Preliminary Agreements as Signposts Instead of Mini-Contracts

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Cathy Hwang, *Deal Momentum*, 65 **UCLA L. Rev.** (forthcoming, 2018), available at SSRN.

Cathy Hwang's article *Deal Momentum* offers empirical evidence to support a new view of preliminary agreements that could reshape the way we think about these hybrids between contract and non-contract. Her data – interviews with deal lawyers and a review of practitioner literature – challenge the conventional wisdom that businesspeople in large mergers and acquisitions hire counsel to draft memoranda of understanding ("MOU"), letters of intent ("LOI"), or term sheets to resolve either deal uncertainty or deal complexity. That view coheres with the standard statement in a LOI – often on every page – that the parties do not intend it legally bind them on substantive provisions such as price. Yet Hwang's interviews with corporate counsel, her review of practitioner literature and case law suggest that most business people resolve uncertainties and complexities before entering a LOI, not afterwards.

Hwang solves this puzzle of why parties pay counsel to draft term sheets that make substantive terms non-binding when in fact the parties usually intend to – and do — go ahead with the deal once they create a LOI. She concludes that preliminary agreements instead serve as "signposts" that "lend form and formality to an otherwise unstructured phase of the negotiation process." (P. 37.) She dubs this tipping point "stickiness," meaning the point when the parties come to believe that the deal will stick.

Deal Momentum, like the work of Robert Ellickson and Lisa Bernstein, demonstrates the power of norms – instead of or in addition to law – to shape relationships. It suggests that law might not be so important to business people as legal scholars assume. But unlike the ranchers, farmers, and merchants in diamonds and cotton, the parties to M&A deals generally are not members of a tight-knit community.

Hwang interviewed twelve deal lawyers with years of experience in private M&A deals at firms in New York, Silicon Valley, Chicago, and Houston, as well as in-house counsel, she reports that the core terms of a deal don't change much between the LOI and the final agreement and closing. (P. 36.) Deal lawyers, bankers, and business people see the "real work" of the deal differently, based on their role:

> From a deal lawyer's perspective, then, the real work of the deal begins after the preliminary agreement. From the perspective of bankers and business people, however, the deal is finalized in broad strokes at the preliminary agreement stage. This explains why preliminary agreement terms remain largely unchanged after the agreement's signing – they are business terms that are negotiated by bankers and businesspeople, who have already completed the bulk of their relevant diligence prior to the agreement's signing. (P. 36.)

Why, then, would a business spend the time and money to negotiate a non-binding agreement, when they could skip right to the stage of finalizing the agreement?

Following Fuller's three functions served by formalities like writing requirements under the statute of frauds – evidentiary, cautionary, and channeling – Hwang sees preliminary agreements as providing a vehicle for parties to

> signal to each other and attach moral suasion to their non-binding agreement . . . [they] can organize their early collaboration, and introduce lawyers, who act as a set of reputational gatekeepers, to help them further solidify their certainty in the deal." (P. 38.)

The moral suasion is particularly surprising, since the parties to these M&A deals are not repeat-players with one another. Accordingly, her subjects report that walking away from a LOI generally does not harm a party's reputation. Yet they also say they care about "their word," and having the reputation as an "integrity player. (P. 39.) Hwang surmises that the multi-stage nature of big deals creates an incentive to induce trust in the other side. As one subject put it, parties want to show commitment short of legal obligation: "You go on dates, . . . but that doesn't mean you're getting married. But you give gifts sometimes. It means some level of commitment." (P. 40.)

LOIs also signal organization. One deal lawyer analogized the attorney's role to the 1980s TV ads for Reese's peanut butter cups:

> Too many times the business people come and they think they have a great idea. Like, I'm going to put my chocolate in your peanut butter. You have to sit back and be like, that's great, but who's going to pay for the packaging? The marketing? How about employees"? [A term sheet] helps both sides knock out the material terms and figure out if there's a skeleton to get the deal done. (P. 40.)

Contrary to the reputation of lawyers as deal-killers, this story – offered by a deal lawyer, of course – shows value that transactional lawyers can bring.

But most interesting for law professors is the role of attorneys as gatekeepers. Unlike the parties, the attorneys are repeat players with one another. Lawyers at the elite firms that structure M&A deals encounter one another repeatedly in different transactions, so they have an incentive to keep their word, and thus function as "reputational intermediaries" that signal to parties, bankers, and regulators that attorneys are on task as gatekeepers of legitimacy, screening out legal flaws and verifying compliance with regulations and procedures. In other words, bringing in the lawyers is a way that the parties tell one another and third parties that they mean business.

Signaling through exchanges on the edge of law shows up in areas other than M&A deals. A couple gets engaged when they have found out enough about one another to conclude that they're sufficiently congenial to make a lifelong commitment. In my book Love's Promises, I dub these not-legally-binding exchanges as "deals" that support relationships. Combining that approach with the idea of deal momentum, the engagement ring signals one party's commitment to provide of financial stability, as well as respectability via the public announcement of that exchange. Moreover, the trouble a proposer takes to pop the question in a dramatic or emotional way implicitly promises years of sharing stories about how that family came to be, a norm that could support them through bad times and give them an additional reason to be glad of their merger when things are going well.

The data compiled in *Deal Momentum* shed light on why parties enter both personal and corporate agreements that are not binding, thus mapping the shadow of the law in which bargaining occurs as well as lawyers' roles. Future scholars may well suggest another term to describe the stage of a deal's life when a LOI is merited. Hwang's term "sticky" coheres with her main point that a term sheet signals the stage in a deal when the parties switch from "why should we enter this deal?" to "why not?," a switch from a "no" default to a "yes" default. The "yes" becomes a sticky default at that moment. Yet stickiness also implies stasis, not movement. The term "traction" may better capture Hwang's

observation that a LOI works as a green light ushering the parties toward completing the transaction.

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