
COMMENT

LETTERS OF INTENT IN CORPORATE NEGOTIATIONS:
USING HOSTAGE EXCHANGES AND LEGAL
UNCERTAINTY TO PROMOTE
COMPLIANCE

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INTRODUCTION

Letters of intent (LOIs) are fundamental building blocks of many corporate transactions. Although their form and terms vary, LOIs are used predominantly to communicate parties' agreement to the basic structure of a deal and a mutual desire to continue negotiating.¹ They are commonly called "agreements to agree" or, somewhat oxymoronicly, "nonbinding agreements."² In almost every respect, these agreements are contracts—except they aren't supposed to be. They state that the parties agree, while also stating that the parties don't agree yet. Under a traditional legal analysis, these agreements pose a problem: either there is an enforceable contract or there isn't one. It's no wonder that LOIs have been described as the contractual equivalent of being "almost pregnant."³

Nevertheless, business professionals value these almost-binding agreements. When two companies sign an LOI, the parties often view it as a reason to celebrate. An LOI is considered a major milestone in the lifecycle of many transactions.⁴

Lawyers, however, are less enthusiastic. One prominent corporate lawyer went so far as to describe LOIs as "an invention of the devil [that] should be avoided at all costs."⁵ Case law provides numerous examples of the potential legal pitfalls of using LOIs. In *Texaco, Inc. v. Pennzoil, Co.*, one of the most prominent cases involving LOIs, the court held a supposed LOI to be a binding contract, which ultimately cost Texaco \$8.5 billion.⁶ Although such a large recovery is rare, the legal conclusion is not. Courts frequently find LOIs to be binding contracts,⁷ but just as often find similar LOIs to be

¹ Judith Silver, *The Letter of Intent: Why Business People Love 'Em and Lawyers Hate 'Em*, COOLLAWYER, https://www.coollawyer.com/webfront/internet_law_library/articles/law_library_letter_of_intent_article.php (last visited Mar. 22, 2014).

² Robert M. Lloyd, *Making Contracts Relevant: Thirteen Lessons for the First-Year Contracts Course*, 36 ARIZ. ST. L.J. 257, 282 (2004).

³ Silver, *supra* note 1.

⁴ See Gregory G. Gosfield, *The Structure and Use of Letters of Intent as Prenegotiation Contracts for Prospective Real Estate Transactions*, 38 REAL PROP. PROB. & TR. J. 99, 100 (2003) (describing the importance of LOIs in the real estate context).

⁵ Andrew R. Klein, Comment, *Devil's Advocate: Salvaging the Letter of Intent*, 37 EMORY L.J. 139, 139 n.1 (1988) (quoting Stephen R. Volk, a former senior partner of Shearman & Sterling LLP, New York, New York).

⁶ 729 S.W.2d 768, 866 (Tex. App. 1987).

⁷ See, e.g., *S. Colo. MRI, Ltd. v. Med-Alliance, Inc.*, 166 F.3d 1094, 1099 (10th Cir. 1999) (finding an LOI binding based on the conclusion that the parties waived the requirement of a final writing by their actions); *Hoxeng v. Topeka Broadcomm, Inc.*, 911 F. Supp. 1323, 1331 (D. Kan. 1996) (finding an LOI binding because the parties' actions reflected an intent to be bound); *Krauth v. Exec. Telecard, Ltd.*, 890 F. Supp. 269, 293-95 (S.D.N.Y. 1995) (finding an LOI binding based on a multifactor analysis).

unenforceable.⁸ In the words of the late E. Allan Farnsworth, “It would be difficult to find a less predictable area of contract law.”⁹

If parties cannot predict the legal effect of LOIs, why are they used so frequently? Many explanations have been proposed, yet none adequately addresses the element of legal unpredictability that inheres in LOIs. In fact, the leading explanations do not identify a meaningful relationship between LOIs and contract law. This Comment identifies how legal unpredictability affects the operation of LOIs as a negotiating tool and ultimately concludes that LOIs manipulate legal unpredictability to the parties’ mutual advantage. Specifically, this Comment argues that signing an LOI facilitates an economic hostage exchange that aligns counterparties’ incentives, decreases both parties’ abilities to act strategically, and makes completion of the transaction more likely.

Part I provides an overview of how LOIs are viewed from business and legal perspectives, highlighting the difficulty that courts have encountered when interpreting LOIs within the framework of traditional contract doctrine. Part II considers the most common justifications for why LOIs are used *despite* their legal uncertainty and explains why these justifications are incomplete. Part III compares LOIs with other forms of nonbinding agreements, noting the differences between each and concluding that the unique attributes of LOIs call for a unique explanation of how they operate. Part IV presents the principal thesis that LOIs are useful precisely *because* of their legal uncertainty. To further this thesis, it demonstrates how parties executing LOIs strategically manipulate uncertainty in the American legal system to create a form of economic hostage exchange. Finally, Part IV provides an overview of the hostage-exchange theory and applies it to LOIs.

⁸ See, e.g., *Rennick v. O.P.T.I.O.N. Care, Inc.*, 77 F.3d 309, 316 (9th Cir. 1996) (finding an LOI nonbinding despite later actions intended to finalize the deal); *Empro Mfg. Co. v. Ball-Co Mfg., Inc.*, 870 F.2d 423, 425-26 (7th Cir. 1989) (finding an LOI nonbinding based on specific language in the agreement); *JamSports & Entm’t, LLC v. Paradama Prods., Inc.*, 336 F. Supp. 2d 824, 846 (N.D. Ill. 2004) (finding an LOI nonbinding as to certain terms because it was conditioned on a final agreement); *Interway, Inc. v. Alagna*, 407 N.E.2d 615, 620-21 (Ill. App. Ct. 1980) (finding an LOI nonbinding based on the conditional language of the writing); *Cabot Corp. v. AVX Corp.*, 863 N.E.2d 503, 513 (Mass. 2007) (finding an LOI nonbinding despite certain terms the parties intended to be binding).

⁹ E. Allan Farnsworth, *Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations*, 87 COLUM. L. REV. 217, 259-60 (1987) (“In doubtful cases, courts have looked to many factors, but no single factor is likely to be decisive. Often the final decision is left to the trier of the facts.” (footnote omitted)).

I. LOIS FROM BUSINESS AND LEGAL PERSPECTIVES

A. *LOIs from a Business Perspective*

Business professionals use LOIs in a wide variety of settings. Most commonly, LOIs are used in “transactions involving the sale of goods and services, financing transactions, and real estate transactions.”¹⁰ They are also common in M&A transactions.¹¹ Regardless of the business transaction they are used in, all LOIs reflect the parties’ preliminary agreements or understandings with respect to a *future* contract. Therefore, they are by definition precontractual rather than contractual.¹² As such, they are not intended to be fully binding.¹³ This is true even when, as is often the case, an LOI contains certain terms that the parties intend to be binding; when it resembles a lengthy, complex contract in every respect; and when both parties sign it.¹⁴

Although the use of LOIs is widespread, there is no consensus among business professionals as to why they are useful. Rather, corporate executives give a multitude of nonspecific justifications for their use.¹⁵ For example, an LOI has been said to serve as “a mere gesture showing interest in the possibility of a transaction” or it may be “an orderly collection of the necessary contractual terms ready to be binding, but missing the key ingredient—the intent to be bound.”¹⁶ Others believe LOIs “set[] the binding ground rules of a negotiation,” or, more generally, “provide some context to the interest of the parties” in a vague, nonbinding fashion.¹⁷

Business professionals value vagueness as a positive attribute of LOIs, and ambiguity¹⁸ is often intended.¹⁹ It has been suggested that LOIs’ ambiguity helps negotiating parties avoid “direct confrontation and deadlock,” and that

¹⁰ RALPH B. LAKE & UGO DRAETTA, *LETTERS OF INTENT AND OTHER PRECONTRACTUAL DOCUMENTS: COMPARATIVE ANALYSIS AND FORMS* 3 (2d ed. 1994).

