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# Case Study on the Legal Effects of Letters of Intent

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## Ⅰ. Introduction

Two cases, decided by courts of the two opposite sides of the Atlantic, illustrate the difficulties which originate from inadequate drafting of letters of intent.

I am referring to the Pennzoil case in the U.S. and the SME case in Italy. In both cases the judges had to face the crucial question as to whether or not a given letter of intent had a binding nature; they had in other words

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to decide whether the wills expressed in such letters still belonged to the pre-contractual stage, or whether their incorporation into a pre-contractual document meant that negotiations were over and binding obligations had already arisen for the parties.

It is, therefore, appropriate to briefly describe these two cases, which are extremely interesting, not only for the many useful lessons which can be learnt from them, but also because they illustrate the consequences of the different approaches of common law and civil law to the pre-contractual liability.

## II. The Pennzoil Case

### 1. The attempt by Pennzoil to acquire Getty

Pennzoil, Inc. v. Texaco, Inc. (the Pennzoil case)[1] provides a remarkable illustration of the potentially disastrous consequences of expressing intentions ambiguously in letters of intent. The case touches the full range of the legal issues which typically concern the letters of intent: the binding effect of the document, approval of the Board of Directors of the parties, reference in the letter of intent to the preparation of a "final formal agreement", the conduct of parallel negotiations and the abrupt termination of negotiations. The key players in the case were three large U.S. oil companies, Pennzoil, Inc., Getty Oil Company and Texaco, Inc. The dramatic fact pattern developed during the first week of 1984.

On December 28, 1983 Pennzoil commence a tender offer for a substantial portion of the shares of the common stock of Getty Oil, at a price of US $ 100 per share.

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1) No. 84-05905, 151st Dist. Ct., Harris County, Tex., Nov. 15, 1985.

The two main shareholders of Getty Oil were Gordon P. Getty, trustee of the Sarah C. Getty Trust, which owned 40.2% of the shares, and the J. Paul Getty Museum (the "Museum"), a charitable trust which owned 11.8% of the shares. On December 30, 1983 they proposed to Pennzoil that it withdraw the tender offer and acquire a minority position in Getty Oil on a negotiated basis. On January 1st, 1984 Gordon P. Getty and representatives of Pennzoil and the Museum held a number of meetings in New York which culminated in the signature of a document called a "Memorandum of Agreement" on January 2nd, 1984. It described a sequence of events, the implementation of which would result in Pennzoil and Gordon P. Getty being the only shareholders of Getty Oil, owning 43% and 57% of the shares respectively. Pennzoil would acquire its shares of Getty Oil at a price of US $ 110 per share, 10% more than price in the tender offer, which Pennzoil agreed to withdraw. The Museum would sell its shares to Getty Oil.

The Memorandum also stated that Pennzoil and Gordon P. Getty would agree jointly on the management of Getty Oil and would work together to effect its restructuring. The Memorandum of Agreement called the sequence of the various steps and commitments which would effect the transition a "plan". Each of the three subsequent paragraphs specifying the various steps and commitments, which were headed "Pennzoil Agreement", "Company Agreement" and "Museum Agreement" began with the following words:

"Subject to the approval of the Plan by the Board of Directors of the Company (Getty Oil) as provided in paragraph 6 hereof..."

Paragraph 6 included the following:

"This Plan is subject to approval by the Board of Directors of the Company (Getty Oil) at the meeting of the Board being held on January 2nd, 1984 and will expire if not approved by the Board".

Agreement, not plans, expire. The approval of Getty Oil's Board of Directors was the only express condition in the Memorandum of Understanding. In a letter also dated January 2nd, 1984, Gordon P. Getty personally undertook to support the Plan before the Getty Oil Board of

Directors on behalf of Pennzoil. He also promised to cause the replacement of the Directors, if necessary, as relative majority shareholder, in order to gain approval, and to resist any alternative proposals of the Board. The Board of Directors, in a meeting which also took place January 2nd, 1984, expressed certain reservations about the transaction, but on January 3rd, 1984, approved the Memorandum of Agreement after Pennzoil agreed to increase the price to be paid to Getty Oil's public shareholders from US $ 110 to a minimum of US $ 115.

