Chapter 2

Letters of Intent

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Sumario:

1. DEFINITION

A letter of intent[1)] is a unilateral or bilateral document whereby one or both parties to a negotiation:

i) State their commitment/intent/desire/offer to start or continue a negotiation process in order to reach a definitive purchase agreement.

ii) Document any established arrangements as the basis for the future negotiation.

iii) Define the key issues to be addressed in order to reach a satisfactory agreement and, if applicable, indicate a preliminary purchase price for the shares or assets.

iv) Establish a set of temporarily binding rules to structure the future negotiation process.

While points (i) and (iii) are typically found in every letter of intent, it is advisable to include content related to point (iv)

when parties anticipate lengthy and complex negotiations in order to mitigate the risk of not reaching a final agreement. Point (ii) is only occasionally included, either because of its intrinsic ambiguity (which should be avoided by both parties' attorneys), or because it implies negotiation that is already well advanced.

This document may sometimes be presented as an «offer» which is subject to certain future conditions (including reaching a satisfactory agreement). In other cases, a letter of intent may be written in a «letter format», which leaves no doubt as to the nature of its provisions by making it clear that *it is aimed at defining certain binding and non-binding commitments and agreements* .

2. DEFINITION OF THE SUBJECT

There are two limitations to the subject of this chapter.

Firstly, we will only examine letters of intent subject to Spanish law. Given that there are no substantive different cross-border rules of law on this issue, our study will focus exclusively on letters of intent under Spanish jurisdiction. Indeed, analysing letters of intent under other specific substantive rules of law is pointless. The difference in terms of effectiveness lies in the interpretation given by the various jurisdictions, instead of any substantive rule of law, which usually does not exist.

Secondly, the chapter will only focus on letters of intent as used in the negotiation of company acquisitions. Although our case law analysis at the end of the chapter will consider a wider scope of events, we will not consider comfort letters or letters issued for guarantee purposes in contexts other than those defined here[2)].

3. THE PROCESS OF ISSUING LETTERS OF INTENT

3.1. OFFER AND ACCEPTANCE

The letter of intent is broadly speaking a supporting document that includes a number of statements involving various commitments by which one of the parties notifies the other of its intent to start and successfully conclude a negotiation. However, we can only define the terms of a letter of intent roughly because there is no standard content or wording. Unlike comfort letters, letters of intent do not include statements made only by one party but statements or «commitments» that both parties must accept, and which may also be binding. Thus, the «bidder», «buyer» or «writer» (as often distinguished in Spanish) not only states an intent or notifies the other party a specific purpose, but also defines the general terms to be agreed upon by both parties.

Thus, the letter is usually signed by both parties to the negotiation.

As noted above, the content of a letter of intent is not regulated in any specific or exclusive way; it varies on a case-by-case basis. Nor is there a single objective or purpose[3)]. Thus, it would be irrational to expect that a letter of intent «may not include» certain statements given that it is a supporting document that may set out any type of commitment. In fact, some letters of intent define the purchase price as a binding clause, without the possibility of further discussion. This is possible because letters may perform the function of a contractual agreement when, for instance, definitive terms cannot be fully agreed by the parties before a specific deadline. In other words, the parties will commit to those terms previously agreed (which may be the most important part of the negotiation) and agree or bind themselves to continue negotiating.

Now, let us analyse non-binding provisions. When the parties sign a letter of intent, their non-binding statements do not become agreements or contractual obligations. In essence, the definitive objective of the future agreement may still be uncertain at the time the letter of intent is signed or because such statements may already be included in a non-binding clause (accepted by the parties), as will be explained later in this chapter. Whatever the case, it is advisable not to add any phrase containing non-binding commitments before the word «offer». Doing so may lead to unnecessary or unintended misunderstandings at a later date as to what the offer involves.

If the writer sets out provisions that could be interpreted as binding commitments, but his «offer» is not accepted because he has not requested that the other party sign the letter and send it back to him, he is not legally bound to comply with such unilateral statements. However, acceptance may be implied even if the letter has not been signed. If the writer has requested the other party's signature as the only means to evidence acceptance, a letter of intent may still be found to have been tacitly accepted if the negotiation process starts pursuant to the terms defined by the writer and the other party's conduct confirms compliance.

3.2. LETTER-STYLE AND MEMORANDUM OF UNDERSTANDING

As mentioned above, a letter of intent may be written as a bilateral letter-style document or as a bilateral pre-contractual document of a more impersonal style called «Memorandum of Understanding». In the first case, one party drafts the

relevant content in a letter format and requires the other party to show acceptance by signing the document[4]. The format maintains the style of a letter in both the opening and closing greetings (e.g. *«Dear Sirs»* and *«Yours faithfully»* in English, and *«Estimados Srs.»* and *«Atentamente»* in Spanish). The wording in the second case is of a more objective style as in other pre-contractual documents.

Not only does a letter format allow the writer to express themselves in a more subjective way, but also allows them to highlight that they are not entering into any firm commitment. This style allows the inclusion of expressions such as: *«I am pleased to present the following offer to you (...), under the following conditions»; «We are pleased to share the following information with you (...) with the sole purpose that you be able to consider a possible purchase»; «It is our intention to welcome X as a partner»* or *«We understand that the merger of our businesses may strengthen (...)»* , etc.

There are slight differences in the way that information is conveyed between the two formats. In the first case (the letter-style) the party receiving the document does not contribute to the drafting of the document and the content is written entirely by the other party. Therefore, it is an «adhesion-type» document given that insofar as it can incorporate contractual commitments, it follows the legal form of an adhesion contract. Although there are no predefined clauses for many equivalent contracts, it is possible to state that without doubt a letter of intent written in a letter-style is an adhesion contract. In addition, if the terms meet the *general conditions of a contract* as set out in Article 1 of the Standard Terms and Conditions Act [*Ley de Condiciones Generales de la Contratación*], this law will apply. A Memorandum of Understanding drafted bilaterally may also be deemed to be an adhesion contract that includes the standard terms of a contract. However, the burden of proof lies with the party that wants to have it considered as such. Conversely, the letter-style document, by its nature, is written by one of the parties and the burden of proof lies with the writer if they want to claim that despite its unilateral form, the content of the letter was drafted by mutual agreement.

Nevertheless, as neither of the parties is considered to be a consumer, the differences analysed above are not particularly relevant in terms of who «controls» the content of the letter of intent and its consideration as an «adhesion contract» will not lead to any specific consequences. The remaining provisions of the Standard Terms and Conditions Act are applied as usual (for example, the requirements to include terms and conditions; as defined in Articles 5 and 7), regardless of how meaningless it may seem to apply this law (for example, the Spanish Registry of Standard Terms and Conditions).

Certainly, there is nothing to suggest that the negotiation process may not start before the letter of intent is drafted and signed. Such a document is not spontaneous, but the result of negotiation between the parties. However, there is nothing to prevent a purely *unilateral letter of intent* at the beginning of the negotiation process whereby one of the parties notifies the other of their intentions. However, negotiations do not usually start this way; they are usually more informal and casual.

3.3. AVOIDING COMMITMENT

Except in certain cases imposing binding obligations, a letter of intent is usually considered to be non-binding. Typically, the parties do not want to bind themselves with regard to any future negotiation; especially to avoid any claims that might be raised by one party if the other backs out of the negotiation process. Therefore, none of the parties may allege that the other has broken a binding commitment or betrayed a legitimate and protected expectation.

We will examine this more fully later. For now it is sufficient to explore five strategies used by the parties to define non-binding commitments in letters of intent.

1. Replacing assertions to perform future actions with clauses that set out the mere intent or optional action of the party. This strategy prevents one party from expecting that the other party will treat any intention expressed as a binding obligation.

2. The deliberate choice not to define the subject matter of future commitments entirely, so that any claim seeking compliance with the contract will fail (see Article 1273 of the Civil Code).

3. The express positioning of a series of events as conditions subsequent to the agreement or commitment.

4. The acknowledgment of one or both parties of the broad right to withdraw at its discretion.

5. A binding clause establishing that all or some of the remaining statements are non-binding.

These strategies are not often used individually. Typically, a letter of intent incorporates a mixed combination of strategies, each of them aimed at a specific purpose. It is worth noting that the «customary» content of letters of intent has been developed and refined over the years. This evolution in the US legal system has been in response to successive case law decisions and the subtleties used to differ binding and non-binding statements. However, Spanish practice has not yet developed such a wealth of experience, as we will analyse later.

3.4. THE LETTER OF INTENT AS AN OBLIGATORY STEP

Sometimes, letters of intent are written as a result of a prior commitment with a third party. Among the clauses of a

company acquisition agreement, a statement is often included to set out the commitment of one of the parties to issue a letter of intent with a third party for the purpose of expressing their intention to enter into a specific agreement with them. For example, a letter of intent may state that the third party (i.e. the recipient of the letter) agrees to a non-binding commitment that they will negotiate a long-term distribution agreement with the writer, or that they will make technology available to them under reasonable terms.

If a letter of intent is required under an agreement previously entered into with another party, it does not mean that the writer is bound to the party receiving the letter. Nor does it mean that, as against the prior promise, the writer and the recipient are obliged at any cost to conclude the negotiation. The letter of intent serves the purpose of communication or diligence as required by the negotiation in question. The writer agrees to apply their best efforts in the negotiation process to achieve a successful outcome. There is no standard or rule that may be used to define the required «diligence» procedure, as it is not related to complying with any obligation. Instead, the signing of the agreement, even under these conditions, is subject to the «principle of autonomy» and the free assessment of potential benefit. In reality, the third party may only request that the first party proceed in the negotiation with the second party in such a way that the rejection of any «reasonable» offer would be considered as bad faith. Not for this reason, the corresponding clause is ineffective, since without it, there would be no right to insist that counterparties deal in good faith in contracts with third parties.