¹¹ *Id.* See generally DONALD M. DEPAMPHILIS, *MERGERS, ACQUISITIONS, AND OTHER RESTRUCTURING ACTIVITIES* 177 (6th ed. 2012) (explaining the role of LOIs in the typical M&A process).

¹² LAKE & DRAETTA, *supra* note 10, at 5-6 (“A letter of intent may be defined as a precontractual written instrument that reflects preliminary agreements or understandings of one or more parties to a future contract.”).

¹³ *Id.* at 7-8 (noting that case law supports the proposition that LOIs are nonobligatory).

¹⁴ *Id.* at 9.

¹⁵ See Gosfield, *supra* note 4, at 106.

¹⁶ *Id.*

¹⁷ *Id.* at 100.

¹⁸ Despite the formal distinction between ambiguity and vagueness, this Comment uses the terms interchangeably to connote a lack of clarity that is generally expected in a final, binding contract.

¹⁹ See LAKE & DRAETTA, *supra* note 10, at 11 (noting that “ambiguity and obscurity may not be entirely unintentional”).

parties often “present nonbinding terms ambiguously with the expectation that the ambiguity will be resolved when the terms become binding.”²⁰

While LOIs are characterized by a lack of clarity, one point is clear: LOIs do *something*—whether easily identified or not—to move parties closer to a final agreement. The frequency of their use and the sophistication of the parties that use them provide the best evidence of this conclusion.²¹

B. LOIs from a Legal Perspective

1. Lawyers’ Perceptions of LOIs

Lawyers generally dislike LOIs. LOIs’ contractual form coupled with their intentionally nonbinding quality place them in an “unclear gray zone” of contract law.²² While business professionals might view this coupling as a positive characteristic, contract lawyers view the coupling as inherently contradictory. Further, lawyers tend to equate ambiguity and uncertainty with poor lawyering because these characteristics invite litigation²³ as well as strategic behavior from counterparties.²⁴ The ultimate legal effects of LOIs have been described as possibly “ruinous.”²⁵ If litigated, courts often ignore the business context in which LOIs were executed and analyze them “as typical contracts, focusing on the sufficiency of their terms and on the parties’ ‘intent.’”²⁶ Courts must use traditional contract doctrine to determine the intent of the parties manifested in an LOI. This creates anxiety

²⁰ Gosfield, *supra* note 4, at 101. It has not, however, been explained how this resolution of the ambiguity eventually occurs.

²¹ See Thomas C. Homburger & James R. Schueller, *Letters of Intent—A Trap for the Unwary*, 37 REAL PROP. PROB. & TR. J. 509, 511 (2002) (noting that sophisticated transactions frequently involve the use of LOIs).

²² LAKE & DRAETTA, *supra* note 10, at 10-11.

²³ See Gosfield, *supra* note 4, at 101 (“Sometimes binding terms are ambiguous, which adds the risk that a third-party finder of fact will be needed to construe the proper meaning or impose a new one.”).

²⁴ See *id.* (“Those who condemn letters of intent for their unpredictability fear the exploitation of that ambiguity as the ulterior strategy of the adverse party.”); see also LAKE & DRAETTA, *supra* note 10, at 11 (“The examination of a number of letters of intent has shown that behind a stated common intention often lie divergent, unrevealed intentions.”).

²⁵ See Gosfield, *supra* note 4, at 101 (“The possible ruinous effects of letters of intent should be to no one’s surprise. Even when composed under a more temperate humor, a letter of intent can promote confusion because it is necessarily incomplete as to the anticipated transaction. This incompleteness implicitly fosters ambiguity.”).

²⁶ Klein, *supra* note 5, at 142.

for lawyers and challenges for courts because LOIs do not fit neatly within the bounds of standard contract law.²⁷

2. LOIs and Traditional Contract Doctrine

When confronted with a dispute over an ambiguous LOI, traditional contract doctrine provides courts with the basic ground rules for discerning the intent of the parties. That doctrine, however, contains little practical guidance for completing the task. In an attempt to accommodate the realities of modern commerce, shifts in contract doctrine during the twentieth century urged courts to find a binding contract—even when a writing lacked the standard formalities or important terms often included in contracts—if the court concluded from the objective manifestations of the parties that they intended to form a binding contract.²⁸ To further this goal, factfinders have been given a variety of gap-filling tools to assist them if they find a binding contract that lacks certain essential terms.²⁹ While this development has proven beneficial in many contexts, it has also increased the chance that a court will find a binding contract when the parties did not intend one. This risk is compounded in the case of LOIs, where terms intended to be binding are often placed side-by-side with terms not intended to bind the parties. The relevant provisions of the Restatement (Second) of Contracts (Restatement) and the Uniform Commercial Code (UCC) illustrate the problem.

Sections 33 and 34 of the Restatement are most relevant to a factfinder confronted with an ambiguous LOI. Section 33(3), entitled “Certainty,” cautions that “[t]he fact that one or more terms of a proposed bargain are left open or uncertain *may* show that a manifestation of intention is not

²⁷ See LAKE & DRAETTA, *supra* note 10, at 18 (“In both common law and civil law countries the use of letters of intent has outpaced the development of their jurisprudence. This is due in part to the fact that letters of intent do not insert themselves in a sufficiently articulated legal context in any of the common or civil law systems.”).

²⁸ See generally 1 SAMUEL WILLISTON & RICHARD A. LORD, A TREATISE ON THE LAW OF CONTRACTS § 3:5 (4th ed. 1990) (describing the development of contract doctrine during the twentieth century).

²⁹ See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 204 (1979) (“Supplying an Omitted Essential Term. When the parties to a bargain sufficiently defined to be a contract have not agreed with respect to a term which is essential to a determination of their rights and duties, a term which is reasonable in the circumstances is supplied by the court.”); see also U.C.C. § 2-204(3) (2011) (“Even though one or more terms are left open a contract for sale does not fail for indefiniteness if the parties have intended to make a contract and there is a reasonably certain basis for an appropriate remedy.”); *id.* § 2-305 (“Open Price Term”); *id.* § 2-308 (“Absence of Specified Place for Delivery”); *id.* § 2-309 (“Absence of Specific Time Provisions”); *id.* § 2-310 (“Open Time for Payment or Running of Credit”).

intended to be understood as an offer or as an acceptance.”³⁰ The first official comment to that same provision, however, recognizes that “the actions of the parties *may* show conclusively that they have intended to conclude a binding agreement, even though one or more terms are missing or are left to be agreed upon.”³¹ In such an instance, the court is called upon “to attach a sufficiently definite meaning to the bargain.”³² Similarly, the official comment to section 34 of the Restatement states that “[a] bargain may be concluded which leaves a choice of terms to be made by one party or the other.”³³ Assuming a state’s law mirrors the Restatement, how should a factfinder determine whether an LOI is binding or not when it lacks essential terms?