On January 4, 1984, before trading on the New York Stock Exchange opened, Getty Oil, the Museum and Gordon P. Getty issued a joint press release announcing the transaction. The same press release was issued later on January 4, by Pennzoil. The press release and the report in the Wall Street Journal on January 5 referred to an "agreement in principle" which was "subject to execution of a definitive merger agreement". It also stated that "upon execution of a definitive merger agreement, the December 28, 1983 tender offer by Pennzoil for shares of Getty Oil stock will be withdrawn".

The press release was the first mention of a subsequent contract. Neither the text of the Memorandum of Agreement, nor Getty Oil's Board of Directors when it approved the acquisition on January 3rd, 1984, had made any mention of the need for a "definitive agreement".

During the evening of January 3rd and through January 4 and 5, lawyers for Pennzoil and Gordon P. Getty worked to prepare a draft of a formal "transaction agreement". This was completed on January 6. The crucial legal issue, of course, was whether the parties intended the drafting work to be merely a memorialization of an already binding agreement, or whether binding obligations were intended to arise only from the "definitive agreement". The text of the Memorandum of Agreement undoubtedly militated in favour of the first alternative, in as much as it was sufficiently detailed and subject only to the approval of Getty Oil's Board of Directors, whose approval was in fact obtained.

The text of the press release, however, indicated the second alternative, particularly as it conditioned the withdrawal by Pennzoil of its tender offer - a key feature of the overall transaction - upon the signature of a "definitive merger agreement". Furthermore, it was discovered that the acquisition of the Museum's shares by Getty Oil, which was critical to the transaction, was likely to subject Getty Oil to US $ 2 billion tax liability. Consequently, even after January 4, 1984 the parties continued to discuss the possible acquisition of the Museum's shares by Pennzoil, instead of by Getty Oil, in order to avoid the tax problem.

On January 5, 1984 Gordon P. Getty and representatives of the Museum secretly entered into discussions with Texaco. These discussions involved a plan for Texaco to acquire Getty Oil at a price of US $ 125 per share, later raised to US $ 128. On January 6, 1984 a press release by Texaco announced that Texaco had signed an agreement with Getty Oil's shareholders to take over the company. Later the same day the Board of Directors of Getty Oil approved the Texaco transaction.

Gordon P. Getty and the Museum expressly excluded their agreements with Pennzoil from their respective written warranties and representations to Texaco that the sellers were free to sell their shares of Getty Oil to Texaco, and that such a sale would not "constitute a violation of or default under, or conflict with, any contract, commitment, agreement, understanding or restriction of any kind...", and Texaco agreed to indemnify Gordon Getty against "any losses, claims, damages or liabilities arising out of" his transactions with Pennzoil.

## 2. The litigation

On January 10, 1984 Pennzoil brought suit in the Delaware Chancery Court for specific performance of the Memorandum of Agreement, including a request for a preliminary injunction prohibiting actions which might prevent a court of equity from affording such ultimate relief in lieu of damages. On February 6, 1984 Pennzoil's motion was denied.

Pennzoil then shifted the battle to its home turf in Houston, Texas, by suing Texaco, on February 8, 1984, for the common law tort of intentional interference with contractual relations and inducement of breach of contract. Pennzoil sought actual damages for an amount of US $ 7.53 billion and punitive damages amounting to an additional US $ 7.53 billion, plus interest.

To prevail in an action of this kind the plaintiff must establish the existence of a valid contract. It was thus critical for the Texas court (District Court of Harris County, Texas, 151st Judicial District) to preliminary determine whether a valid contract existed between Pennzoil and the Getty Oil shareholders. It must be remembered that a unique feature of U.S. litigation is the use of juries in civil cases. After a long trial which saw some of the most prominent U.S. litigators on both sides, the first question which Judge Solomon Casseb posed to the Texas jury was:

"Do you find from a preponderance of the evidence that at the end of the Getty Oil Board Meeting of January 3rd, 1984, Pennzoil and each of the Getty Oil entities, to wit, the Getty Oil Company, the Sarah C. Getty Trust and the J. Paul Getty Museum, intended to bind themselves to an agreement that included the following terms...?"

The reply of the jury was "we do". The Texas Court rendered its judgement on December 10th, 1985. Texaco was found to have knowingly interfered with the agreement between Pennzoil and the Getty Oil

shareholders. Pennzoil was awarded actual damages for an amount of US $ 7.53 billion, and punitive damages for an amount of US $ 3 billion, plus interest, for a total of US $ 11.1 billion. To appreciate the economic significance of this assessment, one has to consider that the entire net worth of Texaco was in the range of nine and a half billion dollars. Some commentators observed that the judgement was greater than the gross national product of some 116 countries.