4. THE FUNCTIONS OF A LETTER OF INTENT

Why is a letter of intent drafted, signed or «accepted»? Why is it necessary in a negotiation if the parties may deem it non-binding or it is superseded by a future agreement because final terms are not necessarily defined in advance? Regardless of its minimum content, it serves a significant function in the negotiation process. It reduces the risks of open negotiations which do not involve commitments and the parties agree to certain rules relating to a specific course of conduct in the future[5)].

4.1. FAULT IN THE CONCLUSION OF A CONTRACT

If the parties have entered into preliminary agreements or agreed to an open negotiation process, liability for breach of these agreements should be analysed under the light of the case law examined in section 8 below, even though it may be ambiguous and often applied with certain restrictions.

However, if the parties have agreed to a letter of intent, the obligation to negotiate in good faith does not relate only to a specific course of action as it may also define the terms of a written contract. It may be reasonable to think that under Spanish Law, good faith is required both during and after the negotiation stage, whether the obligation may be implied or expressed in the agreement or commitment between the parties. No differences should arise in terms of liability, but in relation to the burden of proof; i.e. the party not in default would need to demonstrate there was such a negotiation underway. Thus, a written agreement would leave no doubt whether the obligation existed previously or the parties did not intend to restrict the open negotiation process.

No doubts would arise if the seller were required to provide the potential buyer with certain information. However, the principle of acting in good faith as set out in Article 7 of the Civil Code may be too broad to oblige one of the parties to provide the other with specific information relating to the subject matter of the negotiation and potential acquisition, unless undisclosed information hides material defects. External circumstances affecting the price of the target company are not hidden defects, provided they do not reduce the acceptable standard or quality of the target company.

4.2. ANTICIPATING AGREEMENTS WITH SPECIFIC CONSENT

A letter of intent is essential if a number of complex consents have to be granted successively, but which may not be guaranteed by the negotiation process itself. It is not possible to enter into a pre-contractual agreement with future binding effects, nor is it feasible to «collect and integrate» successive consents into a document whereby signatories bind themselves on a progressive basis, even though subsequent consents may not be granted. The *initial kick-off* starts with the first signature on the letter of intent which opens up the field for subsequent consents and clearances (e.g. the Boards of Directors, the General Shareholders' Meeting, Public Administration, Competition Authorities, etc.). It is worth noting, though, that the parties do not intend to create binding effects only on those who sign the letter. Early signature evidences that the process is being carried out in due terms to incur costs reasonably and to get the necessary consents or clearances.

Company law regulates the rights of the members of the Board of Directors to prevent them from binding the company or themselves under an agreement against the interests of the company to which they owe a fiduciary duty. Thus, a best efforts clause is often included and helps to define the efforts required to fulfil their obligations.

4.3. NO DEFINITE TERMS EARLY IN THE NEGOTIATION PROCESS

The definitive elements of a sale and purchase agreement may only be defined by the negotiation process. It would have no

effect to anticipate a binding commitment if the essential terms of the agreement were still open, pursuant to Article 1273 of the Civil Code. Neither would it be reasonable to agree to a binding pre-contractual agreement, since the undefined subject matter makes the document unenforceable. It would not be possible to anticipate a «formal or effective» agreement under the condition that the parties execute it or bind themselves in the future. The parties, or at least the signatory, may not bind themselves to a greater degree than what is specified in the letter, e.g. «We intend to reach a shareholder agreement with X», or «The parties mutually agree that the joining of their businesses shall allow them to (...)», or «We fully agree to take every step necessary with the purpose of entering into a definitive and binding agreement in the near future». At this negotiation stage, certain terms are not possible to define, such as the party's ownership in the future company, the share capital percentage in the future acquisition, the final price, etc.

Although it is not possible to reach any kind of pre-contractual agreement at this stage of the negotiation process, it is still advisable to sign and agree a letter of intent. In addition to the main function discussed below, a letter of intent is an essential element in the negotiation process. It serves the function of a written «commitment» that provides the directors of the purchasing company with reasonable grounds to incur costs relating to the acquisition process. Otherwise, there would not be any written document stating that the other party agrees to start negotiations. Additionally, without a letter of intent, the directors of the selling or target company would not find it reasonable to provide the future purchaser with accounting and commercial documents or sensitive information that may potentially be used against them.

4.4. THE NEED TO AGREE ON THE NON-BINDING NATURE

Although it may seem paradoxical, if a negotiation process starts without a letter of intent, the parties may be exposed to greater risks of liability than those desired. A letter of intent helps to reduce these risks as the parties state that *these risks may not give rise to any binding obligation* . Otherwise, the parties may find it difficult to determine if their actions at the negotiation stage bind them further. The duty to negotiate in good faith under the broad principle mentioned above and the different criteria followed by the various legal systems do not help to determine if a certain conduct is a tacit agreement or binding conduct that may not be reversed by later conduct. Thus, the parties are uncertain about the degree to which they may be held liable. The only solution to clear up uncertainties is a written agreement given that the actions of the parties may not help to interpret the nature of their obligations properly.

Having said that, one of the most important functions of a letter of intent is to classify or «define» the actions of the parties. Given that their consent turns the letter into an effective document, they mutually agree that the terms of the letter, subsequent representations or facts during negotiation may not be interpreted as contractual obligations before they sign the final written agreement. Accordingly, this interpretation should not be based on the actions, but by the legal relationship already defined by the parties. Indeed, given that words and actions of one of the parties may be interpreted by the other as agreements or binding obligations, they mutually agree on the interpretation they intend to give. Only by means of an explicit agreement is it possible to put an end to the typical uncertainty surrounding the facts.

However, it is important to note that this classification remains effective provided a subsequent agreement does not revoke the terms already agreed. A subsequent action may be deemed an agreement and revoke the earlier terms. Nevertheless, the party raising the claim bears the burden of proof. Evidence should demonstrate they have understood that statements or actions prior to or following the letter of intent were actually binding. Thus, the party should demonstrate they could have reasonably understood (and have actually understood) that the subsequent action of the other party «revoked» the prior non-binding agreement, or that such express agreement was not their true intent.

4.5. RESTRICTIONS ON THE FREEDOM TO NEGOTIATE

Certain rules should be defined if the parties to the negotiation provide and put at risk significant resources and information. Both parties seek to reduce their own costs and risks and prevent the other from using strategies to take unfair advantage of the negotiation. On the one hand, the seller provides the buyer with sensitive information which is intended to be secured and used only in a certain way and to prevent its unlawful use in the future or unauthorised access by third parties that may damage their interests. On the other hand, the buyer incurs costs which certainly increase the book value of the selling or target company's shares and does not intend the seller to take advantage of this benefit and seek competitive offers as if the negotiation process were an auction.

Although not required, it is wise to include provisions to govern certain procedures. For instance, it is advisable to define the intention of the seller relating to the confidential information disclosed and the intention of the buyer of a temporary guarantee of exclusivity. Such written statements may be helpful especially in complex and significant operations where parties may resort to different strategies for their own benefit.

However, there are also other binding obligations or commitments in addition to those which anticipate the risks of a third party accessing confidential information or the possibility of the approach being a bad faith stratagem. It is therefore essential to set out the mere existence of the negotiation process itself. Thus, if the seller does not agree in a letter of intent to provide certain information to the buyer and to notify them of certain events, negotiation may be impossible.

4.6. SEARCH FOR FINANCING

Many financial sponsors are not willing to engage in acquisitions, probably stating so in a separate letter of intent, if the parties do not sign a document that sets out the main lines of the purchase operation.

4.7. RISKS OF A LETTER OF INTENT

The advantages of a letter of intent for one of the parties may be a risk for the other. For example, if one or both parties to the negotiation intend to safeguard their freedom of action in the future, the letter of intent may entail a risk which cannot be eliminated. In other words, regardless of the effort placed in «polishing» a letter of intent to such end, non-binding provisions may be deemed binding later on. Thus, letters of intent may help the Courts determine whether *there is an intent which exceeds that of mere negotiation* . Regardless of explicit agreements, written terms do not prevail over conclusive actions of the parties either before or after the letter of intent is signed. Therefore, the parties may resort to a specific action which may imply a wider negotiating nature in order to «revoke» prior non-binding written agreements. *Such a possibility (and risk) may not be annulled by an agreement* .

Accordingly, lawyers discourage the use of letters of intent if the negotiation process is not complex and may be concluded within a reasonable time. If so, the parties should sign the agreement when consensus is reached even if conditions precedent are included.

5. STRUCTURE OF A LETTER OF INTENT

5.1. DEFINING THE SUBJECT MATTER OF THE AGREEMENT

Letters of intent should outline the subject matter of the negotiation and the terms on which the offeror believes the agreement should be based. At least, the other party should know which terms require the parties' agreement. As such, letters are written prior to any sale and purchase agreement and may be documented and drafted in various ways.

They may include a formula to calculate the purchase price of the shares or assets. Typically, they may specify that if the resulting price is lower or higher than a certain amount, the operation will not be performed. However, the formula is often not binding and typically included in a non-binding clause, and the resulting price is not a condition precedent to the agreement. Actually, the parties are free to negotiate and reach an agreement whether the condition is met or not, even if the remaining terms have already been agreed. As can be seen, the agreement does not come into effect because a condition is met. In other words, the buyer may ultimately not grant final consent even though all of the ancillary terms and conditions have been agreed and the price is fixed within the estimated range.

Certainly, the expression *«on condition of»* is meant to avoid the recipient from having a «legitimate expectation» from the offeror, as the latter may exercise the freedom to withdraw from the process at any time, even after the recipient has incurred significant costs or the parties have agreed to certain terms which may not be possible to reverse; e.g. disclosing specific information to the buyer.