Further complicating matters are the Restatement’s “Rules in Aid of Interpretation” in section 202, which instruct that a writing must be “interpreted as a whole,”³⁴ and that “the manifestations of intention of the parties” must be “interpreted as consistent with each other” whenever reasonable.³⁵ But how does a judge or jury interpret an LOI “as a whole” when it contains both binding and nonbinding terms?

The UCC also asks courts to divine the true meaning of an unclear LOI involving the sale of goods. UCC section 2-204(3), “Formation in General,” reflects the UCC’s general preference for finding a binding contract in questionable situations. It provides that “[e]ven though one or more terms are left open a contract for sale does not fail for indefiniteness if the parties have intended to make a contract and there is a reasonably certain basis for giving an appropriate remedy.”³⁶ To aid in filling any gaps, the UCC contains specific provisions relating to open price,³⁷ time,³⁸ and other essential terms.³⁹ Prior versions of the UCC also provided factfinders with various evidentiary guides to aid them in their task,⁴⁰ but these provisions offered little practical assistance absent a preexisting relationship between

³⁰ RESTATEMENT § 33(3) (emphasis added).

³¹ *Id.* § 33 cmt. a (emphasis added).

³² *Id.* (“An offer which appears to be indefinite may be given precision by usage of trade or by course of dealing between the parties. Terms may be supplied by factual implication, and in recurring situations the law often supplies a term in the absence of agreement to the contrary.”).

³³ *Id.* § 34 cmt. a.

³⁴ *Id.* § 202(2).

³⁵ *Id.* § 202(5).

³⁶ U.C.C. § 2-204(3) (2011).

³⁷ *See id.* § 2-305 (“Open Price Term”).

³⁸ *See id.* § 2-309 (“Absence of Specific Time Provisions”).

³⁹ *See, e.g., id.* § 2-308 (“Absence of Specified Place for Delivery”); *id.* § 2-310 (“Open Time for Payment or Running of Credit”).

⁴⁰ *See, e.g.,* § 1-205 (2002) (“Course of Dealing and Usage of Trade”); *id.* § 2-208 (“Course of Performance or Practical Construction”).

the parties or well-defined customs in the relevant trade or business.⁴¹ If the parties were otherwise unrelated and had just begun negotiations, the UCC's evidentiary guides were of little help.

The ultimate result under traditional contract doctrine is that a judge or jury interpreting an LOI could be justified in finding any or all of its terms binding or nonbinding. Thus, it appears that parties signing an LOI are assenting to a legal gamble.

3. Courts Have Struggled to Interpret LOIs

A study of relevant case law shows that courts have failed to resolve the tension between LOIs and traditional contract doctrine. Several major cases typify the courts' "multifactor" approach to the problem posed by LOIs—all of which effectively reduce to a general consideration of all the circumstances. In short, courts have not developed a solution to the conundrum illustrated by the relevant Restatement and UCC provisions.

For example, in *Texaco, Inc. v. Pennzoil, Co.*, Pennzoil executed an LOI with Getty Oil regarding a merger.⁴² The LOI stated that the parties' obligations would become binding only after execution of a final merger agreement.⁴³ The parties issued press releases describing the terms of the deal, while stating that they had only executed an "agreement in principle."⁴⁴ Before a final merger agreement was signed, Getty began negotiations with Texaco,⁴⁵ and Texaco ultimately made a higher bid than Pennzoil.⁴⁶ The Getty board quickly approved Texaco's offer.⁴⁷ Pennzoil then sued Texaco for tortious interference of contract, asserting that Pennzoil's LOI with Getty was in fact a binding contract.⁴⁸

The court, applying New York law,⁴⁹ considered several factors to determine

⁴¹ *See id.*

⁴² 729 S.W.2d 768, 785 (Tex. App. 1987).

⁴³ *Id.* at 789.

⁴⁴ *Id.*

⁴⁵ *Id.* at 786.

⁴⁶ *Id.* at 787.

⁴⁷ *Id.*

⁴⁸ *Id.* at 784.

⁴⁹ It is particularly appropriate to consider LOIs interpreted under New York law because parties often choose New York contract law due to its relative predictability and the primacy it places on the plain meaning of the writing. *See* N.Y. STATE BAR ASS'N., FINAL REPORT OF THE NEW YORK STATE BAR ASSOCIATION'S TASK FORCE ON NEW YORK LAW IN INTERNATIONAL MATTERS 2 (2011), available at <http://www.nysba.org/workarea/DownloadAsset.aspx?id=34027> (discussing why commercial parties often select New York law to govern transactions). Thus, one may presume that New York law would be relatively accommodating to carefully drafted LOIs.

whether Pennzoil and Getty intended to be bound by the LOI. These factors included

(1) whether a party expressly reserved the right to be bound only when a written agreement is signed; (2) whether there was any partial performance by one party that the party disclaiming the contract accepted; (3) whether all essential terms of the alleged contract had been agreed upon; and (4) whether the complexity or magnitude of the transaction was such that a formal, executed writing would normally be expected.⁵⁰

At first blush, it appears that the LOI in question would not constitute a binding contract under these factors. The parties stated in the LOI that they would not be bound by the terms until a final merger agreement was executed,⁵¹ there was no partial performance, and the magnitude of the transaction—amounting to billions of dollars—would surely be expected to require a formal, executed writing before it could be finalized. And although the parties had agreed on the most essential terms—the transactional structure and price—they had not agreed on many other critical terms, such as the merger’s impact on employees⁵² and how to identify a party that would purchase a significant number of outstanding Getty shares.⁵³

Nevertheless, a Texas jury determined that Pennzoil and Getty had entered into a binding agreement and awarded Pennzoil \$10.53 billion for Texaco’s tortious interference of contract.⁵⁴ The Court of Appeals of Texas upheld the verdict, although it ultimately reduced the damages awarded.⁵⁵ Despite many indications of a lack of intent to be immediately bound by the LOI, the Court of Appeals reasoned that there was sufficient evidence for a jury to conclude that a binding contract had been formed.⁵⁶ Even though the multifactor approach should have guided the analysis, the court stated that the intent of the parties must still be determined by the objective theory of contract⁵⁷ and that when the LOI is ambiguous, the factfinder must consider all evidence—including all written and oral statements made by anyone

⁵⁰ *Texaco*, 729 S.W.2d at 788-89.

⁵¹ *Id.* at 789.

⁵² *Id.* at 794.

⁵³ *Id.* at 792.

⁵⁴ *See id.* at 784 (granting Pennzoil \$7.53 billion in compensatory damages and \$3 billion in punitive damages).

⁵⁵ *See id.* at 866 (reducing the damages awarded to Pennzoil by \$2 billion).

