DELAWARE CORPORATE LAW BULLETIN

TYPE I VS. TYPE II: DELAWARE COURTS DISCUSS ENFORCEABILITY OF PRELIMINARY AGREEMENTS

Parties to Type II preliminary agreements required to negotiate in good faith regardless of inclusion of express provision governing negotiations

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INTRODUCTION

When parties to commercial negotiations reach an agreement on certain basic transaction terms but are not yet ready to proceed to definitive documentation, they frequently will sign a preliminary agreement—usually called a letter of intent or an agreement in principle—to memorialize their then-current intentions. Preliminary agreements typically state that the parties are not obligated to complete the proposed transaction until definitive documentation is fully negotiated and signed. Further, preliminary agreements may or may not address the parties' obligations to continue good faith negotiations.

Dealmakers and their advisors, however, may not fully appreciate the extent to which preliminary agreements may create enforceable contractual obligations. For instance, are so-called preliminary agreements simply "agreements to agree," *or* are the parties required to continue to negotiate in good faith, *or* have the parties created fully binding contracts to conclude the proposed transaction?

Over the last ten years, Delaware courts have clarified that preliminary agreements, depending on the language employed, can create a range of binding legal obligations that carry significant consequences if breached. In 2013, in *SIGA Techs., Inc. v. PharmAthene, Inc.*, 67 A.3d 330 (Del. 2013) ("*SIGA*"), the Supreme Court of Delaware ("*Supreme Court*") adopted the New York law concepts of Type I preliminary agreements ("*Type I Agreements*") and Type II preliminary agreements ("*Type II Agreements*"). Almost ten years later, in *Cox Commc'ns, Inc. v. T-Mobile US, Inc.*, 273 A.3d 752 (Del. 2022) ("*Cox Communications*"), and *GreenTech Consultancy Co. v. Hilco IP Servs., LLC*, No. N20C-07-052 AML CCLD, 2022 WL 1499828 (Del. Super. Ct. May 11, 2022) ("*GreenTech Consultancy*"), the Supreme Court and the Superior Court of Delaware ("*Superior Court*"), respectively, elaborated on the legal ramifications of Type II Agreements.

I. LEGAL BACKGROUND

In *SIGA*, two "research and development" companies, amidst negotiation of a licensing arrangement that later blossomed into a proposed merger, exchanged several drafts of a license agreement term sheet ("*LATS*") providing for the parties to "negotiate in good faith with the intention of executing a definitive License Agreement in accordance with the terms set forth in . . . " the LATS. The LATS included two important caveats: (i) its terms were nonbinding, and (ii) significant economic terms remained open. Although the parties did not sign the LATS, it was ultimately attached as an exhibit to a signed merger agreement. When one of the parties purported to terminate the merger agreement due to a case of "seller's remorse," the other sued to enforce the LATS. The Supreme Court found the LATS to be a Type II Agreement.

Drawing from principles of New York contract law, the Supreme Court recognized "two types of binding [ ] agreements":

- A ***Type I Agreement*** is a "fully binding" preliminary agreement, which is "created when the parties agree on all the points that require negotiation (including whether to be bound) but agree to memorialize their agreement in a more formal document."
- When negotiating a ***Type II Agreement***, the parties "agree on certain major terms, but leave other terms open for further negotiation." As such, the parties "bind themselves to a concededly incomplete agreement in the sense that they accept a mutual commitment to negotiate together in good faith in an effort to reach final agreement within the scope that has been settled in the preliminary agreement." On the other hand, a Type II Agreement "does not commit the parties to their ultimate contractual objective but rather to the obligation to negotiate the open issues in good faith in an attempt to reach the [ultimate] objective within the agreed framework."

The *SIGA* Court also fashioned a remedy for Type II Agreements, declaring 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."

Two questions remained after *SIGA*:

1. Whether, to constitute a Type II Agreement, a preliminary agreement must include express language establishing the obligation of good faith negotiations, or if this obligation was implied in a preliminary agreement that did not qualify as a Type I Agreement.
2. Whether the obligation to negotiate in good faith, express or implied, possessed any value to serve as legal consideration.