Although unusual, a sample text of the future agreement may be attached as an exhibit to serve as a model without binding the parties to the negotiation. The offeror, however, should clearly state that such offer is not submitted on condition of the other party's acceptance or, more likely, is not intended to be used by the other to interpret future terms or incorporate missing terms into the future agreement. To all intents and purposes, care should be taken as this practice may often lead to legal misunderstandings as the parties and even their lawyers may interpret sample texts mistakenly. A practical example of undesirable risks of this kind is seen when parties sign or otherwise accept such exhibits. Thus, to avoid common misinterpretations (i.e. considering the exhibit a binding agreement), the parties should state explicitly that the exhibit is exclusively signed only to agree to the *statements* made; i.e. that *such document is being negotiated and sets the basis for further negotiation in good faith* , without any binding nature whatsoever.

Typically, letters of intent should outline the subject matter of the negotiation and the terms to consider in the agreement.

The offeror often states that the agreement should include typical clauses and provisions setting out possible remedies.

Actually, such statements are significant even if they are part of non-binding clauses. The offeror expressly agrees to the «customary interpretation» as set out in Article 1287 of the Civil Code. Additionally, if the negotiation is broken off by the offeror, the other party may always resort to the list drafted by the former and allege nothing has been done to continue the negotiation in due terms in order to reach agreements. Defining the subject matter of the future agreement is also relevant from the point of view of the offeror. When the offeror states which circumstances are required to reach an agreement, it becomes clear that partial agreements have no legal effect. In other words, the subject matter of the negotiation is an indivisible unity; if the entire agreement is not reached, the other party may not claim the agreed terms are enforceable as partial arrangements. It is also important to note that the rule «what is useful is not vitiated by the useless» [*utile per inutile non vitiatur*] may lead to effects not intended by the parties, but especially by the buyer. Thus, it is essential to set out in

advance what terms are required to reach an effective agreement.

Letters of intent do not usually include Representations and Warranties made by the future seller on the features or lack of liabilities of the company or shares. In contrast, they usually set out that any such statement does not imply any guarantee on behalf of the seller. In addition to legal reasons, it would not be usual and beneficial for the seller to show any exaggerated intent to sell at such an early stage of the negotiation[6]. Indeed, the buyer would perform the due diligence and discover any liabilities, which would impact on the price. In summary, the Representations and Warranties by the seller would not avoid this.

5.2. THE COSTS OF FAILED NEGOTIATIONS

Each of the parties incurs its own «investment costs» right from the onset of the negotiation. This is highly sensitive from a legal point of view, but becomes even more delicate if the negotiation fails. If the party «invited» to the negotiation has reasonable grounds to believe the other has actively caused the negotiation to fail, reimbursement of the costs incurred may be claimed in three ways.

Our first analysis considers that the offer made to start negotiations is the object of a power-of-attorney or an agent contract whereby the recipient of the offer has acted in the interests of the offeror. In accordance with Articles 1729 and 1893 of the Civil Code the attorney-in-fact or business agent may claim compensation for expenses and costs incurred in executing the power, although such a claim would almost certainly fail given that each party acts on their own behalf and runs their own risks. The party may not allege to have pursued a foreign interest given that successful negotiations give rise to advantages for both —even though each party intends to optimise their own benefit rather than favouring the assets of the other—. I believe this also applies even if the party invited to the negotiation has been required to incur preliminary costs to continue negotiating (e.g. to insure assets, audit accounts, etc.). Without doubt, the party acts on its behalf and runs its own risks. Even if the attorney has agreed to make such preliminary investments, subsequent failure to comply with the power does not turn the party into an attorney in default of the principal. The underlying issue is merely that the condition has not been met; it does not mean that the recipient has failed to fulfil an obligation to do a certain thing. There would be no point for the offeror to believe that the other party has agreed to such terms with no direct consideration, and there would be no benefit in the recipient agreeing to such terms. In fact, the principal did not have a separate interest in the fulfilment of the power of attorney. Neither would any benefit be obtained from a course of conduct whose effects have been impaired because the negotiation has failed.

This analysis does not mean that a letter of intent should not include a power of attorney or an agent contract. These documents may even be presumed if the action assigned to the recipient of the letter is from outside the company and benefits the interests of the sender directly[7]. The best criterion to define compensation for reliance loss depends on determining which party has the greater bargaining power after the event [*ex post facto*]. If the offeror, the action should be deemed binding; if the recipient, it is advisable to determine who has made the offer before considering any possibility of compensation[8].

Secondly, the recipient of the letter may seek to recover costs by basing the claim on unjust enrichment. In such circumstances, the party should demonstrate the asset devaluation is the direct cause of the enrichment or advantage to the offeror, that such enrichment is not supported by any justification and that the advantage has not been caused by the recipient intentionally; i.e. free from errors. Certainly, these events are not reasons attributable to the cases analysed here. Accordingly, no undue advantage has been imposed by contract, the recipient has not increased the value of other's asset and the offeror has not acquired assets on its own which are due to the recipient. Without doubt, there has been an «advantage» on behalf of the offeror: the advantage that a negotiation which was not interesting ultimately failed, mainly as a consequence of disclosure costs incurred by the recipient upon the initiative of the former whereby certain information on the business was disclosed which supported the withdrawal from the negotiation. However, this advantage and risk is inherent to any negotiation. Costs have been incurred under this scenario, so the recipient of the letter may not allege that the offeror has been given an unjustified advantage. The recipient could have avoided these expenses, so their loss of value is not by mistake

In addition, this rule should be restricted. It is true that the advantage to one party is the risk to the other. However, the asset may be recovered under the principle of «an action for recovery if the purpose for the transfer has failed» [*condictio causa data causa non secuta*] provided that the event is not considered a condition that was satisfied, but *the start of due performance* . In other words, upon both events both when there is already a contract, even if the parties define it otherwise —or when a party's fulfilment of the obligations before the remaining contract is fully defined, a failed course of conduct leads to enrichment, provided that the asset in question has been delivered by the other party, and even though the former may have lost, used or consumed it—.

Finally, the third means to recover costs is via pre-contractual liability. Here, the recipient may allege that the offeror has acted against the requirement of good faith, or that in general the latter has not sought to fulfil its duty to minimise the costs of the other. The burden of proof is to demonstrate the effective damage and unlawfulness of the actions of the offeror who has failed to fulfil certain procedural rules. We will analyse this case below. So far, let us consider there is risk for the buyer under this abstract concept which may provide the recipient with a way to claim for compensation. Certainly, consideration

for this claim is greater when the course of conduct attributable to a party is not only the action of withdrawing from the negotiation, but making false or fraudulent representations.

5.3. CLAUSE ON RISK ALLOCATION AND FAILED COSTS

The above analysis shows how important it is to define each party's rights relating to the costs incurred by the other in the event that the negotiation fails. The most efficient way to resolve any dispute is common sense. Accordingly, each party assumes its own risks and costs, and may not transfer liability to the other if negotiation fails. Each party assesses the relevance of the negotiation, determines the costs they are willing to assume and does not hold third parties liable for any such expenses.

This binding clause is key to defining the negotiation scenario in due terms and is not included in the non-binding clause below. It is not a promise given that none of the parties agrees to fulfil an obligation towards the other. Similarly to other binding clauses, it serves a «qualifying» function; it helps to define the conduct of the parties by excluding terms that may allow the counterparty to claim liability.

However, it is important to note that the binding nature of this type of qualifying clauses does not prevail over the duty of good faith. Thus, this rule may support compensation claims in spite of the distribution of costs clause. The effective conduct or the silence of one of the parties gives rise to damage to the other. In other terms, the waiver in the indemnity clause relating to failed costs is not equivalent to a liability waiver clause for fault in conclusion of a contract[9].

5.4. NON-BINDING CLAUSE

The most distinctive element of a letter of intent is a statement by the offeror that the intentions are non-binding obligations for any of the parties. The recipient then agrees to the statement by signing and returning the letter to the offeror. Spanish case law has found such intention in the following provision: *«We acknowledge and agree that the shareholders of the Company reserve the right to reject any proposal and to change or end negotiations with us at any given time without having to justify any reasons* [10]». Indeed, non-binding intentions may be effective even if the letter does not include such statements. However, they would be difficult to prove as commitments would have to be interpreted in context; especially, by focusing on terms which have not been sufficiently defined in the letter. Some practical examples could be stating that the estimated term to conclude the negotiation is only approximate or intended; the exclusion of certain obligations in statements (such as the expression *«without committing to»* , etc.); or the definition of the subject matter of the agreement as an intention or belief, to name a few. It is of the utmost importance to apply sound criteria in interpreting statements when the letter does not include a non-binding clause.

In essence, the non-binding clause has relevant legal consequences. Although it does not create any obligation to give, to do, or to refrain from doing something, its legal value lies in defining or classifying the nature the provisions in the letter. Thus, a non-binding clause states expressly that all or some statements in the letter of intent —as the case may be— do not create any enforceable obligations. As can be seen, it entails «a negative connotation», as *there is no obligation of non-enforceability* which the party in question *may not fail to fulfil* .

The non-binding clause serves one purpose. It helps to interpret the intention of the parties as it defines the scope of the statements or promises made before or at the time the letter is drafted and does not enforce any specific obligation, as stated above. Accordingly, a party may allege that, in spite of such a clause, both have agreed that some provisions in the letter would indeed be binding by claiming that the non-binding clause does not represent their true intent. This event is supported by the rule that a false or mistaken description does not vitiate a document [*falsa demonstratio non nocet*], so the actual intention of the parties prevails. Likewise, the party may demonstrate that the *most direct interpretation* of the statements in the letter is not conclusive given that the obligation to act in good faith under Article 1258 of the Civil Code, or the subsequent actions of the parties pursuant to Article 1282 of the Civil Code may lead to a second view that prevails. Under such circumstances, the party would bear the burden of proof and may also support the claim on two other articles of the Spanish Civil Code: (a) words will be construed against the person who put them forward [*contra proferentem*] under Article 1288 of the Civil Code; and (b) the balance of duties and interests in accordance with Article 1289 of the Civil Code.

