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When Your Non-Binding Term Sheet Creates An Enforceable Contract: Important Decision On The Duty To Negotiate In Good Faith

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Term sheets are often used to facilitate the negotiation of a transaction. When a term sheet is used, there is a risk that one party may seek to treat the term sheet as an enforceable contract. A recent decision by the Delaware Supreme Court¹ highlights circumstances in which an agreement to negotiate in good faith can turn a non-binding term sheet into a binding contract. The decision highlights the need to carefully negotiate the obligation of the parties to turn a term sheet into a binding contract.

Background

SIGA Technologies is a biodefense research firm that acquired an antiviral treatment for smallpox. Not having sufficient funds to develop the antiviral treatment itself, SIGA obtained a bridge loan and then entered into a merger agreement with PharmAthene. Each of those documents contained an obligation on the parties to negotiate in good faith a license agreement for the antiviral treatment in accordance with a License Agreement

Term Sheet (a "LATS") if the merger did not proceed. On the bottom of each page of the LATS was a footer that said: "Non Binding Terms."

After the merger agreement was signed, SIGA was able to obtain substantial research grants from the National Institutes of Health. With sufficient funding in hand, SIGA terminated the merger agreement. After the termination, the parties sought to negotiate a license agreement. SIGA sought terms that were substantially different from the LATS. For example, SIGA sought an upfront payment of \$100 million, as opposed to the \$6 million provided for in the LATS. When the parties were unable to reach an agreement, PharmAthene sued.



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The Lower Court Decision

The Delaware Court of Chancery found that (1) SIGA was liable for breach of its duty to negotiate in good faith, (2) SIGA was liable under the doctrine of promissory estoppel (i.e., that SIGA had made a promise that PharmAthene reasonably relied upon), and (3) the proper remedy was an equitable payment stream approximating the terms of the LATS.

The Delaware Supreme Court Decision

On May 24, the Delaware Supreme Court reversed the lower court and held that "the promise to negotiate in good faith for a definitive license agreement in accordance with the LATS's terms is

expressly included in the Bridge Loan and Master Agreement."² As a result, the court found that the proper remedy was for breach of contract, not for promissory estoppel.

The instructive portion of the Delaware Supreme Court's ruling relates to the enforceability of preliminary agreements and the appropriate measure of damages if those agreements are breached.

Adopting a framework of analysis previously used in New York cases, the Delaware Supreme Court defined the LATS as a "Type II Agreement," meaning an agreement in which the parties "agree on certain major terms, but leave open other terms for further negotiation."³ The court explains that a Type II Agreement "does not guarantee the parties will reach agreement on a final contract ... however [it does] bar a party from renouncing the deal, abandoning the negotiations, or insisting on conditions that do not conform to the preliminary agreement."⁴

The key element of the court's decision is that "where the parties have a Type II preliminary agreement to negotiate in good faith, and the trial judge makes a factual finding ... that the parties would have reached an agreement but for the defendant's bad faith negotiations, the plaintiff is entitled to recover contract expectation damages."⁵ Contract expectation damages are generally seen as the broadest possible form of contract damages. Since the lower court did make the necessary findings, the Delaware Supreme Court sent the case back to the Chancery Court for the proper calculation of expectation damages.

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Key Takeaways

The clearest takeaway is that if a party is subject to a legally enforceable obligation to negotiate in good faith, it should not renounce the deal, abandon the negotiations, or insist on conditions that do not conform to the preliminary agreement.

However, the situation in *SIGA*, with a legally enforceable obligation to negotiate in good faith, is not the typical one. The more common situation is one in

which a term sheet that purports to be non-binding either contains language that the parties will negotiate in good faith or is silent on the matter. The risk in that situation is that the supposedly non-binding term sheet is found to be a Type II Agreement. The critical questions are:

- What is the effect of precatory (non-binding) language providing that the parties will negotiate in good faith?
- How far can the parties extend the

implied covenant of good faith and fair dealing to create an obligation to negotiate in good faith?

¹ *SIGA Technologies, Inc. v. PharmAthene, Inc.* (Del. May 24, 2013).

² *SIGA* at 31.

³ *SIGA* at 33 (internal citations omitted).

⁴ *SIGA* at 33-34 and footnote 85 (internal citations omitted).

⁵ *SIGA* at 37.