⁵⁶ *Id.* at 789-95 (holding that “[t]he record as a whole demonstrates that there was legally and factually sufficient evidence to support the jury’s finding . . . that the [parties] intended to bind themselves to an agreement”).

⁵⁷ *Id.* at 789 (“The issue of when the parties intended to be bound is a fact question to be decided from the parties’ acts and communications.”).

involved in the negotiations—in order to ascertain whether or not a binding contract had been formed.⁵⁸ The decision demonstrates how little the factfinder is constrained or guided by the multifactor approach.

A federal court reached a similar conclusion in *Teachers Insurance & Annuity Ass'n of America v. Tribune Co.*, where a dispute arose over an LOI that had been executed in the course of negotiations over a potential loan.⁵⁹ After signing the LOI, Tribune, the potential borrower, refused to continue negotiations with Teachers, the potential lender.⁶⁰ Tribune claimed that it ceased negotiations because Teachers refused to accept a critical accounting term related to the transaction.⁶¹ Teachers, on the other hand, claimed that Tribune had walked away because interest rates had dropped and it sought a better deal from a different lender.⁶²

The court recognized that multiple factors had to be considered in order to determine whether the parties intended to be bound by the LOI. These factors include (1) the language of the agreement; (2) the context of the negotiations; (3) the existence of open terms; (4) partial performance; and (5) the necessity of putting the agreement in final form.⁶³ After being presented with large amounts of conflicting evidence on all of these points, the *Tribune* court carefully considered each factor.⁶⁴ Ultimately, the court rejected as inadequate *all* of the evidence supporting Tribune's arguments, holding that the LOI was binding.⁶⁵

In the same fashion as the *Texaco* decision, *Tribune* demonstrates how the multifactor test collapses into a consideration of all the circumstances, with the judge or jury free to find any factor or factors dispositive. In *Tribune*, it is implicitly clear that the court's perception of the second factor—the context of negotiations—swallowed the other factors. And although Teachers could not directly prove that Tribune had ceased negotiations merely because interest rates had dropped, a reader of the *Tribune* decision will find it difficult to ignore the possibility that the court was convinced by Teachers'

⁵⁸ *Id.* at 796 (stating that when intent cannot be wholly determined by a written agreement, "extrinsic evidence of relevant events is properly considered on the question of that intent").

⁵⁹ 670 F. Supp. 491, 497 (S.D.N.Y. 1987).

⁶⁰ *Id.* at 496.

⁶¹ *Id.* at 491.

⁶² *Id.*

⁶³ *Id.* at 499-503; see also Norris D. Wolff, *Letters of Intent, Preliminary Agreements, and Binding Acquisition Agreements*, 111 BANKING L.J. 292, 292-93 & n.1 (1994) (noting that *Tribune's* multifactor test has been frequently cited in subsequent LOI cases in New York).

⁶⁴ *Tribune*, 670 F. Supp. at 499-503.

⁶⁵ *Id.* at 499 (concluding that the LOI in question "represented a binding preliminary commitment and obligated both sides to seek to conclude a final loan agreement").

unproven contention and used the flexible multifactor test merely as a means to achieve a desired result.

Another similar outcome arose in *Newport Ltd. v. Sears, Roebuck & Co.*⁶⁶ The parties had begun negotiations for Newport to build a warehouse for Sears.⁶⁷ They executed an LOI stating their intent “to enter into the transaction on substantially the . . . terms and conditions” contained in the LOI, although the LOI was not a “comprehensive statement of [the parties’] rights, duties and obligations.”⁶⁸ Sears later determined that it needed to downsize the project, and Newport sued Sears for breach of the contract supposedly formed when the LOI was signed.⁶⁹ The court, citing *Texaco* and other cases, concluded that the LOI was ambiguous as to whether the parties intended it to be binding, and therefore that consideration of all the surrounding circumstances was required.⁷⁰ Presented with conflicting evidence, the jury had considerable latitude to decide either way, but ultimately concluded that the LOI was binding and that Newport was entitled to damages.⁷¹

While the court recognized that the evidence supporting Newport’s damages claim was “admittedly thin,” it confirmed that a jury could award Newport compensation for such categories of damages as “out-of-pocket costs, lost public monies, and lost profits” if the jury believed an expert witness’s testimony regarding the certainty of those values.⁷² A unanimous jury awarded total damages of almost \$13 million, \$10.6 million of which reflected lost profits.⁷³

Ultimately, these cases illustrate three important points regarding the courts’ struggles with LOIs. First, multifactor tests have failed to provide the structured analysis that they may initially appear to provide. Because LOIs are inherently ambiguous, the analyses inevitably break down into a general consideration of all the facts. The tests provide no guidance for weighing competing factors; therefore, the outcome in disputes over LOIs can easily turn on details that would appear arbitrary to many negotiating parties.

⁶⁶ 6 F.3d 1058, 1070 (5th Cir. 1993).

⁶⁷ *Id.* at 1060.

⁶⁸ *Id.* at 1066 (alterations in original).

⁶⁹ *Id.* at 1063-64.

⁷⁰ *Id.* at 1065-66.

⁷¹ *Newport Ltd. v. Sears, Roebuck & Co.*, No. 86-2319, 1995 WL 626188, at *1 (E.D. La. Oct. 24, 1995) (noting that “a unanimous jury returned a verdict of \$10,668,000.00 in lost profits and \$1,900,000 for out of pocket expenses to Newport”).

⁷² *Sears*, 6 F.3d at 1069-70.

⁷³ *Newport*, 1995 WL 626188, at *1.

The second important point these cases illustrate is that the courts' approach to LOIs tends to yield all-or-nothing results.⁷⁴ This reflects the problem with section 202 of the Restatement, which requires terms to be construed as "consistent with each other" whenever reasonable.⁷⁵ While this requirement could mean many things, the plainest meaning—and the meaning that has been borne out by court decisions—is that all of the terms of an LOI will be construed as wholly binding or wholly nonbinding. This approach means that litigation over an LOI will likely generate a windfall for one party or the other.⁷⁶ Courts cannot easily parse an LOI and distinguish binding terms from nonbinding terms. Even if the parties use clear language, there is always the possibility that the court will find very specific considerations dispositive and rule contrary to the parties' intentions.

Third, damages awards, if awarded by the court, are extremely difficult to predict in LOI cases because the range of possible awards is wide. As in *Texaco* and *Sears*, courts may be willing to compensate parties for a variety of damages categories, such as lost profits, provided that an expert witness can convince the factfinder that a certain loss is attributable to breach of the agreement. This wide range makes damages awards exceptionally difficult for litigating parties to predict *ex ante* and injects considerable legal uncertainty into negotiations in which LOIs are used.

The tension between LOIs and standard contract doctrine, as well as the courts' struggles to interpret LOIs, has been identified in numerous other analyses.⁷⁷ Yet at this point in other analyses, commentators generally proceed to either (1) provide reasons why courts should respect the "intent" of the parties and find LOI terms binding only when the parties so intend

⁷⁴ See Harvey L. Temkin, *When Does the "Fat Lady" Sing?: An Analysis of 'Agreements in Principle' in Corporate Acquisitions*, 55 *FORDHAM L. REV.* 125, 130 (1986) ("Through using the 'all or nothing' approach, courts, for the most part, have not considered the 'agreement in principle' cases as a separate category. Thus, the commercial expectations of the parties at the middle 'agreement in principle' stage are often ignored, creating an inequitable and an inefficient situation.").