On the other hand, the non-binding clause does not have any effect over future events as it may not define the scope for future acts, statements or promises. Technically, it is not possible to assume that a clause may restrict the effect of statements to be provided in the future. The party claiming enforceability will need to evidence that both parties have implicitly agreed to the binding legal effects of the new statements by supporting the claim on a specific ruling or sound criteria. Thus, the party should not seek to eliminate the assumption of the non-binding nature, but prove that the proper interpretation is the binding effect intended by the parties. This evidence will automatically lead to the conclusion that the parties have implicitly agreed to bind themselves (rather than trying to eliminate the effect of a prior non-binding clause by a subsequent act).

Having said that, it is clear that such a clause is admissible under Spanish law as a standard criterion to express the true intention of the parties. However, it does not prevent the parties from evidencing other criteria to interpret statements. The

parties may base their claim on other resources; e.g. Articles 1281 to 1287 of the Spanish Civil Code help to interpret the true and mutual intention of the parties, Articles 1288 and 1289 of the Civil Code help to guide the interpretation criteria in ambiguous statements, and the requirement to act in good faith. However, if one of the parties performs or starts performing an obligation under the non-binding clause it does not mean that both have agreed to change or withdraw such clause. In this case, if the other party fails to perform the obligation because it is non-binding, and the party in compliance may claim compensation accordingly as there is no legitimate cause of action[11].

In summary, a binding clause doesn't have a regulatory effect but it contributes to the interpretation of the statements in the letter. It does not define the nature of future commitments or actions. Nor does it *assign* any specific unconditional attributes of nature to past or present statements or actions, as their effect may be neutralized by other criteria when interpreting the intention of the parties. Seeking a greater effect is as unfeasible as trying to defy gravity.

A non-binding clause should not be confused with a clause not entitling the parties to bring an action to court to enforce contractual obligations (see *Klageausschluss* vs. *Anspruchausschluss* , pursuant to the German law system). Under such circumstances, the parties may agree that an effective and entirely defined contract in terms of its essential elements gives rise to obligations which may not be enforceable in court. Therefore, such obligations would be binding, compliance would be due, payment made by one of the parties would not be reimbursed, a penalty clause and bond would have to be agreed, compensation would apply, etc[12].. However, such an agreement would not be acceptable under Spanish law, unless the parties have agreed on an alternative dispute resolution procedure which final resolution would be binding on the parties. Not only would this practice be against Article 1256 of the Civil Code, but against constitutional right to effective judicial protection under the Spanish legal system.

5.5. NON-BINDING CONTENT

Typically, the parties state and agree that certain provisions in a letter of intent are non-binding, for example:

- A description of assets or shares to be sold.
- The type of liabilities the seller will undertake.
- The purchase price.
- The payment method.
- Guarantees of the seller to compensate for any damage out of false representations.
- Closing date of the negotiation.
- Indemnities in general.
- Representations and Warranties.
- Terms governing the defined agreement.
- A provision regarding the seller's commitment to perform an interim course of action.
- Buyer's future commitments regarding hiring the directors/managers of the target company.
- Others.

Although provisions not fully defined in the agreement are often non-binding, they are sometimes found to create liabilities. Under such circumstances, an issue arises regarding the right to withhold payments [*solutio retentio*]. Thus, is the «complying party» to a non-binding agreement entitled to recover payment by claiming nothing was actually due? In fact, unless the payer evidences payment by mistake, the other party may withhold the amount as it evidences a fair cause and shows that the true intent of parties after or at the time the letter was drafted in spite of the non-binding clause was to create a binding agreement. Otherwise, if the other party proves that there was non-binding agreement and does not intend to fulfil their «obligation», the party in compliance may claim unjust enrichment as payment was made for no consideration [*causa data causa non secuta*].

5.6. IS A LETTER OF INTENT PRESUMED TO BE NON-BINDING?

Is there a general presumption that terms and commitments in a letter of intent are non-binding? In fact, no presumption may be held in advance as letters do not include any typical content, as explained above. Thus, we would need to presume that the letter carries and automatic presumption of being non-binding, unless proved otherwise.

Such a presumption is acceptable in Comparative Law, although we believe it may not be held in technical terms[13]. It does not imply allocating the burden of proof or holding a conclusive interpretation whereby provisions should be deemed non-

binding if found ambiguous. If there were such a rule, it would need to be supported on the subjective and objective criteria of Articles 1281 to 1289 of the Civil Code, which cannot be relied on. We believe the typical use of certain terms or documentation formalities may not have such effects in Spanish Law.

Indeed, some criteria are actually used to construe and assess the scope of representations or statements in the letter. For example, if one of the parties considers certain events to be of utmost importance, in the event of uncertainty, it may be proper to deem the obligation binding. Thus, if one of the parties has made payment in advance in favour of the other, in case of doubt, it may be wise to deem that the obligation was binding[14]. If one of the parties does not object to the actions performed by the other (in terms of financial obligation), the agreement is deemed to be binding.

However, an issue may arise with respect to this extensive criterion. The parties may agree, even implicitly, that their promises or commitments are non-binding regardless of their degree of specificity as they are set out in a letter of intent. In other words, they may believe the mere format of a letter of intent prevents any of the parties from raising a claim. As explained above, this case also applies the rule that a false or mistaken description does not vitiate a document [*falsa demonstratio non nocet*] if both parties did not intend to bind themselves to the agreement and believed by mistake that a specific document format would trigger such effect, because the mutual intention prevails over any objective interpretation on the statements.

However, this rule does not apply if both parties support two opposing views. If the «proper» interpretation of the statement is that the agreement is binding and the recipient so considers it, the writer may not deem it to be non-binding unless the latter challenges the agreement on grounds of substantive error relating to the scope of the statements. Pursuant to Spanish case law, however, such substantive error will almost certainly not make the agreement null and void[15]. Thus, it is important to reiterate that a party may not support and uphold the view of a non-binding agreement if the statement was interpreted by the recipient as being binding.

5.7. DEGREES OF BINDING

As explained above, if a letter of intent is drafted and signed in a complex negotiation process, it is important to differentiate various «binding degrees» to move the negotiation forward and to prevent the other party from strategically abusing the situation. Additionally, the structure of the contract is often complex as it may include content referred to at the negotiation stage.

Let us analyse below five different binding degrees.

(i) *A higher-level binding clause* . As explained above, only a binding clause may define terms in the letter of intent as being non-binding obligations. If a non-binding clause were also non-binding, it would be superfluous and ineffective in relation to other provisions.

(ii) *A higher-level binding effect in a statement* . Representations in a letter of intent are not warranties of the truth, entirety or source of the statements made by the parties.

(iii) *The clause imposing a duty to act in good faith at the negotiation stage* [16] . This clause is superfluous in Spanish law as the parties cannot avoid the duty to act in good faith[17]. However, it may be relevant in other legal systems if this obligation is ambiguous[18] or ignored and the parties may agree to contractual clauses which do not oblige them to negotiate in good faith[19].

No case law examples can be found to show clear actions contrary to good faith. However, we may use some examples analysed by Farnsworth[20] which should be considered in the light of a number of various events. Accordingly, one of the parties may not agree to enter into the agreement if the obligation to act in good faith may be reasonably interpreted by considering preliminary relations or events. Likewise, one of the parties may not agree to enter into the agreement unless inadmissible conditions are permitted (e.g. introducing unlawful proposals, challenging the representatives of the other party, etc.). Other examples may include using improper tactics or making unreasonable offers to break off the deal, not providing the other party with necessary documents to continue negotiations and carrying out simultaneous negotiations with third parties provided the other party is not granted the possibility to adjust and make better offers. A claim of intimidation may be raised if an agreement was signed on terms unreasonably advantageous to the interest of the defendant who threatened to break off negotiations after the claimant had incurred high «unrecoverable» costs. Such agreement would be deemed null and void (and the claimant could even claim compensation for damages for non-performance of pre-contractual obligations)[21]. Pursuant to the Ruling of the Appeal Court of 15 October 2012 (Social Aranzadi No. 2 of 2013) in terms of the «negotiation» ruled by Article 51 of the Statute of Workers to access the records of the collective employment agreement, no negotiation is conducted if (*i*) the representatives of the workers may not reasonably examine the causes alleged by the company and (*i*) «it is not possible to see the process of offers and counteroffers given that (a) negotiations always imply compromises and (b) the party may not allege that other options have not been accepted if they did not provide reasonable and feasible alternatives».

(iv) *Temporary binding clauses* . These binding clauses set out procedural rules which are only effective during the negotiation process or state provisions that come into force if no agreement is reached. In the former event, obligations expire upon execution of the agreement or when the negotiation is broken (stop-gap agreements). There are many examples which can illustrate this point:

- Automatic termination clause sets out that the entire letter of intent shall not be effective if the agreement is not

signed by a specific date although exception clauses may introduce an option to purchase.

- Pursuant to the entire agreement clause, promises or commitments not included in the definitive document shall not be part of the agreement.

- Under the severability clause, if a provision of the letter of intent is held to be unenforceable, the others shall remain in effect.

- The choice of law clause specifies the applicable law governing the commitments set out in the letter of intent.

- The confidentiality and exclusivity clauses state the seller's obligation of a temporary exclusivity guarantee and the buyer's obligation of confidentiality[22] relating to the information disclosed.

