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Litigation Risks Arising From Failed Contract Negotiations

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Contract negotiations are fraught with legal perils prompting a wide variety of questions concerning the implications of entering into the contemplated deal. *What are the liabilities that are created by signing this agreement? How can the company be sued for breach in the event of non-performance?* While these common questions and their imponderable variations are understandably the focus of contracting parties and their counsel, a parallel series of questions should also be considered. *What legal obligations has the company undertaken by merely engaging in contract negotiations? What duties might be owed to the potential partners in the event the deal craters?* These and similar questions are often overlooked because the prevailing notion is that, until the deal is inked, no contract is created and hence no legal duties arise. As is often the case with conventional wisdom, these notions are incorrect and negotiating parties relying on such assumptions do so at their peril.

Two Principal Risks in Negotiations

California courts have recognized various theories of liability arising from failed contract negotiations. Only two will be highlighted here: the risk that an unsigned contract will create contractual obligations and a claim that a party breached a duty to negotiate in good faith. These risks are best explored by examining a typical scenario, applying the relevant law and considering practical ways to avoid these legal pitfalls.

A. Contractual Obligations Flowing From the Unsigned Agreement

The Scenario: Developer and Owner enter into discussions to build a shopping center on a piece of vacant property. The parties engage contractors and incur significant costs which are shared on a fifty-fifty basis. They negotiate a development agreement that outlines their respective duties, responsibilities for financing and milestones to be achieved. The document goes through several redlines as lawyers review and haggle over the details. Owner's lawyer approves all changes and sends a "clean" version to her counterpart with an e-mail noting that the parties will each need to sign the agreements by the end of the week. Owner's lawyer is not aware that, two days earlier, Owner received an offer to buy the land for a price that exceeds what he believed the property was worth from a third party. Owner accepted that deal and now does not want to build the shopping center.

The Law: While there are many legal theories that may be asserted against owner, one threshold question is whether a contract has been created notwithstanding the absence of a signature. Developer may have been operating on the mistaken assumption that, until he puts pen to paper to sign the agreement, no contractual obligations have been created. While such a bright line rule may make sense from a practical standpoint, it is not the law in California.

The law of contracts is based on the concept of mutual assent. While the Statute of Frauds does require some contracts to be in writing, even where a written contract is required, some courts have discounted the importance of a physical signature on a piece of paper. When the negotiations break down after the parties have outlined all the material terms and manifested their mutual assent, they may be bound by those terms even without a physical signature. In a seminal case on this question, a California court clarified that a signature is required only when the parties have contemplated that no agreement is binding until it has been signed.¹ The court stated the rule as follows: "[I]f the respective parties orally agreed upon all of the terms and conditions of a proposed written agreement with the mutual intention that the oral agreement should thereupon become binding, the mere fact that a formal written agreement to the same effect has not yet been signed does not alter the binding validity of the oral agreement."²

A party may manifest assent to an unsigned contract through an e-mail which may arguably obviate the need for a conventional signature. As the practice of e-mail confirmation of deal points is now commonplace, physical signatures may become a fading relic of the past. Reflecting this trend, California, like other jurisdictions, recognizes the concept of an electronic signature.³ Even if the underlying agreement contemplated a physical signature, one might argue that a joint venture has been created by the parties' oral agreement and conduct.

Best Practices to Mitigate the Risk: Any agreement, whether the preliminary memorandum of understanding or the "final" deal documents in execution form, should contain a provision that reflects the parties' intention to be bound by the terms of the agreement only when they physically sign the final document and that no joint venture arises from their conduct or oral agreements. Parties and their counsel exchanging draft agreements should include a caveat in e-mail transmittals indicating that a further final approval is required. A transmittal e-mail such as, "here is the final redline reflecting the changes we have discussed, which I will separately forward to my client for a final review" is preferred over a careless statement such as "here are the final drafts ready to be signed" (unless their client is willing to be bound by the act

of sending such an e-mail). While these hastily drafted e-mails may seem insignificant at the moment, they may become the critical fact in a lawsuit which questions whether the parties reached the point of mutual assent.

B. Breach of a Duty to Negotiate in Good Faith

The Scenario: Medical Device Company and Consultant enter into a memorandum of understanding regarding the licensing of certain technology owned by the Consultant which the Company intends to use in a new heart valve. The parties sign a standard confidentiality agreement reflecting their commitment to negotiate in good faith toward a formal licensing agreement.