⁷⁵ See *supra* note 35 and accompanying text.

⁷⁶ The all-or-nothing results observed in the case law can also be explained by the traditional notions of mutual assent and the duty of good faith and fair dealing. According to the traditional notion of contract formation, a binding agreement is formed at the instant of mutual assent. Herbert Bernstein & Joachim Zekoll, *The Gentleman's Agreement in Legal Theory and in Modern Practice: United States*, 46 *AM. J. COMP. L.* 87, 93 (Supp. 1998). It thus becomes tempting for a court to find *all* terms in an LOI binding when it concludes that at least *some* terms are binding. The classic notion of mutual assent struggles to accommodate piecemeal agreements. *Id.* Further, the fact that many LOIs contain obligations to negotiate in good faith makes it more likely that a court will find multiple terms in an LOI binding because, at common law, the duty of good faith and fair dealing does not exist until an otherwise enforceable contract is formed. *Id.* at 93-94.

⁷⁷ See, e.g., Temkin, *supra* note 74, at 131-35 (discussing the inherent tensions between standard contract doctrine and LOIs); Klein, *supra* note 5, at 144-48 (highlighting the inconsistent case law regarding LOIs).

(without suggesting how this intention may be ascertained given the restrictions of existing contract doctrine) or (2) explain nonlegal ways that LOIs nevertheless induce compliance with their terms.⁷⁸ These nonlegal explanations are summarized in Part II, which also identifies why other commentators' explanations are insufficient.

II. THEORETICAL JUSTIFICATIONS FOR THE USE OF LOIS DESPITE THEIR LEGAL UNCERTAINTY

Given the legal uncertainty that accompanies LOIs, why are they used at all? How can LOIs be useful if parties cannot predict how courts will enforce them? Many explanations have been proposed to answer these questions, and while each explanation helps to identify certain attributes of LOIs that make them useful under certain conditions, none have identified a link between LOIs and the American legal system. This is troublesome because LOIs are inherently legal documents and often contain terms that the parties intend to be legally enforceable. The most common theoretical justifications for the use of LOIs are considered below, as are reasons why each justification does not sufficiently explain why LOIs remain effective negotiating tools despite their legal uncertainty.

A. *Reputational Consequences of Noncompliance*

Perhaps the most common justification for the efficacy of LOIs is that business professionals fear the reputational consequences of noncompliance.⁷⁹ Under this theory, reputational consequences operate in lieu of the legal system either to induce compliance or administer punishment for breach. Legal uncertainty is unimportant because the theory does not contemplate a need to resort to the legal system. Rather, under appropriate conditions, agreements enforced through reputational consequences are essentially self-enforcing.

But there are fundamental problems with this "reputational consequences" rationale in the LOI context. For the reputational element to have an appreciable effect, the parties must be members of a reasonably small

⁷⁸ See, e.g., Temkin, *supra* note 74, at 127 (concluding "that courts have not focused on the probable expectation of the parties in determining whether a binding and enforceable contract has arisen at the 'agreement in principle' stage," and then proposing a new way for courts to categorize LOIs); Klein, *supra* note 5, at 169 (arguing that "[l]etters of intent should not be interpreted as binding merger contracts").

⁷⁹ See, e.g., Jack L. Goldsmith & Eric A. Posner, *International Agreements: A Rational Choice Approach*, 44 VA. J. INT'L L. 113, 118-19 (2003) ("Letters of intent, which are common, depend for their efficacy on reputation and good faith, not enforcement.").

community, ideally one with “long-term bonds of trust between the market participants.”⁸⁰ A good example of such a community is the diamond industry, which uses a combination of “reputational bonds, customary business practices, and arbitration proceedings” to enforce agreements and sanction noncompliance.⁸¹ The necessary small size and long-term bonds are not present in a vast majority of the industries or transactions in which LOIs are used. In most instances, there are simply too many market participants for the “reputational consequences” rationale to fully explain how LOIs work. In many cases, the parties are not even members of the same market.

Additionally, the reputational element requires publicity of both the LOI and the final outcome.⁸² If either of these is confidential, the reputational device cannot operate.⁸³ Thus, the reputational rationale is unavailable if, as is often the case, an LOI is signed alongside a confidentiality agreement.⁸⁴ The reputational rationale, therefore, cannot fully explain why LOIs are used despite their legal uncertainty.

B. *Strength of Moral Obligations*

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.⁸⁵ It has been suggested that “reasonably principled businessmen” view LOIs as a moral obligation that should be taken “quite seriously.”⁸⁶

However, the morality rationale is problematic in the LOI context for several reasons. Most importantly, it is not clear whose morals promote compliance. LOIs are usually executed between corporate entities, not individuals, and they are used in negotiations that involve many individuals

⁸⁰ Bernstein & Zekoll, *supra* note 76, at 108 (describing long-term bonds of trust as “a necessary condition for the smooth and efficient operation of business” that relies on reputational effects to support exchange).

⁸¹ Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115, 157 (1992).

⁸² Thomas C. Schelling, *An Essay on Bargaining*, 46 AM. ECON. REV. 281, 288 (1956) (“Both the initial offer and the final outcome would have to be known; and if secrecy surrounds either point, or if the outcome is inherently not observable, the device is unavailable.”).

⁸³ *Id.*

⁸⁴ See Silver, *supra* note 1 (“An LOI typically comes into play after a round of initial discussions and after the signing of a Confidentiality Agreement . . .”).

⁸⁵ See, e.g., SPECIAL STUDY FOR CORPORATE COUNSEL ON USING LETTERS OF INTENT IN BUSINESS TRANSACTIONS § 1:2 (2013) (“[C]lients may . . . want a letter of intent to put moral pressure on a reluctant party when it comes time to finalize the deal or perform on the contract. Having ‘agreed’ to a deal, that party may feel obligated to continue negotiations.”).

⁸⁶ Klein, *supra* note 5, at 142 (quoting JAMES C. FREUND, ANATOMY OF A MERGER 60 (1975)).

with very different roles.⁸⁷ For the morality rationale to function, one must first answer the question: Whose morals control the final decision to comply or not? The bankers', the attorneys', the consultants', the Board of Directors', or the negotiating employees'? In the most pristine model of corporate decisionmaking, ultimate authority resides in the CEO. But in reality, corporate decisionmaking processes are far more complex, with many participants influencing outcomes.⁸⁸ If complying with an LOI becomes adverse to a corporation's interests, it is unlikely that such a collection of individuals would feel bound by a collective moral compass.

Further, there is tension between the morality rationale and the fact that LOIs contain so many legal formalities. It is not clear why a seemingly legal document would be necessary to communicate a moral commitment. If all that the parties wish to do is express a moral commitment, there are far simpler ways of doing so that do not include signing a formal document. Thus, the morality rationale is insufficient because it ignores the realities of corporate decisionmaking as well as the inherently legal nature of LOIs.