- Arbitration clause provides that the parties shall resolve any dispute arising out of the letter of intent through an arbitration process.

- Under a non-disclosure clause the parties agree to not disclose the existence of the negotiation.

- An indemnity clause sets out the obligation to compensate if a party fails to fulfil binding obligations.

- Positive or affirmative obligations relate to the duty to give or to do something, for example a clause whereby the seller agrees to provide the buyer with certain documents and information.

- As explained above, the parties may agree to not claim reimbursement for costs incurred if the negotiation fails.

As with «confidentiality letters», these binding clauses may be attached separately to avoid confusion with non-binding clauses (i.e. to be clear on the scope of the binding provisions and to avoid applying this effect to the entire letter of intent). Thus, it helps to understand that the obligation of the recipient to provide the offeror with certain information is not part of a broader and effective agreement if the seller has already fulfilled or has started to fulfil the obligation.

(v) *Permanent binding clauses* . Provisions under these clauses are binding obligations assumed by the parties in the letter of intent and the terms and effects are not subject to the execution of the definitive agreement; in other words, they survive the agreement. Clear examples of this type of clauses are the commitment of the seller to secure certain assets and the obligation to obtain necessary consents. However, the letter of intent may include other provisions relating to obligations and rights which will be repeated in the definitive agreement.

5.8. OBLIGATIONS AND CONDITIONS

It is often difficult to understand —even for legal advisors— the meaning of certain terms transferred from English practice into agreements signed in Spain. One example is the use of the word «conditions», in particular the term «conditions precedent». Typically, contracts and pre-contractual agreements include a number of conditions precedent; i.e. future acts or events that must occur before a certain obligation arises. Terms such as «conditions precedent», «promissory conditions» —to name a few— entail a complex analysis even in English contractual law. This may explain why the terms have become meaningless in Spanish law.

However, it is worth defining what acts or events are considered to be conditions precedent to give rise to obligations, and what acts or events are required by the effective agreement. Technically, the difference is that conditions are not enforceable but «deferred», so commitments are not enforceable until the condition is met. In contrast, the party failing to perform an obligation as set out in the effective agreement becomes a party in default[23]. However, letters of intent may also include other provisions with unclear legal meaning; for example, conditions precedent of not making certain investments, not paying dividends, not entering into certain agreements during the negotiation process, etc.

These events should not be considered as obligations, but conditions precedent. In essence, the recipient of a letter of intent is often not subject to any obligation if the related responsibility of the other party has not yet been defined. Therefore, the action or event in question is not enforceable even though the seller has agreed and signed the letter. This view if also upheld even if a party fails to fulfil their obligations after the condition has already been met by the other, especially if it implies the transfer of property. If this event has been performed for the benefit of the offeror, the recipient may recover the property on the grounds of enrichment. Such circumstances may be supported by the principle of «an action for recovery if the purpose for the transfer has failed» [*condictio causa data causa non secuta*]. Otherwise, the recipient assumes its own risk by performing actions related to the transfer of property without securing any guarantee or immediate profitability.

5.9. THREE FINAL COMMENTS ON THE NATURE OF LETTERS OF INTENT

The information analysed in this chapter leads us to three temporary but certain conclusions on the meaning and importance of letters of intent. Let us examine them more in depth.

i) The letter of intent is not a contract, a pre-contractual agreement or a specific statement of intention. It is a *mere*

document that lays out a number of statements with different legal effects. As in comfort letters, letters of intent set out various statements, some of which have no legal effect (not necessarily under an explicit non-binding clause) if it includes proper «counter-statements» or the subject matter is not adequately defined. Other statements may be binding (i.e. contractual obligations) and both require the offer and the acceptance of the parties. Thus, commitments may be deemed pre-contractual agreements if they depend on a specific condition or formalities; or definitive agreements with no specific term of effectiveness subject to a certain condition.

ii) Technically, the letter of intent is fully *divisible* in terms of its legal effects. In essence, no «prevailing» legal effect may be attributable as it depends on the content which is not standardised. Thus, the letter may include non-binding statements of intent and binding commitments in one single document. Therefore, it does not make legal sense to analyse a letter of intent as a pre-contractual agreement or a contract, or to uphold a certain view related to its legal effect.

iii) The written formality of a letter of intent, if any, should not lead to presumptions relating to the legal value of the statements or commitments as no interpretations are possible. Neither is it possible to refer to a contractual unity as set out in Article 1285 of the Civil Code.

6. UNITY OF THE AGREEMENT AND PARTIAL AGREEMENTS[24)]

It is important to differentiate between two types of contracts: (a) an agreement embracing a mere meeting of minds, and (b) an agreement structured as a complex unit that includes various statements of intents aimed at a common general purpose. Thus, if a letter of intent includes bilateral binding statements whereby the parties have agreed that one or both will give, do or refrain from doing a specific thing, it is an «agreement» as set out in Article 1254 of the Civil Code. In contrast, if the parties state that their commitments or interests depend on an overall and definitive agreement relating to the entire operation, the letter of intent is not an «agreement».

This distinction gives rise to the issues analysed below.

6.1. PARTIAL AGREEMENTS AND INCORPORATION POWER OF THE COURTS

A letter of intent may include all of the partial agreements reached by the parties at the negotiation stage and set out that open terms will be further negotiated in the future. In addition, the parties may draft and sign a letter of intent without reaching conclusive agreements and agree on the terms before one decides to break off negotiations. This leads us to the following question: can the party «not in default» raise a claim for *full* performance by asking the judge to incorporate the open terms or raise a claim for compensation for failure to comply with the agreement as a unit, including the terms not negotiated?

It is a highly discussed issue in the United States courts given that different jurisdictions uphold various views on the power of the hearing judge to incorporate open terms in agreements that include only essential terms. However, a positive approach is often followed[25)]. Pursuant to Article 2 of the Swiss Code of Obligations, the agreement is binding if the parties have agreed on all the essential terms and any secondary terms can be incorporated by the court. Under English law incomplete agreements may also be effective if missing terms may be supplied reasonably[26)].

However, we believe courts are not empowered to incorporate terms. Let us analyse two sides to the argument:

a) The parties may have left terms open *deliberately* at the negotiation stage (even essential terms, such as the price).

b) The parties may have not been able to negotiate all of the intended terms because *there has not been a meeting of minds* .

The first event may be deemed agreement provided that the open terms, whether essential or not, are incorporated pursuant to objective criteria rather than the will of one of the parties[27)] or supplementary law is used as a resource. This event is also possible under Spanish Law even in the absence of a provision such as the Article 315 of the German Civil Code[28)].

However, if such an article existed in Spanish legislation, courts cannot substitute the parties' freedom to negotiate by considering a specific decision would be fair or reasonable. Incorporation would not be feasible in these circumstances and a second question would arise: do the terms already agreed remain effective in the absence of an entire complex agreement that defines (as a unit) the subject matter of the negotiation? The issue is clearer if the open term is the price. For example, there are no objective references to determine the price in company acquisitions, so the courts may not be able to define it «reasonably». Thus, the power to incorporate terms into agreements may be exercised for commodity-type products or services which have a direct and objective reference to the market price; i.e. the intention of the buyer and seller is not a variable. For companies or businesses that already operate in the market no «reasonable» value or figure may be determined objectively. Neither is it possible to use a standard such as current market prices as provided by Article 55 of the Vienna Convention on International Sale of Goods.

This analysis may be outdated following the incorporation of Article 798 of the Spanish Law of Civil Procedure/2000 whereby the courts may supply the statement of intent which the party does agree to express, even in the absence of non-essential terms[29]. However, this rule is incorporated into the procedural law rather than into the substantive law and is not applicable in this regard. It supports the fact of a preliminary ruling ordering the party to express the statement of intent as agreed. The event analysed in this section is different. The court may not order the party to make a statement of intent relating to the open terms. Thus, the court may not incorporate the non-essential terms or order compensation for redress [*id quod interest*] in the absence of essential terms.

6.2. PARTIAL VALIDITY VS. NON-BINDING CONTRACT

Let us examine a second issue: may the party claim effectiveness of the terms agreed in the absence of the overall agreement given that other terms in the negotiation still remain open?

The first main problem is to determine whether there is an overall project that serves as a background to define the intended agreement. Why should a party accept the exception that valid terms are not binding because others have not been agreed yet? In essence, the party who claims the non-binding effect should demonstrate that the negotiation was supported by a number of partial agreements that would later make up an agreement as a complex unit in itself. In these circumstances, the parties would not be bound to the overall agreement as it could have been bound under the previous partial agreements[30]. None of the parties should be bound to commitments on circumstances with no relevance in isolation.

Thus, if a party has demonstrated that the negotiation process involved a number of partial agreements to reach an overall agreement as a unit, the counterparty should demonstrate that terms already agreed still meet the interests of the parties. It may be easier to evidence if the negotiation is advanced or the terms agreed are substantial. The party may even demonstrate that open terms are only apparent given that they have agreed to resort to supplementary law or the interpretation of their intent as resources to integrate the agreement. Indeed, this issue is even clearer if some obligations have already been fulfilled[31].

Thus, in these circumstances the «quasi-rule» that prevails in the Spanish courts relating to partial invalidity does not apply. In other words, the presumption that the parties agree on partial effectiveness even though the remaining agreement is ineffective is not considered by the courts. Thus, under the field of negotiations we may refer to the rule of «what is useful is vitiated by the useless» [*utile per inutile vitiatur* [32]].

Quite different is the situation of covert disagreement. Accordingly, the parties may believe they have agreed on all the terms of the contract, but there is a missing term for the contract to be valid as a unit. In these circumstances, the contract is effective under the terms agreed if the parties have entered into the agreement even in the absence of such term[33].