These questions were addressed some ten years later, initially in *Cox Communications*, and then in *GreenTech Consultancy*. Accordingly, dealmakers and their legal counsel engaging in early-stage negotiations now must be aware that a preliminary agreement—whether denominated in a letter of intent, an agreement in principle, a term sheet, or some other formulation—found to be a Type II Agreement imposes an implicit, yet enforceable, obligation to bargain in good faith, which, if breached, can lead to an award of expectation damages.

II. FACTUAL BACKGROUND

A. Cox Communications

On December 6, 2017, cable systems operator Cox Communications, Inc. ("*Cox*"), and telecom giant Sprint Corporation ("*Sprint*") signed a settlement agreement ("*Settlement Agreement*") providing for each party to drop a patent infringement lawsuit against the other. Pursuant to Section 9(e) of the Settlement Agreement ("*Section 9(e)*"), "Cox agreed that, before it offered wireless mobile services to its customers, it would enter into a 'definitive' exclusive provider agreement with Sprint 'on terms to be mutually agreed upon between the parties for an initial period of 36 months[.]' "

Thereafter, Cox continued to study entrance opportunities into the wireless mobile market. In April 2020, soon after T-Mobile U.S., Inc. ("*T-Mobile*") acquired Sprint, Cox launched a formal process "seeking an exclusive [provider] to power its entry into the wireless mobile market." Both T-Mobile and Verizon Communications Inc. ("*Verizon*") submitted bids, but after allowing T-Mobile to make a series of enhanced offers, Cox ultimately selected Verizon's less expensive bid. After learning that Cox was partnering with its rival Verizon, T-Mobile—in its purported capacity as Sprint's "successor-in-interest" under the Settlement Agreement—threatened litigation to redress Cox's alleged breach of Section 9(e)'s exclusive provider clause.

"Seeking peace of mind as it ramped up its relationship with Verizon," on January 6, 2021, Cox asked the Delaware Court of Chancery ("*Chancery Court*") for "a declaration that Section 9(e) is either an unenforceable 'agreement to agree' or a Type II preliminary agreement requiring Cox and T-Mobile to negotiate in good faith." If the Settlement Agreement was a Type II Agreement, Cox argued, Section 9(e) permitted it to partner with Verizon after "good-faith negotiations" with T-Mobile "failed." T-Mobile responded with a motion to permanently enjoin Cox from violating the Settlement Agreement, arguing "that Section 9(e) means that, although Cox is not obligated to provide wireless mobile services, if it wishes to do so, it must first enter into an exclusive provider agreement with T-Mobile . . . ." Moreover, Cox's inability to "negotiate the definitive terms of the agreement" with T-Mobile "means that Cox *may not enter the wireless mobile market at all*." [emphasis added].

The Chancery Court, siding with T-Mobile, determined that "Section 9(e) contains two promises[.]" *First*, "a present obligation . . . that [Cox] either refrain from entering the [w]ireless [] [m]arket or make a deal with Sprint." *Second*, "a Type II preliminary agreement that . . . requires both parties to negotiate open issues in good faith." In short, the Chancery Court ruled, the Settlement Agreement permitted "T-Mobile [to] hold Cox to its original promise": either provide mobile services through T-Mobile, "or not at all." On this basis, the Chancery Court "permanently enjoined Cox from 'partnering with any mobile network operator other than T-Mobile . . . .'" Cox appealed this ruling to the Supreme Court.

B. GreenTech Consultancy

In 2017, GreenTech Consultancy Company, WLL ("*GreenTech*"), and Hilco IP Services, LLC ("*Hilco*"), formed "a joint venture to develop and commercialize" certain internet domain names owned by GreenTech. Hilco's financial commitment was key to GreenTech's ability not only to commercialize the domain names, but also to maintain their registration with Internet Corporation for Assigned Names and Numbers ("*ICANN*"), which "oversees the coordination of policies of the Internet's Domain Name System. . .."

The prospective joint venturers memorialized the "general terms and conditions" of their arrangement in a "six-page 'Term Sheet' " ("*Term Sheet*"). Among other things, the Term Sheet (i) required Hilco to "invest up to $250,000 in order to fund . . . direct expenses[,]" (ii) included a termination provision subjecting GreenTech to certain financial consequences if it terminated the transaction prior to closing, (iii) conditioned closing on "negotiation and execution" of definitive transaction documents and receipt of consents from ICANN and other third parties, (iv) selected "the laws of the State of Delaware without reference to its conflicts of laws principles" to govern the joint venture, and (v) set an outside date for closing ultimately extended to December 31, 2018.