The general response to this verdict has been to call it such things as "shocking", "a fluke", a "travesty" and an "absurdity". A New York Times editorial called the case a "sad farce". Part of the strategy of Pennzoil's chief trial lawyer, Joseph D. Jamail, a flamboyant personal injury lawyer and relentless Texan, was to cast the case to the jury in terms of Wall Street against Main Street; of Texas men of honour against Northern sharpies. Jamail asked the jury to "send a message to corporate America".

Texaco reacted to the judgement from the Trxas trial court in two ways:

(a) It first asked the U.S. District Court for the Southern District of New York for a temporary restraining order (which it obtained on December 17th, 1985) and then a preliminary injunction restraining Pennzoil from taking any action to enforce the judgement of the Texas Court. The District Court granted the injunction on January 10, 1986 on the basis that enforcement of the Texas judgement would result in the bankruptcy of Texaco, with consequent prejudice towards Texaco's assertion of its appeal rights, and would cause harm to the public whose welfare was dependant upon Texaco's continued existence as a vital wealth generating economic enterprise.

There is some criticism of the Texas Court judgement which can be read between the lines of the District Court's judgement. It stated that its only intention was "to assure Texaco its constitutional right to raise claims (in the appeal proceeding) that we view as having good chances of success". It found it to be "quite obvious" that punitive damages should not have been awarded and that the compensatory damages awarded were too high. The

practical effect of the federal court decision was the saving of Texaco from bankruptcy, by freeing the company from the requirement of having to post an appeals bond for the full amount of the Texas Court judgement.

(b) In a separate move Texaco filed an appeal before the Court of Appeals for the First Supreme Judicial District of Texas. On May 12, 1986 the Attorney General of the State of New York took the unusual step of filing a brief amicus curiae in the Texas Court of Appeals, urging a reversal of the trial courts judgement against Texaco. In its brief to the appeal court, New York stated that trial judge Solomon Casseb has "misstated numerous principles of New York law" in his charge to the jury, and that his instructions "failed to describe the pertinent New York law accurately" and "served to mislead the jury". These statements referred particularly to New York's law of contract formation.

With specific regard to the key issue of the binding effect of the Memorandum of Agreement the amicus curiae brief contained the following:

"For example, reference in the January 4, 1984 press release to an "agreement in principle" that was "subject to the execution of a definitive merger agreement", and language in the draft definitive merger agreements which stated that the agreement was not to become effective until "after execution and delivery of the Agreement", support Texaco's argument that the parties to the Memorandum of Agreement had expressly reserved the right not to be bound in the absence of their formal execution of a definitive merger agreement".

The brief discussed the four factors applied by New York courts to determine the binding effect of letters of intent, which it called the "Winston test", noting that the Second Circuit Court of Appeals "has repeatedly emphasized that the last factor cited -usage and custom- should be weighted heavily". The brief noted that the trial judge refused to inform the jury "of these considerations mandated by New York law".

The amicus curiae brief also observed that the charge to the jury failed to emphasize that, under New York law, "actual knowledge" of a contract is

an essential element of the tort of intentional interference with contract, and that element must be proved by the plaintiff. With regard to punitive damages, the New York Attorney General noted that, given all the circumstances of the case, the Texas trial court had no basis to conclude that Texaco's conduct could fairly be characterized as malicious. Indeed, according to the brief, Texaco's conduct promoted, rather than harmed the public interest in an open competition for the stock of Getty Oil, advanced Texaco higher bid.

## 3. The judgement of the Texas Court of Appeals

On February 12, 1987, the Texas Court of Appeals upheld the entire US $ 7.53 billion in actual damages that the trial court had awarded to Pennzoil, but reduced the punitive damages to UD $ 1 billion from US $ 3 billion. Nevertheless, considering the additional amount of interest, the total award still exceeded US $ 10 billion.

In its lengthy opinion, in excess of 100 pages, the court addressed the issues in painstaking detail. The opinion discussed virtually all of the theories which American courts have used to validate or invalidate letters of intent as final agreements -completeness, partial performance, the language of the letter of intent, the words "subject to", the captioning of a preliminary agreement, negation of contractual intention, the magnitude of the transaction. It is easy to disagree with the conclusions. They are in most respects contrary to the opinion of the New York Attorney General and the thinking of the Second Circuit Court of Appeals considering New York law. Indeed, the Texas Court of Appeals opinion may be read as a response to the amicus curiae brief. The significance of the opinion is its stress on, and deference to, the factual determination of the jury in the lower court hearing.