A letter of intent is significant to demonstrate what the contract implies given that the parties define the circumstances required to reach a definitive agreement at the negotiation stage. This helps to define both the concept of the binding contract and the interests of the parties. Thus, the counterparty may not claim that the partial agreements reached before negotiations are broken are deemed a contract as set out in Article 1254 of the Civil Code, unless otherwise provided in the letter of intent; e.g. temporary binding clauses comprising the duty of confidentiality or exclusiveness agreements, etc.

6.3. AGREEMENT AND WRITTEN FORM[34]

The agreement is not binding if drafted by the parties in a private document provided that substantial formalities of public documents are required by law. However, if a party does not intend to comply with the obligation in the written document, it constitutes an abuse of law given that a defect of form is alleged to withdraw from the agreement because other external options may be more interesting. Pursuant to Spanish case law, enforcement applies in these circumstances in favour of the «innocent» party if the following conditions are met:

(a) It is a bilateral agreement; and

(b) (i) One of the parties is held liable for the defect of form;

(ii) The counterparty has «irrevocably» agreed to the contract; or

(iii) the «innocent» party has relied on the other's stated expectation to be bound[35].

Secondly, another issue to consider is whether the parties are free to break off negotiations before partial agreements are gathered ultimately in a definitive written document. Under the general theory of Contract Law, if the parties have reached an agreement, it is binding regardless of its form —provided that no special formalities are required—. However, the burden of proof would need to be satisfied. The final wording of the document would prevail if the parties set out expressly that they would not bind themselves until the definitive document is signed by both and includes all of the partial agreements. However, such a clause is not common. Neither is it clear what effect it should have if a party demonstrates that they have actually agreed to bind themselves in spite of the clause and implicitly deem the written agreement otherwise.

The absence of specific case law makes it difficult to determine if such a clause is deemed implicit in lengthy and complex negotiations where terms relate to and depend on each other even in relation to open terms, and where parties may go over the agreements again until the last term is finally agreed[36]. Under a neutral and typical standpoint, the parties *may really* believe they do not bind themselves until the agreement is signed. Such a case would require solid evidence to demonstrate mutual agreement, and the terms not included formally in the definitive document will not be binding pursuant to the rule of «a false or mistaken description does not vitiate a document» [*falsa demonstratio non nocet*]. However, in other circumstances, it is not possible to support a specific interpretation of final written documents in the negotiation process of company acquisitions. At least in Spain, it is not possible to hold that the actions of the parties prior to entering into the written agreement should not be deemed in terms of an offer and acceptance exchange, but as a negotiation process[37].

Without doubt, it is worth considering that *oral agreements* (even if demonstrated) are not deemed an enforceable contract given that a contract is often entered into in writing. Thus, it is presumed that every term is left open until the definitive contract is drafted and signed by the parties. The Supreme Court Judgment of 14 October, 1996 (Aranzadi Case Law Digest No. 7560 1996) on co-guarantees (as will be explained below), may be a good example for this interpretation or approach. It may also be reasonable to believe that the definitive written form should not be conclusive if the parties have agreed that fulfilment (at least by one of the parties) may occur before such event. Neither should it be conclusive if there is a widely used standard document form.

6.4. GOOD FAITH AND RENEGOTIATION

If partial agreements are deemed non-binding by rule as examined above, parties have a wider range of negotiation strategies. Given that they are mere non-binding steps in a negotiation process, a party may agree on future terms provided that the previously agreed terms are renegotiated. Agreement on a critical issue may even become subject to the renegotiation of a closed term[38].

Such a procedure should not be considered as being contrary to the requirements of good faith. Why should it be bad faith to end the negotiation process and reach an agreement only under satisfactory terms? Seeking the best negotiation possible rather than just a good negotiation should not be considered bad faith. Who is entitled to assess the negotiations? Of course, not the courts. Let us examine additional facts that evidence bad faith:

i) If the party in question does not have a real intention of reaching agreements and seeks to deviate the attention of the other party or makes the latter incur costs or lose opportunities;

ii) If a party acts against the reliance of the other by adding new terms or insisting on odd terms unexpectedly (when the latter has already assumed significant commitments and incurred substantial costs) and such reliance is supported on the representations made by the former even if promises are not binding[39];

iii) If the party interested in renegotiating terms has allowed the other to fulfil or start fulfilling the agreements already reached;

iv) Most importantly, if the party who breaks off the agreement intends to negotiate incompatible opportunities or matters already unattainable to the parties early in the negotiation process or claims requirements or circumstances previously known at the start of the negotiation and that have not been changed during[40] the process[41].

Pre-contractual liability would arise under such events of bad faith. However, Article 7 of the Civil Code is too broad to define the power of the courts to avoid abuse. Courts should be entitled to incorporate secondary terms under due prudence to render the agreement effective. The party acting in bad faith does not have the right to claim this event breaches the right to self-define the agreement.

7. DEFINED AGREEMENTS

7.1. REQUIREMENT OF A FULLY DEFINED SUBJECT MATTER

The subject matter of an agreement is fully defined if a potential claim for fulfilment may be upheld without a Court or a third party determining the unfulfilled obligations provided that the parties have not agreed to do so themselves or via a third party, and a new agreement between the parties is not required to resolve the terms in question. Agreements are not fully defined if the enforceability depends on the criteria of the party subject to it or if the future conducts of the parties other than the fulfilment depends on the will or criteria of any or both parties.

In summary, the issue in question is subtle. For example, if the agreement sets out fixed terms to which a party is subject, it is sufficiently defined. Alternative obligations of the Civil Code would apply by analogy.

Therefore, an agreement to agree, or an agreement subject to contract, are not defined contracts in terms of their subject matter. They do not give rise to effects given that the conduct of the parties relating to the direct purpose of the initial

agreement may not be enforced and it may not be possible to determine what the liability would be of the other party who fails to negotiate or agree.

However, if the subject matter is not fully defined, the agreement is not necessarily null and void. There is simply no agreement as such, without the need for a court decision, or the appearance of interim validity which has to be destroyed by a court decision, which in turn is subject to a limitation period. Thus, such an agreement or contract is only a non-binding agreement of intents. Neither should it be deemed to be a pre-contractual agreement given that the subject matter of pre-agreements should also be fully defined[42)].

7.2. DETERMINABILITY AND NEGOTIATION IN GOOD FAITH

It is important to note that an agreement to agree is not completely spurious. If the parties do not agree to agree or break off the negotiation with no legitimate reasons, they would be liable under the rule of fault in the conclusion of a contract [*culpa in contrahendo*].

However, this event should only apply in jurisdictions which do not recognise the general duty to negotiate in good faith before the agreement is signed. In such an event, the agreement to agree would be valid as it would fully define the obligation of negotiating in good faith. Such obligation would not exist otherwise and would neutralise the «all or nothing rule» considered by US Courts[43)]. However, we have already explained that under the Spanish legal system such an instrument is not necessary for an obligation to exist prior to the definitive agreement. The purpose of the agreement to agree is significant, as it defines the scope of the negotiation and demonstrates that the intention of the parties (at least of one of them) has been to negotiate or start negotiations in due terms. It is important when it is difficult to evidence that the parties have undertaken the negotiation process.

Additionally, the letter of intent provides another added-value feature. Although the parties may have bound themselves to continue negotiating, they would not normally be obliged to start a new negotiation again, unless they have already entered into an agreement that sets out certain liabilities (e.g. the renewal of an agreement that has terminated). A letter of intent may not create such an obligation to negotiate, but helps to elucidate when the parties have started negotiations. The real negotiation stage starts when the recipient signs the letter of intent (if it is bilateral); this event puts an end to the previous stage where any doubt could arise as to whether the parties were negotiating or not.

Anglo-Saxon legal practice has analysed whether an agreement to agree is the same as an agreement to negotiate in good faith, and if the latter may be equal to an agreement, which subject matter is to define the best efforts of one or both parties[44)]. We believe there is no difference.

7.3. DEFINITIVE AGREEMENT SUBJECT TO A CONDITION AND LETTER OF INTENT TO NEGOTIATE

Two events may seem to give rise to the same effect in the negotiation process between the parties:

a) If the parties agree to a «definitive» agreement under a condition subsequent to be fulfilled at the entire discretion of one of the parties, if this were possible;

b) If the parties bind themselves in a letter of intent to negotiate on the basis of a background whose subject matter is already defined.

However, they are quite different. If the party does not comply with a valid condition intentionally, the condition is deemed fulfilled and the agreement is considered effective under Article 1119 of the Civil Code. However, if the conduct set out in the agreement of intent, even with a certain degree of intentionality, is not performed in good faith, the party held liable may be ordered to compensate for reliance loss on the grounds of fault in the conclusion of a contract.

The difference between both events comes to light if such a «condition» implies the approval of the negotiation by the Board of Directors of the company (the selling or merging company, etc.) and such an approval is not granted because the negotiators (members of the Board) no longer intend to negotiate (for instance, they may have lost interest in the negotiation). Such an event calls for strict attention at the time of its interpretation. As long as there is a sufficient degree of specificity, the agreement should be deemed to be definitive and subject to a condition precedent to prevent any malevolent tactics of the party not willing to agree, as set out in Article 1119 of the Civil Code. Likewise, if the parties agree to a letter of intent whereby a guarantee is granted under a condition that the customer in turn grants sufficient guarantees[45)], such a document may not be considered a letter of intent but a guarantee subject to a condition precedent.

A condition subsequent for cancellation such as the «go-shop» clause gives rise to the same legal effects as a letter with non-binding commitments, although the non-binding effect of the former is limited given that the buyer may not withdraw from the operation and the seller is granted a maximum 60-day period to find a better offer, among other reasons. A definitive agreement with a «go-shop» clause is also preferable for the buyer as the risks of an open negotiation are reduced and there is usually a termination break-up fee if the seller finds a better offer[46)].