Although the parties initially cooperated, their "relationship . . . became contentious in the spring and summer of 2018." Then, in August, "Hilco stopped performing its obligations under the Term Sheet. . .." Without Hilco's financial support, GreenTech could no longer afford to maintain registry of the domain names with ICANN. ICANN terminated GreenTech's registrations "after the November 30, 2018 registry fees went unpaid" and, thereafter, the domain names "ceased to exist."

GreenTech filed a complaint with the Superior Court in July 2020 "alleging Hilco breached the Term Sheet by 'failing to provide the agreed-to funding . . . .' " As a result, GreenTech charged, Hilco should be held liable for "damages to GreenTech 'in an amount greater than $3 million' " as compensation for the lost domain names. In response, "Hilco contend[ed] the Term Sheet is not a 'final, binding contract, but merely a preliminary 'agreement to agree.' " Reminiscent of T-Mobile's argument in *Cox Communications*, Hilco claimed that, "at best," the Term Sheet was "a Type II agreement that only obligated the parties to negotiate the open issues in good faith." Not only had it negotiated in good faith, Hilco argued, but it "backed out of the agreement only because it developed legitimate business concerns about the project's viability."

For its part, GreenTech was not interested in parsing the differences between Type I and Type II Agreements. More to the point, it claimed, "the Term Sheet was a binding contract that encompassed all the substantial terms of the contemplated transaction. All that remained to be done was for Hilco to 'perform its contractual obligations . . . and work toward the closing.' " And even if the Term Sheet was a Type II Agreement, in GreenTech's view, Hilco failed to "negotiate in good faith" before it "abandoned its obligations under the Term Sheet. . .and pressured GreenTech to buy its way out . . . ." Each party moved for summary judgment.

III. THE COURTS' ANALYSES

A. Cox Communications: Supreme Court's Analysis

The Supreme Court vacated the Chancery Court's injunction and directed it to consider, on remand, whether the parties had "discharged their obligations to negotiate in good faith as required by Section 9(e) . . . ." Rejecting the Chancery Court's interpretation that Section 9(e) embodied *two separate promises*, the Supreme Court explained that Section 9(e) reflected

> a single promise that unambiguously contemplates a future 'definitive' agreement but leaves many terms open, "to be mutually agreed upon between the parties[.]" Because it leaves material terms open to future negotiations, Section 9(e) is a paradigmatic Type II agreement of the kind we recognized in *SIGA* . . . . Parties to such agreements must negotiate the open terms in good faith, but they are not required to make a deal.

The Supreme Court acknowledged that, traditionally, "the absence or indefiniteness of material terms" from the Settlement Agreement would have rendered it "unenforceable." However, the *SIGA* Court abandoned the "traditional rule" when it "recognized . . . two types of enforceable preliminary agreements," Type I Agreements and Type II Agreements. Because the Settlement Agreement left "a number of terms open, such as price," and expressly "contemplate[d] a future 'definitive' agreement" in which "open terms will 'be mutually agreed upon between the parties[,]' " the Supreme Court agreed with Cox that the

Settlement Agreement "is a Type II preliminary agreement." Accordingly, "Cox's only obligation under Section 9(e) is to negotiate open terms in good faith within the bounds of a 36-month exclusive relationship with [T-Mobile]." There could be no assurance, however, that "the parties will reach agreement on a final contract because [ ] 'good faith differences in the negotiation of the open issues' may preclude final agreement."

The Supreme Court also addressed the Chancery Court's concern that, because Section 9(e) "served as consideration for Sprint's dismissal of the patent suit against Cox," the provision "should not be interpreted as 'nearly worthless to Sprint.' " The Supreme Court dismissed this concern by explaining that "Delaware law recognizes that obligations to negotiate in good faith are not worthless." In effect, the parties' agreement to negotiate in good faith consistent with the Settlement Agreement supported their mutual dismissal of pending litigation.

Finally, the Supreme Court considered it unrealistic that "reasonable actors in the position of Cox and Sprint" would have intended that, if "Cox in good faith [could not] come to an agreement with T-Mobile," it would become "permanently barred" from partnering with any other mobile service provider. The Settlement Agreement "cannot bear the weight of this result, nor can our decision in [*SIGA*], which explicitly contemplates that parties to Type II agreements have no obligation to enter a final agreement once they negotiate in good faith."