The opinion begins with a statement of the familiar rules that if parties

to an informal agreement do not wish to be bound to it until a formal agreement is executed, they may delay the constitutive effect of the informal agreement until that execution. The court must "examine the words and deeds of the parties, because these constitute the objective signs of such intent". The four factors of the "Winston Test" were considered in detail.

(a) Whether the parties expressly reserved the right to be bound only when a written agreement is signed

Texaco had contended that (i) "subject to" language of the press releases; (ii) the drafts of the "transaction agreement" which stated that the obligations would be binding "after the execution and delivery of a definitive merger agreement; and (iii) the reference to the parties' understanding in the press releases as an "agreement in principle" all indicated an intent not to be bound until the execution of the subsequent agreement. The court dismissed the first argument by showing that the press release as whole was phrased in "indicative terms, not in subjective or hypothetical ones".

The phrase "after the execution and delivery of this agreement" was found to "indicate the timing of various acts that were to occur, and not to impose an express precondition to the formation of a contract". The use of the term "agreement in principle" was also seen as a factual determination. The court observed that "the jury was the sole judge of the credibility of the witnesses and was entitled to accept or reject any testimony it wished...".

(b) Whether there was partial performance by one party that the party declaiming the contract accepted

Although admitting that "we find little relevant part performance in this

case", the court again deferred to the factual determination of the jury ("...partial performance, and on the other hand, conduct that is inconsistent with an intent to be bound, are again merely circumstances that the finder of fact could consider... The evidence on the parties' conduct was presented to the jury, which could either accept or reject the inferences the parties asked it to draw from these fact").

(c) Agreement on all essential terms

Texaco had alleged that there was no agreement on which party would buy the Museum's stock, on the existence and the extent of price protection for the Museum, on the payment of a first quarter dividend and the US $ 5 stub, on whether the definitive agreement would ensure that Pennzoil and the Getty Trust could avoid purchasing the remaining outstanding shares once they had control, and whether Getty's pension plans were to be honoured. The reaction of the court to these items was a repetition of the proposition that they were jury questions and that there was evidence of a finding that they were either not in dispute or insubstantial.

(d) The size and complexity of the transaction

The court dealt with this point in one short paragraph.

"We agree with Texaco that this fact tends to support its position that the transaction was such that a signed contract would ordinarily be expected before the parties would consider themselves bound. However, we cannot say, as a matter of law, that this factor alone is determinative of the question of the parties' intent".

This is the weakest part of the opinion as regards the contractual effect of the Memorandum of Agreement.

Usage and custom has acquired a particular weight in U.S. courts which

have stated consistently that the greater the complexity and importance of transactions, the more likely that informal communications are intended to be only preliminary, especially where the parties have expressed an intention to execute a definitive written agreement. In this respect it appears difficult to deny that the established custom is in the sense of consummating similar transactions through articulated written agreement.

Secondly, the Court asserted that Texaco knowingly interfered with such a binding agreement between Pennzoil and the Getty entities.

As to the amount of damages, the Court stated as follows:

"Though the compensatory damages are large, they are supported by the evidence, and were not the result of mere passion, prejudice, or improper motive. We have received many amicus curiae briefs suggesting that the verdict should be greatly reduced or overturned because of the adverse economic impact it would have, if allowed to stand, on certain states and industries, and on Texaco's many shareholders. Though we are mindful of the economic effect the judgement might have on some individuals and institutions, and we are sympathetic with those who might be affected by the verdict though no fault of their own, we are not authorized by law to substitute our judgement for that of the jury, and to make redress as we deem appropriate. Because we are of the opinion that the evidence supports the jury's award of compensatory damages, we do not consider a remittance of these damages appropriate".

However, the Court found that the punitive damages were excessive and that the trial court abused its discretion in not suggesting a remittance. It then affirmed the decision of the trial court, subject to Pennzoil's acceptance of a reduction of the punitive damages from US $ 3 billion to US $ 1 billion.

The opinion contains much more, of course, including decisions on Texaco's allegations of bias, mis-assignment of the trial judge and jury misconduct.[2)]

2) Just for your information, in April 1987, Texaco declared bankruptcy, and the case was ultimately settled for an amount in the region of US $ 3 billion.