8. SPANISH CASE LAW ON LETTERS OF INTENT AND PRE-CONTRACTUAL AGREEMENTS

8.1. INEFFECTIVENESS OF DEFINITIONS GIVEN BY THE PARTIES (SUPREME COURT JUDGMENT OF 2 DECEMBER 1995 [ARANZADI CASE LAW DIGEST NO. 9156 OF 1995] AND SUPREME COURT JUDGMENT OF 14 OCTOBER 1996 [ARANZADI CASE LAW DIGEST NO. 7560 OF 1996])

The first criteria to consider when analysing Spanish case law is that the classification given to an agreement by the parties involved may be deemed ineffective by the court. For instance, «letters of intent» are now frequently used for any type of agreements between parties, some leave non-essential terms open and others are subject to conditions beyond the will of the parties. As a result, the courts often ignore such «classifications».

The Supreme Court Judgment of 2 December 1995 resolved a case involving a letter of intent whereby a car dealer from a certain area agreed to act as the sub-agent of the other party. As a result and by mutual agreement, the latter began acting as agent in fact, incurring costs associated with the car distribution process and ultimately distributing the other party's vehicles pursuant to the terms agreed. The Supreme Court considered that this was a case of a non-regulated commercial contract of a binding nature and that a breach by one of the parties would be interpreted as a unilateral termination of a distribution agreement.

This ruling is significant as it shows the natural propensity of the courts to recognize that a contract exists when one of the parties complies with the corresponding commitments.

The second case cited, the Supreme Court Judgment of 14 October 1996, redefined a «Memorandum of Understanding» on a surety bond as a pre-contractual agreement. The surety bond would have been issued if the customer had provided certain guarantees, but the guarantor was found not to be bound by the agreement because the conditions were not met, and not because they reconsidered the offer.

8.2. PARTIAL AGREEMENTS AND FINAL DISAGREEMENT (SUPREME COURT JUDGMENT, CHAMBER 4, 9 MARCH 1998 [ARANZADI CASE LAW DIGEST NO. 2372 OF 1998])

There is no judgment from the First Chamber (Civil) of the Supreme Court that examines in detail the issue analysed above as it relates to the effectiveness of partial agreements reached during the negotiation phase when one party walks away from the deal and no final agreement is reached.

The Supreme Court Judgment of Chamber 4 of 9 March 1998 is especially important due to both the relevance of the case and the way that the facts were weighed to support the decision. The case involved a collective bargaining agreement in the aviation field. The claimant unions held that in spite of having not come to agreement on the final text of the agreement, which was not signed, the parties had reached a partial binding agreement by which the claimant was bound to submit the aviation firm's Future Plan. The National Court upheld the claim and the Supreme Court reversed the decision.

According to the Supreme Court, the obligation to negotiate in good faith as set out in Article 89 of the Statute of Workers does not require the parties to conclude the negotiations, even if they have agreed to specific significant terms. In addition, neither the principle of good faith nor contract law can oblige one of the parties to bind themselves to those terms agreed to if they have not come to an agreement on all the terms in dispute, which causes the parties to break off the negotiation and to not conclude a definitive agreement. The Chamber holds the view that the court may not modify or construe the intention of the parties by supplying terms related to unresolved issues in order to create a fully integrated contract.

Certainly, this is the most significant ruling in Spanish Law on preliminary arrangements. It affirms two principles that have been assumed in the development of this text. First, the courts are not empowered to integrate an incomplete agreement arising from disagreement during the negotiation stage unless the parties' failure to reach an agreement is the result of the specific intent to have the court resolve a disagreement by incorporating terms. Secondly, the parties are not bound by partial agreements if the terms defined at the onset of the negotiation for inclusion in the final agreement are not fully resolved.

8.3. ESSENTIAL ELEMENTS OF THE AGREEMENT AND THE POWERS OF THE COURT TO INCORPORATE TERMS INTO AGREEMENTS: PRE-CONTRACTUAL AGREEMENTS TO SET UP COMPANIES (SUPREME COURT JUDGMENT OF 5 JULY 1940 [ARANZADI CASE LAW DIGEST NO. 684 OF 1940]; SUPREME COURT JUDGMENT OF 9 JULY 1940 [ARANZADI CASE LAW DIGEST NO. 691 OF 1940] AND SUPREME COURT JUDGMENT OF 13 NOVEMBER 2009 [CLA NO. 474637 OF 2009]; RULING OF THE PROVINCIAL APPEAL COURT OF VIZCAYA OF 13 OCTOBER 2000 [CIVIL ARANZADI NO. 2441 OF 2000] AND RULING OF THE PROVINCIAL APPEAL COURT OF MADRID OF 13 SEPTEMBER 2000 [CLA NO. 279377 OF 2000])

The Supreme Court Judgment of 9 July 1940 considers an agreement to set up a company. The parties have not defined some of the essential elements required to incorporate a company pursuant to the Commercial Code. The Appeal Court ruled to grant the Certificate of Incorporation to form a limited company. According to the Supreme Court, if the essential terms have

been agreed, the open terms for the incorporation of the company may be supplied «in compliance with the legal provisions in effect to enforce the agreement and enter into a public deed of incorporation». Other terms were left for future definition, such as the company's corporate management and its term of existence. According to the court, the terms to incorporate into the agreement should be supported by Articles 129 and 224 of the Commercial Code.

The ruling would not be worth analysing if the parties had already agreed on all of the essential elements of the agreement and the other terms were to be supplied pursuant to law or were not required to incorporate the company pursuant to the Commercial Code. The key issue to note is that the court defines the content of the agreement to be reached by the parties by excluding the terms that may be negotiated but are not required for a contract to be effective.

The importance of this ruling is the following: if the parties have agreed on certain terms which are deemed sufficient to start their negotiation but have left open other terms which are not necessary or essential (although they may be equally important in the view of the parties), failure to agree on these non-essential terms does not void the remaining agreement if the parties have agreed on all of the essential terms. However, such a statement has not been included in the ruling, and has not been included in other subsequent rulings.

It is worth analysing if the implicit criteria in this ruling are contrary to the approach discussed above from the Fourth Chamber of the Spanish Supreme Court that upholds the view of non-binding agreement in a similar case. The issue may lie in subtle differences. It is not clear if the Supreme Court Judgment of 9 July 1940 had sufficient information to interpret whether there was an overall consensus and the parties had agreed to resort to supplementary law for open terms.

Similarly, the Supreme Court Judgment of 9 July 1940 resolved a case on an agreement of joint ownership by heirs that agreed to establish a company under commercial law. The parties had not agreed on the type of company but «agreed on certain terms which shall be considered in due time». Indeed, one of the partial agreements set out that the company would acquire the most convenient type. The Appeal Court ordered the parties to set up a corporation under certain agreements. However, the Supreme Court dismissed the ruling.

According to the Supreme Court, the parties have reached a *pactum de contrahendo* which «serves the main function of an agreement to agree; i.e. it binds the parties to commit themselves to agree on a future agreement without giving rise to its legal effects. The only obligation is to provide consent in due time. Failure to fulfil this obligation may result in compensation for damages».

The Judgment is correct in spite of the opposing academic and legal opinion. It is a different decision whereby the Supreme Court adopts a specific concept of the pre-contractual agreement as a *pactum de contrahendo* whose execution is not subject to a definite term. Indeed, the important note that makes it appropriate is that a court may not order the fulfilment *in natura* of obligations set out in the definitive agreement. Neither can it order enforceability without infringing the right of the parties if essential elements have not been defined to interpret the intention of the parties. This rule is later repeated in a similar case; Supreme Court Judgment of 2 February 1960 (Aranzadi Case Law Digest No. 456 of 1960).

The Judgment is conclusive as it opens up a new and coherent field in Spanish Law. The Supreme Court considers the possibility of compensation for damages if a party fails to fulfil the *pactum in contrahendo* , as it is not fully defined. Thus, what compensation is applicable? If the Supreme Court orders compensation for non-performance, an order for performance may be implied. However, this opposes the opinion above. Should the court order compensation for reliance loss (i.e. costs incurred by the claimant who relied on the company having to be formed)? The Supreme Court has never resolved this issue in subsequent case law[47)].

More recently, Supreme Court Judgment of 13 November 2009 (CLA No. 474637 of 2009]) has considered there was a binding pre-contractual agreement to set up a company. Although the parties had not defined the type of company they would establish, the pre-contractual agreement was sufficiently defined to provide the claimant with remedies other than specific fulfilment, given that it is a case of failure to fulfil contractual obligations.

The Ruling of the Provincial Appeal Court of Vizcaya deals with a case of negotiations where a corporation should have been established with the claimant who would provide the distribution licence granted by a third party. The other parties set up the corporation without including the plaintiff as former licensee. Surprisingly, the Provincial Appeal Court contradicts itself. First, it affirms that a binding partial agreement may be reached at a preliminary stage in the negotiation even prior to the contract or pre-contractual agreement. Then, it states that the parties are free to withdraw from the negotiation at the preliminary stage of arrangements and hold their negotiation autonomy. «Accordingly, the pre-contractual agreement is the final phase of the preliminary stage of arrangements, not a part thereof. Should such criteria not include all of the agreement reached within a contractual negotiation process, the outcome for this case would not differ given that the alleged memorandum of understanding between the parties would evidence agreement on certain terms which would not allow them to withdraw. However, it would be clear that they should continue negotiating the remaining terms until the intended corporation is established —their freedom to contract to reach further agreements would not be affected as they would still be in the stage of preliminary negotiations which —as such— does not bind the parties to enter into a contract—. The former criteria whereby the pre-contractual agreement obliged the execution of the contract are not applicable. If the essential elements of the intended contract are not defined in a pre-contractual agreement no other agreement may be possible and there is no reason for the court to overrule the autonomy of the parties (whether to formalise the contract or

not). Under such circumstances, the parties are within the scope of structuring the final contract on a progressive basis which —technically— does not exist in legal terms yet. Thus, the parties are free to reach binding agreements between them, save to bind themselves to a contract which has still not yet been created. They may break off negotiations, as shown by the appealed decision». Pursuant to the decision, the parties have exchanged communication (faxes) with proposals and ideas, but they have never created a unitary document.