C. *Simplifying Complex Negotiations*

Some scholars have argued that LOIs serve as a tool for simplifying and organizing the terms of complex negotiations. Under this justification, the LOI serves merely as a reminder of terms that have already been agreed upon.⁸⁹ The need for such a reminder supposedly arises from the many tax and regulatory aspects of modern business transactions, which "can tax the memory of any negotiator."⁹⁰

The simplification rationale suffers from two primary flaws. First, it ignores the fact that there are many other ways to record settled terms without signing a legal document. A summary of agreed-upon terms need not be signed to serve its purpose. This explanation does little more than recognize that writing terms down aids the parties' memories. Second, this explanation ignores the fact that LOIs also introduce new forms of complexity to negotiations, such as the possibility of litigation and uncertain enforcement of random terms. It is not clear why parties would summarize terms

⁸⁷ See LAKE & DRAETTA, *supra* note 10, at xxi (explaining that oftentimes "the participation of third parties, such as financial institutions, governmental officials, subcontractors, and consultants in the negotiation is essential").

⁸⁸ See Paul Shrivastava & John H. Grant, *Empirically Derived Models of Strategic Decision-making Processes*, 6 STRATEGIC MGMT. J. 97, 98 (1985) (noting that corporate "[d]ecision making occurs in sequential phases, at multiple levels of the organizational hierarchy").

⁸⁹ See LAKE & DRAETTA, *supra* note 10, at 15 (suggesting that "[l]etters of intent are often used as frameworks for future negotiations").

⁹⁰ *Id.* at 16.

through an LOI rather than through an alternative form that does not carry similar legal risks.⁹¹

D. Securities Laws and Financing

Although not a justification for the efficacy of LOIs, it should also be noted that LOIs may be relevant in the context of federal securities laws and financing agreements. Specifically, signing an LOI may trigger certain responsibilities of directors and officers under Securities and Exchange Commission (SEC) Rule 10b-5,⁹² even though an LOI is not required under the SEC's regulations. Additionally, LOIs may be shown to a party's potential financing sources as evidence of a viable deal,⁹³ although this is not always done. Therefore, LOIs remain an optional device whose utility cannot be fully explained by their relevance to securities laws or financing agreements.

Ultimately, none of these justifications fully explains the relationship between LOIs and the American legal system. A comparison of LOIs with other nonbinding agreements demonstrates why such an explanation is necessary.

III. COMPARISON WITH OTHER NONBINDING AGREEMENTS

Various types of agreements do not rely on the coercive power of the state for their enforcement. Instead, they rely on alternative mechanisms to induce compliance and punish noncompliance. These agreements will be collectively referred to as "nonbinding" or "self-enforcing" agreements. Traditionally, several mechanisms have been used in lieu of the legal system to enforce nonbinding agreements, most notably (1) reputational consequences, (2) private arbitration, (3) physical or economic retaliation, and (4) collateral, or hostage, exchanges.⁹⁴

While many factors may lead parties to enter a nonbinding agreement, parties are most likely to do so by necessity when there is no legal regime that can enforce their agreement. Treaties between nations are perhaps the

⁹¹ For example, the parties could exchange unsigned drafts of the agreement and mark up each version received before sending it back to the other party. This process would similarly clarify those terms over which there is apparent agreement and those over which there is not agreement.

⁹² See *Basic Inc. v. Levinson*, 485 U.S. 224, 232-41 (1988) (considering when merger discussions and agreements-in-principal may rise to the level of a "material" event for purposes of SEC Rule 10b-5); 17 C.F.R. § 240.10b-5 (2013).

⁹³ See DEPAMPHILIS, *supra* note 11, at 177.

⁹⁴ See Katharina Pistor, *Supply and Demand for Contract Enforcement in Russia: Courts, Arbitration, and Private Enforcement*, 22 REV. CENT. & E. EUR. L. 55, 66-67 (1996) (describing enforcement mechanisms that may serve as an alternative to a formal legal system).

most visible, studied, and well-understood form of nonbinding agreements. Treaties have traditionally relied on reputational consequences and the potential for physical or economic retaliation to induce compliance with their terms.⁹⁵ Reputational consequences are an effective enforcement mechanism for treaties because the global community of nations is small—totaling approximately 195 nations.⁹⁶ Further, nations are almost necessarily repeat players in their interactions with one another, and they depend on one another in a multitude of ways.⁹⁷ These conditions make reputational consequences a particularly potent enforcement mechanism for agreements between nations. And because treaties are almost always highly publicized, there is little impediment to the reputational effect functioning properly.

Another interesting example of nonbinding agreements is private contracts formed under weak legal regimes that do not have the capability or resources to enforce them. Private contracts that were formed in post-Soviet Russia during the late 1990s serve as a prime example.⁹⁸ Several studies demonstrate that during this period, when the Russian government was not strong enough to enforce contracts, parties resorted to the use of alternative enforcement mechanisms. These included reputational mechanisms at times, but were primarily more coercive in nature. The use of criminal groups and private protection companies to provide physical retaliation for noncompliance was particularly prevalent, as was the use of hostage or collateral exchanges.⁹⁹

LOIs belong to the family of nonbinding agreements because, by definition, they include certain terms that the parties do not expect to be enforced through a legal system,¹⁰⁰ yet the parties still expect one another to comply with those terms. Therefore, the parties must rely on some other mechanism

⁹⁵ See Abram Chayes & Antonia Handler Chayes, *On Compliance*, 47 INT'L ORG. 175, 203-04 (1993) (providing various justifications for why nations comply with treaties).

⁹⁶ *Independent States in the World*, U.S. DEP'T ST. (Dec. 9, 2013), <http://www.state.gov/s/intr/rls/4250.htm>.

⁹⁷ See generally Jana von Stein, *Do Treaties Constrain or Screen? Selection Bias and Treaty Compliance*, 99 AM. POL. SCI. REV. 611 (2005) (providing an extensive analysis of reputation as a compliance mechanism for treaties and describing the nature of continued interaction between nations with respect to treaties).

⁹⁸ See Pistor, *supra* note 94, at 62-63 (“[I]n the former socialist countries, particularly in Russia[,] . . . [there was] neither an effective court system nor a well-developed system of private dispute resolution mechanisms.”).

⁹⁹ See *id.* at 66-67 (describing the various contract enforcement mechanisms used in Russia during the 1990s); see also Vadim Volkov, *Security and Rule-Enforcement in Russian Business: The Role of the “Mafia” and the State* 1 (European Univ. at St. Petersburg, PONARS Policy Memo No. 79, 1999) (“In the mid-1990s up to 70% of all contracts were enforced without any participation from state organs.”).

¹⁰⁰ See LAKE & DRAETTA, *supra* note 10, at 7-9.

to induce compliance, as other nonbinding agreements do. However, LOIs are unique compared to other nonbinding agreements because the parties to an LOI consciously attempt to opt out of the legal system. This difference calls for a closer examination of the relationship between LOIs and the American legal system.

Whereas prior analyses seem to simply extend explanations of treaties to LOIs (thus focusing primarily on “soft” enforcement mechanisms, such as the reputational rationale), Part IV seeks to expand the understanding of why parties adhere to “nonbinding” LOI terms. It does so by considering one of the less frequently studied, more coercive enforcement mechanisms observed in more primitive forms of nonbinding agreements: the hostage exchange.