The Pennzoil case is a very forceful example of the unpredictability of the factual approach to party intention in letter of intent cases. In even a casual reading of the Texas Court of Appeals decision, one is struck by the reliance of the court on the factual determination of the jury. Although other American courts have been willing to make determinations more on a legal basis, the Pennzoil case shows the vagueness and seemingly whimsical results of the common law approach.

The Pennzoil case demonstrates the inadequacy of the common law in its current state to deal with contracts in negotiation, and particularly with the conduct of parallel negotiations. It should not be forgotten that the conduct of Gordon Getty, Getty Oil and Texaco was not of a high ethical standard. The much maligned jury was placed in the unfortunate position of having to find a complete agreement in order to punish bad faith negotiations. In a civil law country, litigation on the facts of the Pennzoil case would have been pursued on a different set of legal theories. There would have been no need to have characterized the Memorandum of Agreement as a complete and final contract because Pennzoil could have sued in tort in France and Italy or in contract in Germany for fault during the negotiation process. The New York Attorney General's amicus curiae brief noted that "an agreement to agree or an oral contract for the sale of securities is only entitled to minimal protection from interference by competitors". In a civil law jurisdiction the protection would be more than minimal. The claim would have been for not negotiating in good faith, and the defendant may have been Getty Oil, not Texaco. In this respect a consideration of the facts in the Pennzoil case would be very different from the SME case, which I will discuss in a moment, in that the latter did not involve an allegation of bad faith in negotiation, but was a genuine dispute over the effect of a preliminary agreement. It is also interesting to speculate whether the Memorandum of Agreement in the Pennzoil case could have been a contract to negotiate under a more developed common law.

The case also shows the importance of drafting letters of intent. The preparers of the Memorandum of Agreement could have stated much more clearly that it was not intended to be a contract, and thus avoided the ensuing dispute. Of course a party conducting parallel negotiations would wish to do that, but Getty Oil was not in negotiation with Texaco until after the Memorandum of Agreement was signed. It seems that the wording of the Memorandum of Agreement was discussed in detail, and the Court of Appeals opinion makes it clear that the words "in principle" were inserted in the press release by Getty over the objections of Pennzoil.

## III. The SME Case

There are very few cases in civil law countries bearing on the issue of the legal effect of letters of intent. A recent Italian case, Buitoni S.p.A. v. Istituto per la Ricostruzione Industriale (the SME case)[3], however, adequately illustrates the problems which may be encountered in civil law countries when letters of intent are not properly drafted as well as the factors civil law courts consider in assessing the enforceability of letters of intent.

### 1. The facts of the case

On April 29, 1985 a document was signed between Mr. Romano Prodi, Chairman of Istituto per la Ricostruzione Industriale, a large Italian State owned holding ("IRI") and Carlo de Beneditti, Chairman of Buitoni S.p.A., a privately owned Italian food company. Mr. De Benedetti is a prominent

3) The decision of the Rome Tribunal is, Judgement of July 19, 1986, Trib. Rome, I Foro It. 2284 (1986); the decision of the Court of Appeals is, Judgement of March 9, 1987, I Foro It. 1260 (1987); the Judgement of the Corte di Cassazione is Judgement of July 11th, 1988, I Foro It. 2584 (1988).

Italian industrialist, better known as the Chairman of Olivetti. The document was not called an "agreement" or a "letter of intent", and simply began with the names of the parties, stating that between them "the following understandings have been reached". Commentators have subsequently referred to the document as "the SME letter of intent". Its main points were as follows:

First, Mr. De Benedetti declared his "availability to buy the shares of SME", another Italian food company owned by IRI.

Second, Mr. Prodi declared he was "of the opinion that it is advantageous for IRI to sell its share ownership in SME" at the conditions stated in the letter of intent.

Third, Mr. Prodi committed himself "to submit, before May 7th, 1985, the above mentioned acquisition to the Board of Directors of IRI", and to support it before the said Board. The document also contemplated that the Board approval should take place with respect to the acquisition "in its entirety as defined in the present document"; an express exclusion of the possibility of a partial Board approval which could lead to a renegotiation.

Forth, the transfer of the shares had to take place before May 10, 1985; the price and the payment terms were also clearly specified.

Finally, Mr. Prodi committed himself to "timely request from the Government Authorities the authorizations required by law".