B. GreenTech Consultancy: Judge LeGrow's Analysis

In their respective pleadings, Hilco argued that the Term Sheet was "merely. . . '[an] agreement to agree' " lacking any binding contractual force, while GreenTech countered that the Term Sheet was, in fact, "a 'binding contract.' " In the words of Superior Court Judge Abigail M. LeGrow, "[b]oth parties appear to misinterpret *SIGA*." According to *SIGA*, "Type II preliminary agreements *are* binding and enforceable contracts. The difference between Type II preliminary agreements and 'normal' contracts is simply which obligations bind the parties." While a Type II Agreement "does not commit the parties to their ultimate contractual objective," it does require the parties "to negotiate the open issues in good faith," effectively barring the parties "from renouncing the deal, abandoning the negotiations, or insisting on conditions that do not conform to the preliminary agreement."

Against this backdrop, Judge LeGrow determined that "[t]he Term Sheet is a Type II preliminary agreement as defined in *SIGA*." Among the factors driving this conclusion were that the Term Sheet (i) "recognize[d] that this transaction will require further documentation . . . setting forth the specific terms and conditions of the *proposed transaction* in more detail . . . [;]" (ii) referred to the transaction as "proposed," reflecting that "the parties had not yet agreed on its full terms and that more negotiations would be necessary[;]" and (iii) "described several 'Conditions to Closing[,]' " including "negotiation and execution" of definitive documentation for the joint venture.

Judge LeGrow also noted that "[u]nlike the agreement in *SIGA*, the Term Sheet . . . did not expressly state that the parties would exercise 'good faith' in negotiating the open issues." This distinction did not alter the result. Consistent with *Cox Communications*, the Judge noted, "the Term Sheet nevertheless contained an *implied obligation* to negotiate in good faith." (emphasis added). In short, "[t]he lack of an express good faith obligation . . . does not hinder this Court's conclusion that the Term Sheet is a Type II preliminary agreement."

Having found the Term Sheet to be a Type II agreement, Judge LeGrow turned to the question whether Hilco met its duty "to negotiate the open issues in good faith in an attempt to reach the . . . objective within the agreed framework." In this connection, the Judge noted that for purposes of Delaware law, "bad faith is not simply bad judgment or negligence, but rather implies the conscious doing of a wrong because of dishonest purpose or moral obliquity . . . ." Judge LeGrow then walked through the timeline of interactions between Hilco and GreenTech, finding that while Hilco initially showed indications of good faith, "reasonable minds could differ" whether actions taken by Hilco after "the relationship between GreenTech and Hilco began unravelling" constituted "bad faith in the full context of the challenges facing the . . . " nascent joint venture. Because issues of bad faith are "especially difficult to resolve on summary judgment[,]" Judge LeGrow denied the parties' respective motions for summary judgment.

CONCLUSION

While parties to preliminary agreements governed by Delaware law may stipulate "there's no deal until there's a deal," they must be aware of the circumstances under which a preliminary agreement may constitute either a Type I Agreement or a Type II Agreement. Type I Agreements are rare; if the parties to a proposed transaction have devoted enough time and energy to negotiate all essential terms, they probably will proceed to definitive documentation rather than rely on a letter of intent or agreement in principle. On the other hand, Type II Agreements, which require only that certain major terms be established while others are left to future negotiation, are much more common in private commercial transactions. Even absent express language establishing an obligation to negotiate unresolved terms in good faith, this duty is implied in every Type II Agreement. And neither "buyer's remorse" nor "seller's remorse" will permit a party to a Type II Agreement to turn to a more attractive transaction partner without at least a good faith attempt to resolve all open issues with the original partner.

It is not clear whether, post-*SIGA*, *Cox Communications*, and *GreenTech Consultancy*, parties to a preliminary agreement may leave enough issues unresolved, or perhaps expressly disclaim an obligation to continue to negotiate in good faith, to avoid characterization of their agreement as a Type II Agreement. That would seem to defeat the purpose of entering into a preliminary agreement in the first place. As in public merger negotiations, the best policy for parties who do not wish to incur preliminary obligations is to proceed directly to the negotiation of definitive documentation. As a backstop, it would be prudent to include in preliminary agreements an outside date for completion of negotiations.