IV. LOIS AS A FORM OF HOSTAGE EXCHANGE

Viewing LOIs as a form of economic hostage exchange provides an explanation of how LOIs interact with the American legal system. Specifically, the hostage theory demonstrates how LOIs manipulate uncertainty within that system to increase their utility as a bargaining tool. To understand how this manipulation functions, one must first consider the modern theory of economic hostage exchanges.

A. *The Hostage Theory*

Other than physical retaliation for nonperformance, hostage exchanges are perhaps the most primitive contract enforcement mechanism.¹⁰¹ In its most basic form, a hostage exchange arises when the parties’ agreement involves a desired performance to take place at some point in the future. To mitigate the risk of contingencies that may arise between the time of agreement and the time of performance, the promisor gives the promisee a hostage, which increases the likelihood that the promisor’s performance will occur.¹⁰² The “hostage” can be anything (or anyone) of value to the promisor.¹⁰³ The promisor knows that the promisee can destroy the hostage if the promisor does not perform, which incentivizes the promisor to keep his end of the bargain; in turn, the promisee is made more secure.¹⁰⁴ The promisee need not resort to the legal system to enforce the agreement because he

¹⁰¹ See Anthony T. Kronman, *Contract Law and the State of Nature*, 1 J.L. ECON. & ORG. 5, 12-15 (1985) (describing the traditional hostage-exchange model).

¹⁰² *Id.* at 12.

¹⁰³ *Id.*

¹⁰⁴ *Id.*

possesses both a coercive means for inducing compliance and a means for punishing noncompliance. By providing a hostage, the promisor's commitment becomes more credible.

In 1983, Oliver Williamson first elaborated the theory that hostage exchanges are used in modern commerce to create credible commitments.¹⁰⁵ According to Williamson, credible commitments are made when parties perform reciprocal acts designed to "safeguard a relationship."¹⁰⁶ He posited that economic hostage exchanges are a form of reciprocal act, the use of which "is widespread and economically important," despite the fact that hostage exchanges are often viewed as "a quaint concept with little or no practical importance to contemporary contracting."¹⁰⁷ Furthermore, he explained that this perception has arisen from the "convenient," but false, assumption that "the legal system [always] enforces promises in a knowledgeable, sophisticated, and low-cost way."¹⁰⁸ Ignored by "legal centralists," "additional or alternative modes of governance have arisen" in response to inefficiencies in the legal system, and modern commerce is replete with "bilateral efforts to create and offer hostages."¹⁰⁹

The effect of the hostage exchange is to "protect contracts against expropriation" by expanding a contractual relationship through the creation of a "mutual reliance relation."¹¹⁰ The parties create a state of reciprocal exposure by "credibly 'tying [their] hands.'"¹¹¹ Each party does so by providing the other with a means of extracting value in the event of non-compliance. Despite traditional notions of the hostage-exchange scenario, Williamson explained that modern economic hostage exchanges do not occur because a stronger party demands something of the weaker party; rather, the exchange serves efficiency purposes and "is in the mutual interest of the parties."¹¹²

Williamson's key insight is that the efforts made by one party to adhere to an agreement are influenced by their counterparty's incentives.¹¹³ To

¹⁰⁵ See generally Oliver E. Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 AM. ECON. REV. 519 (1983) (presenting the modern hostage-exchange model).

¹⁰⁶ *Id.* at 519.

¹⁰⁷ *Id.* at 537.

¹⁰⁸ *Id.* at 519.

¹⁰⁹ *Id.*

¹¹⁰ *Id.* at 528 (italics omitted).

¹¹¹ *Id.* at 519; see also Erin Anderson & Barton Weitz, *The Use of Pledges to Build and Sustain Commitment in Distribution Channels*, 29 J. MARKETING RES. 18, 20 (1992) (explaining "how parties can paradoxically strengthen a relationship by 'tying their hands'").

¹¹² See Williamson, *supra* note 105, at 538.

¹¹³ See *id.* at 520; see also Christina Ahmadjian & Joanne Oxley, *Using Hostages to Support Exchange: Dependence Balancing and Partial Equity Stakes in Japanese Automotive Supply Relationships*, 22

describe the effect more plainly, posting a hostage gives party *A* an incentive to invest fully in the relationship and adhere to the preliminary agreement—an incentive that is observable by party *B*. Accordingly, party *B* may invest fully in the relationship, knowing that party *A*'s performance is more likely. Although Williamson's analysis focuses on investments specific to the context of buyer–supplier relationships, he acknowledged at the outset that economic hostage exchanges are “widespread.”¹¹⁴ He also recognized that a party's incentive to safeguard bilateral contracts through hostage exchanges “is a function of the efficacy of court adjudication” in the sort of transaction involved.¹¹⁵ Thus, when courts are incapable of effectively adjudicating claims related to a particular type of transaction, parties to those transactions are more likely to use hostage exchanges to safeguard their agreement.

B. LOIs as a Form of Hostage Exchange

Precontractual agreements present an ideal scenario for hostage exchanges because American courts have struggled to effectively enforce them. Negotiating parties in a precontractual situation often desire a credible commitment that their counterparties will invest fully in the relationship. This desire is often expressed in LOIs through terms requiring that the parties use “best efforts” or negotiate “in good faith” to consummate a final deal. However, these terms carry little practical effect because courts are not realistically capable of enforcing them. Courts cannot be expected to accurately reconstruct the negotiation process *ex post* and determine whether a party used “best efforts” or acted with subjective “good faith.” But by exchanging hostages, parties in precontractual negotiations are able to achieve the result sought through “good faith” and “best efforts” clauses: a credible commitment that they are mutually invested in the relationship. An LOI permits such a hostage exchange to occur.

How do LOIs create this economic hostage exchange? In the traditional hostage-exchange scenario, party *A* gives something of value to party *B*, which *B* may destroy if *A* does not live up to his end of the bargain. In the LOI scenario, party *A* gives party *B* the right to sue based on the LOI if *A* does not comply with its terms. Party *B* gives party *A* a reciprocal right by also committing to the LOI. Even if the parties do not intend the LOI to be binding, case law demonstrates that there is no assurance this intent will

J.L. ECON. & ORG. 213, 215 (2006) (summarizing the key insights of Williamson's hostage-exchange model).

¹¹⁴ See Williamson, *supra* note 105, at 537.

¹¹⁵ *Id.* at 521.

be recognized by a court. Thus, each side exposes itself to the possibility of uncertain legal repercussions for noncompliance. In this way, an LOI expands the parties' relationship by creating a state of reciprocal exposure. While the parties are not bound by a formal contract, they are left with a higher level of commitment to the relationship than they had prior to signing the LOI. Walking away without fear of consequence is no longer an option—an LOI permanently changes each party's calculus in assessing whether to terminate negotiations.