In spite of its rather rudimentary nature, the letter of intent did not contemplate a subsequent definitive or final agreement. Clearly, it was not drafted by lawyers. Although the time of the sale of the shares, their price and related payment terms were specified in what could appear to be a complete form, the buyer only declared "his availability to proceed on the purchase" and the seller only expressed the "opinion that the transfer would be beneficial to IRI". Italian words indicating agreement, such as "obbligo" or "impegno" were not contained in the text of the letter of intent.

In any event the acquisition was described as being subject to two conditions: the approval of the Board of Directors of IRI and the obtaining

of the required governmental authorizations.

On May 9, 1985 the Chairman of IRI informed the Chairman of Buitoni that the Board of Directors of IRI had unanimously approved the transaction on May 7, 1985 and had empowered Mr. Prodi to take all steps necessary to implement it. Consequently, the first of the two above mentioned conditions was met. The Ministry responsible for the control of government-owned enterprises such as IRI (Ministero dele Partecipazioni Statali) did not approve the disposition of SME, however, and IRI refused to proceed with the acquisition, maintaining that the SME letter of intent was not legally obligatory. Buitoni sued IRI on July 19, 1985, before the appropriate court of first instance, Tribunal of Rome, for breach of contract on the theory that an already binding contract had been agreed by the parties.

## 2. The decision of the Tribunal of Rome

Buitoni requested the court of first instance, the Tribunal of Rome, to declare that a valid agreement concerning the sale of SME shares existed between IRI and Buitoni on the basis of the April 29, 1985 document. If it was not a definitive contract, Buitoni maintained that the SME letter of intent had to be at least construed as a preliminary contract ("contratto preliminare"), i.e., a binding commitment to enter into a subsequent final contract.

Buitoni's position was that the April 29, 1985 document contained all the material terms of the contemplated transaction. The approval of IRI's Board of Directors, which occurred on May 7th, 1985, ratified the signature of the IRI's Chairman, Mr. Prodi, who did not have the necessary powers to dispose of IRI's assets. Therefore, according to Buitoni, a valid final contract (or a preliminary contract) was entered into between the parties on May 7th, 1985.

Alternatively, Buitoni asked the Court to consider the April 29th, 1985 document as a valid offer from Buitoni, which was accepted by IRI on May 9th, 1985, when IRI's Chairman informed Buitoni of the approval of its Board of Directors. Buitoni argued that the requirement for the approval of the Ministero delle Partecipazioni Statali was immaterial since there was no legal requirement that such an approval be obtained. According to Buitoni, IRI's Board of Directors was fully empowered to dispose of its assets, while the Ministry's task was only that of providing general supervision and control to IRI's activity.

IRI's position was diametrically opposite. According to IRI, the April 29th, 1985 document was simply aimed at recording the basic points of a negotiation which wss still going on and the parties never intended to bind themselves legally with its signature. The IRI Board of Directors approval did not mean ratification of a binding contract, but the initial step of the internal formation of the will of IRI. Alternatively, IRI maintained that the express condition of the obtaining of governmental approval had not been satisfied. The Rome Tribunal rendered its decision in favour of IRI on July 19th, 1986, exactly one year after the date of the deed of summons - an exceptionally short time. The judges agreed with IRI's position regarding the April 29th, 1985 document and the surrounding facts. The Court expressed the opinion that the letter of intent, "though including almost all the material terms of the future contract, was not meant to specify the terms of a legally binding agreement, but simply to record the understandings reached by the Chairman of the two companies, upon the conclusion of the negotiations; they both knew, however, that the memorandum was not intended to perfect any contract, nor a proposal formulated by one of the parties to the other".

The Court reached its decision after having considered first of all the wording of the document. The parties themselves referred to the contents of the letter of intent as an "understanding" ("intese" in Italian), while at the same time carefully avoiding using a more committing terminology. The

Court was impressed by the circumstance that both parties appeared to know that the Chairman of IRI had no power to sign a dispositive contract. In fact, Mr. Prodi did not state in the document that he was acting in the name and on behalf of IRI, nor that he was committing IRI in any other way. He simply declared he was "of the opinion that it is advantageous for IRI to sell its share ownership in SME" at the conditions stated in the document. Mr. De Benedetti, on the other hand, did not express anything firmer that "its availability to buy the shares of SME".