Consultant, believing that Company is serious about reaching a deal by the end of the year, (1) terminates discussions with another entity regarding licensing the technology and (2) retains lawyers who negotiate with Company's

lawyers over several months and incurs a bill of \$250,000. Company continues to express its interest in the technology but is internally questioning whether it can bring the heart valve to market because of its own cash flow challenges. Nonetheless, Company strings along Consultant, hoping that its cash flow will improve and because it fears that Consultant will reach a deal with a competitor. Frustrated with the delay, Consultant issues an ultimatum: sign by the end of the month or no deal. On the last day of the month, Company reluctantly terminates negotiations with Consultant through a two-sentence letter from the vice president of Product Development. By this time, the competitor that was interested in doing a deal with Consultant a year ago, has reached a deal with another entity and there is no market for Consultant's technology. Does Consultant have a claim against Company?

The Law: The traditional rule was that no cause of action arises under these circumstances because there is no cause of action for breach of an agreement to agree in the future. But California courts have more recently indicated that parties may undertake a duty to negotiate in good faith and, while they are within their rights to terminate negotiations, they may be liable for bad faith negotiations and damages that arise.⁴

If, despite their good faith efforts, the parties fail to reach ultimate agreement on the terms in issue the contract to negotiate is deemed performed and the parties are discharged from their obligations. Failure to agree is not, itself, a breach of the contract to negotiate. A party will be liable only if a failure to reach ultimate agreement resulted from a breach of that party's obligation to negotiate or to negotiate in good faith.⁵

Because the cause of action for breach of agreement to negotiate was only recently recognized in California, few cases provide insight concerning the type of conduct that will support such a cause of action. Three examples can be derived from the cases and other authorities.

(a) Change of Business Plans While Continuing Negotiations. One way in which a party may arguably breach a duty to negotiate in good faith is by not promptly disclosing that further negotiations are futile when it reasonably anticipates that a deal cannot be reached. The Company in the scenario above should have recognized that Consultant was passing up other opportunities to market his product and should have disclosed that its long-term plans might not be realized, releasing the Consultant to pursue other options.

(b) A Take-It-Or-Leave-It Approach. An agreement to negotiate is a real promise to do something rather definite, the breach of which may create damages. Negotiations involve a "give and take" between parties in an attempt to reach a deal. If after promising to provide a draft and negotiate an agreement, a party never proposes terms and an opportunity to negotiate as promised and/or presents the other party with a final contract on a "take-it-or-leave-it basis," refusing to negotiate any of

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the terms, they may be in breach of a contract to negotiate.

(c) Introducing New Terms Late in the Negotiating Process. One recent California court held that, where the parties are negotiating deal points and, having resolved certain fundamental terms, renegeing on those terms introduces significant new terms at the end of the negotiations, a claim may arise for breach of duty to negotiate in good faith.⁶

Best Practices to Mitigate the Risk: It is impossible to address every type of wrong that might be committed in the context of contract negotiations. The sharper the negotiation tactics, the more likely it is that a court will conclude that a duty was breached giving rise to damages. One noted authority on the subject has listed seven bases for liability in the pre-contract negotiation period: (1) refusal to negotiate; (2) improper tactics; (3) unreasonable proposals; (4) non-disclosure; (5) negotiation with others; (6) renegeing; and (7) breaking off negotiations.⁷

C. Other Contract Negotiation Risks

These are only two of the many potential liabilities that are created in contract negotiations. In deals involving the exchange of technology or other proprietary information, it is not uncommon for a party to assert that the other party misappropriated trade secrets, terminating the negotiations only to utilize the secrets without paying the costs. A party's

awareness that the other party is bound by an existing contract with a third party that may be breached, may give rise to interference with contract and business relations by that third party. Promises made in connection with negotiations may give rise to equitable claims of detrimental reliance, which requires little more than a promise that another reasonably and detrimentally relied.⁸

As parties undertake negotiation of significant deals, consideration should be given to the liabilities that may arise, not only if the deal materializes, but in the event that no deal is reached.

¹. *Banner Entertainment, Inc. v. Superior Court*, 62 Cal.App.4th 348, 358 (1998).

². *Id.* at 358.

³. California Civil Code § 1633.7(a). See *Lamle v. Mattel, Inc.*, 394 F.3d 1355, 1361-62 (Fed. Cir. 2005).

⁴. *Copeland v. Baskin Robbins U.S.A.*, 96 Cal.App.4th 1251 (2002).

⁵. *Id.* at 1257.

⁶. *Kitty-Anne Music Co. v. Swan*, 112 Cal.App.4th 30 (2003).

⁷. *Precontractual Liability And Preliminary Agreements: Fair Dealing and Failed Negotiations*, 87 Colum. L. Rev. 217, 273-285 (1987).

⁸. 1 Witkin, *Summary of Cal. Law* (2005) Contract § 244, p. 275. There are three basic elements: (1) promise; (2) reliance; and (3) injury. *Division of Labor Law Enforcement v. Transpacific Transportation Co.*, 69 Cal.App.3d 268, 274 (1977).