concerning the possible acquisition by the Purchaser from the Vendor of all of the issued and outstanding shares of _____ (the "**Corporation**") and such possible acquisition is hereinafter referred to as the "**Transaction**".

The acknowledgement by the Parties of this Letter is not intended to create a binding contract or agreement between the Parties with respect to the matters set out herein, except as to the matters specifically referred to in Sections 5, 6, 7, 8, and 9, which the Parties mutually agree to be binding upon them upon the Vendor signing the acknowledgement below, and returning the duplicate copy to the Purchaser. Notwithstanding any further negotiations or settling of outstanding issues in whole or in part, the Parties expressly confirm that no contract or agreement exists between the Parties until a formal and binding share purchase agreement (the "**Purchase Agreement**") has been settled, executed and delivered by the Parties.

Any obligation of the Vendor and the Purchaser to complete the Transaction will be subject to the Purchase Agreement which, if agreed to by the Vendor and the Purchaser in final form, will evidence the terms of the Transaction and will contain covenants, representations, warranties, indemnities, and terms and conditions typical of such a transaction, including, without limitation, the completion of a satisfactory due diligence review of the Corporation and the business, assets and financial condition of the Corporation, and confirmation of the absence of any material adverse change to the Corporation or the business, assets and financial condition of the Corporation prior to closing.

The Purchaser and the Vendor intend to work diligently and in good faith to negotiate and endeavour to settle the Purchase Agreement as at the close of business on the ____ day of _____, 200__ (the "**Effective Date**") with a view to completing the Transaction on or before the ____ day of _____, 200__ (the "**Closing Date**"). If the Parties are unable to settle the Purchase Agreement by the Effective Date, then this Letter and negotiations between the Parties shall terminate and be of no further force or effect and, except with respect to breaches of Sections 5, 6, 7, 8 and 9 below, neither of the Parties shall have a remedy or claim against the other.

The Purchaser and the Vendor acknowledge that the Purchase Agreement, if settled, will include the following terms, which may be altered due to the negotiations:

1. SHARES

The Purchaser will purchase from the Vendor all of the Vendor's shares of the Corporation (hereinafter referred to as the "**Purchased Shares**").

2. PURCHASE PRICE

The purchase price payable by the Purchaser to the Vendor for the Purchased Shares shall be the sum of _____ (\$_____), (the "**Purchase Price**") which has been calculated and shall be adjusted on the following basis:

[set out any formula for Purchase Price and basis of any adjustment]

3. PAYMENT OF PURCHASE PRICE

If the Purchase Agreement is executed by the Vendor and the Purchaser, the Purchase Price will be paid and satisfied as follows:

- (a) the Purchaser shall pay by certified cheque or bank draft, to the solicitors for the Vendor to be held in escrow the sum of _____ dollars (\$_____), at the time the Purchase Agreement is executed, which amount shall be held as a refundable deposit in an interest-bearing account until all conditions specified in the Purchase Agreement have been satisfied or waived, at which time it will become a non-refundable deposit, or if all conditions specified in the Purchase Agreement have not been satisfied or waived, the deposit shall be returned to the Purchaser with any accrued interest;
- (b) the Purchaser shall pay the further sum of _____ dollars (\$_____) to the Vendor by certified cheque or bank draft on closing subject to any adjustments;
- (c) the balance of the Purchase Price, estimated at the sum of dollars _____ (\$_____) shall be satisfied by the Purchaser giving and the Vendor accepting a promissory note payable by the Purchaser to the Vendor. **[Add terms of interest and payment for the Note, and any security for the Note].**

4. **CONDITIONS**

The Purchase Agreement, if settled, executed and delivered, shall be conditional upon all conditions set out in the Purchase Agreement being satisfied or waived, including the following:

- (a) upon the Purchaser obtaining the necessary financing for the Transaction;
- (b) upon the absence of any material change in the affairs of the Corporation;
- (c) upon the Purchaser being satisfied with the due diligence;
- (d) upon finalization of any adjustments to the Purchase Price as herein provided;
- (e) upon the obtaining of all requisite third party approvals, consents, agreements or governmental authorizations;
- (f) upon the execution and delivery by the Purchaser and the Vendor of the other documents, certificates and contracts contemplated by the Purchase Agreement.

5. **EXCLUSIVE DEALING**

The Parties will deal exclusively and will negotiate in good faith with each other for the purchase and sale of the Purchased Shares until the Effective Date. Neither Party shall break off negotiations, threaten to break off negotiations or fail to negotiate in good faith prior to the Effective Date, or such later date as the Parties, in writing, mutually may agree upon, after which time, if the Purchase Agreement has not been settled by the Vendor and the Purchaser, the negotiations may be terminated by either Party.

6. **DUE DILIGENCE**

The Purchaser proposes to conduct due diligence, at its sole expense, into the financial, legal and operational affairs of the business of the Corporation, for which purposes the Purchaser is to be given full and free right of inspection into such matters. The Vendor agrees to provide the Purchaser and its agents, employees, representatives, consultants and advisors access to, and will make available to them for inspection and review, all books of account, and financial records, leases, agreements and licences, permits, documents of title and ownership, and other documents of or relating to the business of the Corporation. The Vendor will make its accountants, legal counsel and other representatives available for consultation and verification of any information so obtained. If the Purchase Agreement is not settled by the Effective Date, unless the Parties have agreed otherwise in writing, all documents and information in any media obtained by the Purchaser and its

agents, employees, representatives, consultants and advisors shall be returned to the Vendor within five days (5) after the Effective Date.

7. **CONFIDENTIALITY**

Except for any disclosure specifically authorized in writing by both Parties, the Parties agree to keep confidential their negotiations pending the successful negotiation and completion of the Transaction, and further agree not to disclose to any other person any confidential documentation or other information exchanged during the negotiations or any due diligence period, except with the express permission of the other Party. For greater certainty, it is agreed that the Parties shall be entitled to disclose all information to their legal and financial advisors without violating this provision.

8. **ANNOUNCEMENTS**

Each of the Vendor and the Purchaser and the Corporation agree not to make any public announcement concerning the Transaction or related negotiations without the prior written approval of the other Party, except as may be required by law.

9. **FEES AND COSTS**

The Purchaser and the Vendor agree that they shall be responsible for their own costs, including legal fees, accounting fees and consultant's fees and disbursements, in connection with this Letter, the Purchase Agreement, and the Transaction.

To acknowledge the status of negotiations and agreement with paragraphs 5, 6, 7, 8 and 9, please sign and return one copy of this Letter to the Purchaser.

Dated at _____, Ontario, this ____ day of _____ 200__.

Purchaser

ACKNOWLEDGED this ____ day of _____ 200__.

Vendor