Consequently, the April 29th, 1985 document was nothing more than "the formalisation of the intent to negotiate and the identification of the terms of negotiation, but certainly not the declaration of a will to conclude a contract, either preliminary or definitive".[4] The Court added that under Italian law only the Board of Directors of IRI, and not its Chairman, could have disposed of the assets of IRI. Consequently, Buitoni could not claim that it had a reliance interest to be protected, because ignorance of the law cannot be admitted. Nor was it possible to conceive the Board of Directors' subsequent approval as a ratification of what the IRI's Chairman had agreed to, because it appeared from the Minutes of the Board of Directors Meeting that it was aware that the Ministry could subsequently oppose the sale of SME.

Actually, the minutes of the IRI Board of Directors Meeting indicate that the Board gave the Chairman of IRI the power to adopt all terms and conditions necessary to implement the deal, to be identified and perfected by the Chairman himself, as well as to do whatever is necessary to implement the Board resolution. In this connection, the Court maintained that these "terms and conditions" were new ones and not those contained in the April 29th, 1985 document. This conclusion is not totally convincing.

Finally, the Court found that the April 29th, 1985 document could not be construed as an offer by Buitoni to acquire SME, which was subsequently

4) It should be recalled that a preliminary contract is a binding contract according to Italian law.

accepted by IRI through its Board of Directors' resolution. The Court based this conclusion on the fact that the document was bilateral and not a unilateral offer. Furthermore, the Court found that the wording of the Board of Directors' resolution could not be interpreted as the acceptance of an offer. Such a resolution was merely an internal act of IRI, without legal effect towards third parties. The resolution implied that the Chairman of IRI could proceed with the request of the necessary governmental approval, failing which the acquisition could not be consummated.

With regard to the governmental approval, the Court admitted that although it was not required by any specific legal provision, the requirement of the approval was implied in the powers of supervision and control that the Ministry had over IRI's activity, particularly considering the importance of the divestiture of such a large subsidiary as SME. It is curious to note that the Court stated that such powers of supervision and control had to be intended "in the English sense", which, according to the Court, meant that they were informal and advisory in nature.

In any case, the Court concluded, Buitoni knew and accepted the fact that IRI needed a governmental authorization in order to dispose of SME. Hence, IRI was not even liable for the failure of the negotiations.

## 3. The decision of the Court of Appeals of Rome

Buitoni appealed to the Court of Appeals of Rome against the decision of the Tribunal. The Court of Appeals, with a judgement dated March 9th, 1987, affirmed the judgement of the Tribunal, although on slightly different grounds. The higher court first clarified that IRI, though being a State owned entity, is subject to the general private law rules regarding the formation of contracts. The governmental control and supervision inherent to IRI's public nature have an internal relevance; i.e., they only affect the formation of the internal will of IRI.

The Court then applied the general principles of contract formation, on the basis of which, contrary to the findings of the Tribunal, it found that the April 29th, 1985 document was in fact an offer formulated by Buitoni. The Tribunal had stated that the bilateral nature of such document constituted an insurmountable obstacle to its being considered an offer. The higher court held that the April 29th, 1985 document had a dual nature; a unilateral offer from Buitoni and, at the same time, a bilateral pre-contractual instrument, containing the draft of a proposed future transaction.

Having affirmed the existence of a valid proposal, the Court of Appeals focused on the crucial question as to whether or not a binding contract was formed.

Regarding the purported acceptance of the offer, it should be recalled that under Article 1326 of the Italian Civil Code, a contract is formed when the acceptance by the offeree comes to the offeror's knowledge.[5)]

The Court of Appeals, in order to resolve the dispute, did not wish to

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5) The basic position as to the formation of a contract under Italian law is stated in Article 1326 of the Civil Code: "A contract is formed at the moment when he who made the offer has knowledge of the acceptance of the other party"(Michael H. Whincup, *Contract Law and Practice*, Kluwer Law International, 1996).

rely exclusively on the text of the April 29th, 1985 document, nor to concentrate on the issue as to whether it already contained the complete agreement of the parties on all the material elements of the transaction. The Court stated instead that it was necessary to investigate the real intention of the parties, i.e., whether or not they intended, by signing the April 29th, 1985 letter of intent, to bind themselves or to condition such binding effect to a subsequent declaration of will.