Of course, that calculus is not easy to assess. Neither party to an LOI knows the precise value of the hostage they hold because the legal system makes the effect of an LOI uncertain, as the discussion in Section I.B explains. If one party sues on the LOI—assuming an expected-value analysis¹¹⁶ is conducted—the probability of an adverse ruling to either side is effectively 50%. This probability presents no challenge to an expected-value calculation itself, but the difficulty of ascribing values to the possible range of outcomes makes reliance on the expected-value calculation more troublesome. The case law summarized in subsection I.B.3 demonstrates that the range of possible damages awards in a dispute over an LOI is particularly wide, which changes the perceived risk of noncompliance.¹¹⁷ The effect of this extreme legal uncertainty is that noncompliance with the LOI appears riskier to both sides, which in turn makes it more likely the parties will comply with the terms of the agreement.¹¹⁸

A simple illustration may clarify this point. Assume that party *A* and party *B* are negotiating a merger. They sign an LOI agreeing to the price and transactional form, yet leave major terms to be decided. The LOI also contains stated obligations for the parties to continue negotiations “in good faith” and use their “best efforts” to consummate the deal. If party *C* approaches party *A* with a more favorable offer, how would party *A* assess its ability to walk away from negotiations with party *B* in light of the LOI already in place? Table 1 provides a possible summary:

¹¹⁶ See Joseph A. Grundfest & Peter H. Huang, *The Unexpected Value of Litigation: A Real Options Perspective*, 58 STAN. L. REV. 1267, 1272-73 (2006) (providing a summary of the basic expected-value model in the context of litigation).

¹¹⁷ See P.V. Viswanath, *Risk and Return*, PACE U., <http://webpage.pace.edu/pviswanath/notes/corpfm/risknret.html> (last visited Mar. 22, 2014) (explaining the relationship between risk and the variance in possible returns).

¹¹⁸ This assumes that both parties are risk averse.

Table 1: Party *A*'s Assessment

Scenario	Probability	Cost	Expected Cost
(1) Party <i>B</i> does not sue on the LOI.	70%	\$0	\$0
(2) Party <i>B</i> sues on the LOI, and the court finds it is not binding.	15%	\$0	\$0
(3) Party <i>B</i> sues on the LOI, and the court finds it is binding.	15%	\$10 million	\$1.5 million
Total			\$1.5 million

Therefore, assuming the values above can be predicted with accuracy, party *A* has posted an economic hostage of \$1.5 million by signing the LOI. To walk away from negotiations with party *B*, not only would party *C*'s offer need to be at least \$1.5 million more attractive than the deal with party *B*, but party *A* would also need to have considerable confidence in the expected cost of Scenario 3 before it could rely on its comparison of both options.

But valuing Scenario 3 is not as simple as the example above may suggest. Clearly defined legal entitlements provide parties with "bargaining chips" that permit a reliable comparison of strategic alternatives.¹¹⁹ However, when rules of law yield uncertain outcomes, parties cannot accurately estimate the value of their legal entitlements, and outcomes become increasingly subject to the "unfettered discretion" of the court.¹²⁰ In these cases, ascribing reliable values to the components of the expected-value calculation becomes extremely difficult. In the case of LOIs, the challenge is compounded by the wide range of possible damage awards available to litigants. This variance increases the perceived riskiness of noncompliance; therefore, noncompliance becomes less attractive to risk-averse parties.¹²¹

For example, suppose in the example above that instead of a single Scenario 3 with a 15% probability of occurring, there were instead 15 separate scenarios (Scenarios 3 through 17), each with a 1% probability of occurring. Suppose that the cost in Scenario 3 is \$3 million, and the cost increases by \$1 million in each scenario to a maximum of \$17 million in Scenario 17. While the

¹¹⁹ See, e.g., Robert H. Mnookin & Lewis Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L.J. 950, 968-69 (1979) ("The legal rules governing alimony, child support, marital property, and custody give each parent certain claims based on what each would get if the case went to trial.")

¹²⁰ Anthony D'Amato, *Legal Uncertainty*, 71 CALIF. L. REV. 1, 6 (1983).

¹²¹ See Peter Carr & Liuren Wu, *Variance Risk Premiums*, 22 REV. FIN. STUD. 1311, 1312-13 (2009) (explaining that an increase in variance also produces an increase in risk).

expected cost of breach would remain \$1.5 million, the increased range of possible outcomes would appear to render a breach riskier, and therefore less attractive to risk-averse actors. Faced with such a scenario, party *A* will discount the expected value of a deal with party *C* to reflect this increased risk.¹²² The LOI has effectively destroyed any perceived value of noncompliance. Strategic behavior has now become more difficult and less attractive, and ultimately, the parties are more likely to adhere to the LOI. This result, with its reciprocal effect on both parties, is possible precisely because of the legal uncertainty surrounding LOIs.¹²³

In effect, LOIs' most beneficial quality—that they make final deals more likely to occur—results from what lawyers perceive to be their most unattractive quality: their legal uncertainty. As has been demonstrated, an LOI manipulates this legal uncertainty to make strategic behavior more difficult, to align the parties' interests, and to make a final deal more likely. This conclusion is supported by an economic analysis using a hostage-exchange model.

CONCLUSION

LOIs are fraught with contradiction. They are loved, yet hated; binding, yet nonbinding; beneficial, yet “ruinous.” This Comment expands the understanding of how these contradictory devices operate by viewing them through the lens of the hostage-exchange theory. This theory provides a much-needed explanation of how LOIs interact with the American legal system, despite that system's inability to deal with them in a consistent way.

¹²² See Grundfest & Huang, *supra* note 116, at 1272-73 (explaining that increased risk or uncertainty of a future return is expressed through changes in the relevant discount rate).

¹²³ The conclusion that legal uncertainty limits a party's ability to act strategically is recognized in other bargaining theories. For example, theorists frequently state that effective negotiators begin negotiations with a concept of what they can hope for if the parties fail to reach an agreement. This is called the party's “Best Alternative to a Negotiated Agreement” (BATNA). See Benjamin L. Snowden, Student Article, *Bargaining in the Shadow of Uncertainty: Understanding the Failure of the ACF and ACT Compacts*, 13 N.Y.U. ENVTL. L.J. 134, 173 (2005) (describing the BATNA concept and how it affects parties' behavior in a negotiation). When litigation is a potential result of failed negotiations, knowledge of background law is critical to a party's determination of its BATNA. *Id.* at 186. But when background law is highly uncertain—as is the law surrounding LOIs—a reliable BATNA cannot be determined, and a party is thus restrained in its ability to know whether walking away from negotiations would be more beneficial than continuing to negotiate. *Id.* This reduces the ability to act strategically. In other words, highly uncertain background law makes an “efficient breach” assessment extremely difficult to perform. See Richard R.W. Brooks & Warren F. Schwartz, *Legal Uncertainty, Economic Efficiency, and the Preliminary Injunction Doctrine*, 58 STAN. L. REV. 381, 406 (2005) (finding, in the context of preliminary injunctions, that efficient breach is more difficult to rely on when the legal rule is less clear).

In sum, an LOI pushes parties closer to a final deal by fundamentally changing their relationship with one another. Through the exchange of uncertain legal entitlements, the parties intentionally create a state of reciprocal exposure to uncertain legal outcomes. In doing so, the parties align their interests, communicate credible commitments to each other, and reduce their ability to act strategically. Ultimately, LOIs allow parties to use legal uncertainty to their mutual benefit.