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NEWS

Heads of agreement: are you headed for heartbreak?

Transactions of all sizes are frequently detailed under a range of pre-contractual agreements before reaching lawyers for full documentation. These include heads of agreement, letters of offer, and memorandum of understanding style of agreements. An important step to conclude negotiations and facilitate entry into a final contract, these agreements can also be the cause of a major dispute if the transaction does not proceed or if a party wants terms not covered in the agreement. This is often to the surprise of the parties. In this article, partner Mark Lyons offers a timely reminder about thinking twice before signing on the dotted line.

BINDING VERSUS NON-BINDING

As a starting principle, pre-contractual agreements are not legally binding if they are mere agreements to agree to proceed to formal contract. However, there may be an intention for these agreements to give rise to legal obligations and the courts will support enforceability where the prerequisites of a legally binding agreement are satisfied.

This issue typically arises when a transaction does not proceed to formal contract, and the extent to which the agreement is enforceable is required to be determined. Too often, there is not enough thought about whether the obligation to sign a formal contract, or some other obligation, should be enforceable. The issue becomes unclear and ripe for dispute.

It is imperative parties are clear about whether the agreement (or some part of it) is, or is not, intended to be binding. General statements about enforceability, such as 'subject to board approval' or 'subject to contract', only go so far. These are certainly not get out of jail free cards, and should be accompanied by express provisions confirming the binding (if any) and non-binding aspects of an agreement.

Provisions commonly intended to be binding include:

- An obligation to negotiate the formal contract in good faith.
 - Provisions regulating the undertaking of pre-contract due diligence (including access to the property and information held by a counter-party).
 - Exclusivity obligations, including any fees paid in consideration for exclusive dealing.
 - Payment of legal or other costs if the negotiation fails.
 - Confidentiality obligations.
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ONEROUS PROVISIONS

Pre-contractual agreements are becoming increasingly complex, moving far beyond a simple summary of key commercial

terms. We are seeing a variety of onerous or unusual obligations sneak into these agreements which would not traditionally be expected of preliminary negotiations. Transactions to watch include those for hotly contested assets and financing transactions with non-bank lenders.

These obligations are usually expressed to be binding on parties, irrespective of whether formal negotiations succeed and are fully intended to be enforced. For example:

- An obligation on a party to unconditionally release a sum of money.
- Payment of exorbitant signing fees and charges.
- The assumption of liability by an individual as guarantor of the primary party.
- Charging real property to secure payment or performance obligations.

There is a risk these provisions are enforceable against an unwitting party with the result of serious financial consequences.

TERMS OF SALE

In property transactions, it is common for most contract negotiations to be consumed by debating the level of warranty given about the property sold and any associated leases. It is no coincidence these commercial terms are also the ones we see most regularly overlooked in pre-contractual agreements.

In our experience, contract negotiations can be significantly expedited where the parties identify the terms of sale in the pre-contractual agreements. Examples include:

- Confirming the property is sold on an 'as is, where is' basis. This is typically the case where the buyer is sophisticated and will be afforded the opportunity to conduct an unrestricted due diligence.
- Clarifying which party takes tenancy risk, what aspects of the leases will be warranted and how the leases will be managed during the contract period.
- Avoiding overly general terms, such as 'subject to entry into contract on usual commercial terms', as the parties may have very different views on what constitutes usual commercial terms.

Taking steps to cover these issues benefits both parties, allowing a faster and smoother transition from in-principle agreement to formal contract. This reduces the risk of a transaction falling over, as well as avoiding unnecessary time delays and legal expense negotiating documents.

WHAT CAN YOU DO?

Falling into dispute on these agreements can be costly and time consuming. Our lawyers are experienced in a broad range of commercial and property transactions and can review and advise on these pre-contractual agreements. We can assist you with timely and cost-effective advice on these documents before they are signed.

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