Of pivotal importance in answering this question was, according to the Court of Appeals, the fact that the Chairman of IRI agreed to submit th April 29th, 1985 document to both Board and governmental approvals. Such a commitment, in the light of the subsequent behaviour of the parties, led the Court to conclude that the parties were of the intention to postpone contract execution to a moment when such authorizations had been obtained. In other words the Court found that Mr. Prodi did not wish to bind IRI by signing the April 29th, 1985 document, but simply, in the presence of Buitoni's proposal, to set the scheme of a future contract to be submitted to Board of Directors and government prior approval.

The fact that the process of contract formation was not concluded with the April 29th, 1985 document, and that, therefore, the parties still retained their freedom to contract, was confirmed -in the eyes of the Court of Appeals- by the behaviour of the parties themselves. The Court was impressed by the fact that the May 9th, 1985 letter from the Chairman of IRI to Buitoni, announcing the Board approval, made express reference to the need for a subsequent governmental approval and that, in the light of that requirement, the parties agreed to postpone by a few weeks the date they had originally established for contract execution.

As to the requirement of the governmental approval, the Court made investigation at to its real nature. It concluded that such approval was an essential step in the process of formation of the will of IRI. Though if the end result would not have changed, probably the Court should have more simply qualified such an approval as a legal condition to which the

agreement between the two parties was subject.

The Italian Court of Cassation affirmed the Court of Appeals on July 11th, 1988.

I wonder how the SME case might have been decided by a U.S. court. The SME letter of intent certainly seems to be as complete as that in Pennzoil case. The approach of the court in attempting to determine the real intention of the parties is interesting, and the focusing of the court on the effect of the subsequent approvals to determine the subjective intent of the parties may not have occurred in a U.S. court. In this respect, the SME decision supports that U.S. courts pay more attention to the true intention of the parties and less to such objective manifestations as the language of a letter of intent, partial performance and the like.

# Ⅳ. Conclusion

The Pennzoil case and the SME case illustrate the difficulties which originate from inadequate drafting of letters of intent. In both cases the judges had to face the crucial question as to whether or not a given letter of intent had a binding nature; they had in other words to decide whether the wills expressed in such letters still belonged to the pre-contractual stage, or whether their incorporation into a pre-contractual document meant that negotiations were over and binding obligations had already arisen for the parties.

The judges gave opposite answers to such a question in the two cases. In the Pennzoil case they stated that a valid contract had been formed, while in the SME case they took a contrary attitude. In both cases the economic consequences for the losers were enormous.

As reviewed before, some problems may occur when a party has documented a stage in the negotiations by memorandum of agreement, heads of agreement or letters of intent. Such documents may well explicitly spell out if, and to what extent, the parties should be bound by what they have already agreed or to carry on negotiations in order to reach the final contract. But if the documents are silent, some problems would arise. Contracting parties are therefore well advised to spell out if, and to what extent, they should be bound by such preliminary agreements. Here again, it might be prudent to explicitly set forth that the parties should not be bound until there is a final written contract signed by authorized representatives of the parties[6] but that they shall abstain from such measures which may defeat their stated objective to reach final agreement, e.g. by diminishing the value of performance under the contemplated contract.

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6) Jan Ramberg, *International Commercial Transactions*, Kluwer Law International, 2000, p. 29.

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Pennzoil, Inc. v. Texaco, Inc. (the Pennzoil case)

## ABSTRACT

Case Study on the Legal Effects of Letters of Intent

Choi, Myung Kook

The Pennzoil case and the SME case illustrate the difficulties which originate from inadequate drafting of letters of intent. In both cases the judges had to face the crucial question as to whether or not a given letter of intent had a binding nature; they had in other words to decide whether the wills expressed in such letters still belonged to the pre-contractual stage, or whether their incorporation into a pre-contractual document meant that negotiations were over and binding obligations had already arisen for the parties. In other words, some problems may occur when a party has documented a stage in the negotiations by letters of intent. The letters may well explicitly spell out if, and to what extent, the parties should be bound by what they have already agreed or to carry on negotiations in order to reach the final contract. But if the letters are silent, some problems would arise. Contracting parties are, therefore, well advised to spell out if, and to what extent, they should be bound by such preliminary agreements. Here again, it might be prudent to explicitly set forth that the parties should not be bound until there is a final written contract signed by authorized representatives of the parties but that they shall abstain from such measures which may defeat their stated objective to reach final agreement, e.g. by diminishing the value of performance under the contemplated contract.


Key words : letter of intent, pre-contractual liability