The Ruling of the Provincial Appeal Court of Madrid of 13 September 2000 (CLA No. 279377 of 2000) deals with a failed negotiation to establish a joint venture. The essential terms of the agreement have not been agreed and there is no reason to believe that the ultimate lack of agreement could be attributable to bad faith by any of the parties. Pursuant to the ruling there is no pre-contractual agreement and there are no grounds to consider pre-contractual liability. Neither does it mention the power of the court to incorporate terms into the agreement.

8.4. COMPLIANCE AND COMPENSATION CLAIMS (RULING OF THE PROVINCIAL APPEAL COURT OF GRANADA OF 27 APRIL 1999 [CIVIL ARANZADI NO. 4573 OF 1999])

This ruling provides clear evidence of current Spanish case law regarding this issue and is closely related to the analysis provided in the previous section.

The court held that if a pre-contractual agreement contains all the elements of a definitive agreement, it can be treated as a final contract on the basis of the legal theory supporting the Supreme Court Ruling of 4 July 1991 (Aranzadi Case Law Digest No. 5325 of 1991). However, it may only be legally enforceable «if there is a full and complete definition of all the elements and circumstances of the business». If not, the court may only order compensation for losses and damages. According to the legal theory used in the Supreme Court Judgment of 24 December 1992 (Aranzadi Case Law Digest No. 10657 of 1992), the parties may be ordered to perform as promised if the execution of the agreement were deferred. Thus, the claimant may only receive economic compensation if the parties have left «the full and complete definition of all the elements of the agreement» for future resolution.

This provides evidence once again that Spanish Law assumes an agreement to be valid and effective even if its subject matter is not entirely defined. However, it is not clear what compensation would apply. Nor is it possible to know how this lack of specificity does not allow the court to order enforcement but compensation of an amount corresponding to the claimant's interest in performance.

However, this case law (although rather ambiguous) suggests that courts need not resign themselves to reach a specific definition (i.e., to define if a document is deemed to be an agreement or not). Nor do they consider the «all or nothing» rule that is often used in American courts to examine agreements in principle[48].

8.5. PACTUM DE CONTRAHENDO, THEORIES ON PRE-CONTRACTUAL AGREEMENTS, MEMORANDA OF UNDERSTANDING, AND DEGREE OF CONTRACTUAL DETERMINATION (SUPREME COURT JUDGMENT OF 11 NOVEMBER 1943 [ARANZADI CASE LAW DIGEST NO. 1170 OF 1943]; SUPREME COURT JUDGMENT OF 1 JULY 1950 [ARANZADI CASE LAW DIGEST NO. 1187 OF 1950]; SUPREME COURT JUDGMENT OF 7 FEBRUARY 1966 [ARANZADI CASE LAW DIGEST NO. 793 OF 1966]; SUPREME COURT JUDGMENT OF 1 JUNE 1966 [ARANZADI CASE LAW DIGEST NO. 2848 OF 1966]; SUPREME COURT JUDGMENT OF 30 JANUARY 1998 [ARANZADI CASE LAW DIGEST NO. 353 OF 1998]; RULING OF THE PROVINCIAL APPEAL COURT OF CORUÑA OF 9 DECEMBER 1994 [CIVIL ARANZADI NO. 2103 OF 1994]; SUPREME COURT JUDGMENT OF 28 APRIL 2000 [ARANZADI CASE LAW DIGEST NO. 2677 OF 2000]; RULING OF THE PROVINCIAL APPEAL COURT OF LEÓN OF 8 FEBRUARY 2002 [CLA NO. 113725 OF 2002]; RULING OF THE PROVINCIAL APPEAL COURT OF MURCIA OF 18 SEPTEMBER 2003 [CLA NO. 250942 OF 2003])

The Supreme Court Judgment of 1 July 1950 confirms the legal interpretation used to support the Supreme Court Judgment of 9 July 1940 (Aranzadi Case Law Digest No. 691 of 1940), but it did not overrule or amend the principle, as was once believed. In essence, the Supreme Court does not recognize that the enforcement of specific agreements can be based on different interpretations of the meaning of *pactum de contrahendo* ; but instead bases its view on the fact that an initial agreement (or pre-contractual agreement) defines the essential elements of a future purchase agreement. However, although subsequent rulings have also been based on the same criteria (e.g. the Supreme Court Judgment of 2 February 1959 [Aranzadi Case Law No. 2894 of 1959]) the issue has become more ambiguous. As a result, if the «intended» agreement is deemed to be effective by the court, the term «pre-contractual agreement» becomes meaningless given that it has been held to be a definitive agreement (albeit not certified by Notary Public). Therefore, there are three possible outcomes relating to the function or effectiveness of a «future» agreement: (i) it becomes superfluous; (ii) it confirms the previous agreement; or (iii) it becomes ineffective, as it does not include sufficient new cause for a purchase or sale. This key issue was later highlighted by the Supreme Court Judgment of 7 February 1966 (Aranzadi Case Law Digest No. 793 of 1966) and the Supreme Court Judgment of 1 June 1966 (Aranzadi Case Law Digest No. 2848 of 1966). Regardless of the apparent contradiction of these two rulings and of the various legal theories related to the concept of pre-contractual agreement, the key factor is the degree of determination of the initial agreements. Accordingly, a pre-contractual agreement is deemed effective and enforceable if its terms have been fully determined; thus, the court does not ask the parties to state their intention, but to fulfil their obligations as already established in the contract. A final example might be the Ruling of the Provincial Appeal

Court of Murcia of 18 September 2003 (CLA No. 250942 of 2003) on an agreement / pre-contractual agreement issue:

> «In essence, in order to determine the legal effect of a pre-contractual agreement, it is necessary to analyse the intention of the parties. In order to determine real intent, two opposing hypothesis should be evaluated:
>
> (i) Was the initial intention of the parties only to commit themselves to be bound by a future agreement? In other words, the court has to determine if the parties had committed and agreed exclusively to enter into a future agreement on the basis of the pre-contractual agreement (i.e. the pre-contractual agreement would only serve the function of defining the terms leading to the future agreement).
>
> (ii) Did the parties intentionally enter into the pre-contractual agreement dated 31 August 1999, in accordance with the Supreme Court Judgment of 21 June 1966 of 24 December 1992 (Aranzadi Case Law Digest No. 10657 of 1992) and the Supreme Court Judgment of 3 June 1994 (Aranzadi Case Law Digest No. 4576 of 1994), with the intention of concluding a definitive agreement at a future date and, by having identified the elements and terms of the future agreement, thereby demonstrated their intention to enter into a genuine agreement?
>
> In the case in question, the Court held that when the parties entered into the pre-contractual agreement, their intent exceeded that of a mere statement to 'commit themselves to be bound in the future' given that within the document they defined the duration of the agreement, the delivery date for the first lot of goods, the price, the method of payment and the method of delivery. This interpretation is supported by the fact that a meeting was held by the parties in Yecla on 28 October 1999 because they anticipated that the products would be approved. Pursuant to the defendant, his intention in the meeting was to enter into a definitive agreement and he attended the meeting with his attorneys and financial consultant (Mr. Vicente). The qualification of the document of 31 August 1999 as a pre-contractual agreement would not prevent the parties from entering a definitive agreement and it is clear that the parties had intentionally granted legal effects to the pre-contractual agreement in addition to their statement to commit themselves to be bound. In essence, a number of rulings are based on Article 1451 of the Civil Code which establishes that the mutual expressed commitment to buy and sell, when accompanied by the identification of the subject matter and the price, may be deemed to be a purchase agreement in implicit terms (Ruling of 7 July 1994 [Aranzadi Case Law Digest No. 6296 of 1994] following Ruling of 22 March 1985 [Aranzadi Case Law Digest No. 1196 of 1985], Ruling of 26 July 1973 [Aranzadi Case Law Digest No. 2587 of 1973] and Ruling of 1 June 1966 [Aranzadi Case Law Digest No. 2848 of 1966]. This interpretation could only be rejected if it was clear and evident that the intention of the parties was to exclude the effects of the sale and purchase agreement and to substitute it with the 'promise' or mere intention of «agreeing to agree».

On the other hand, certain pre-contractual agreements with a low level of specificity can be deemed effective and enforceable. This may be the case with surety bonds, as demonstrated in the Supreme Court Judgment of 30 January 1998 (Aranzadi Case Law Digest No. 353 of 1998). This type of agreement creates a unilateral obligation that is secondary to the primary obligation. The slightest determination is sufficient to create an effective and enforceable agreement; basically, it is sufficient to define who the guarantor and the beneficiary are. A simple agreement of intent with this minimum description is deemed an effective agreement and the distinction between a pre-contractual agreement and an effective agreement is entirely insignificant. Thus, the court may not «fill the gap» or supplement any statement of intent by the principal but instead orders the payment of the amount promised.

Therefore, to clarify this analysis, according to the legal theory supporting the Supreme Court Judgment of 1 July 1950, the *pactum de contrahendo* , the pre-contractual agreement, the preliminary agreement and the agreement to agree become superfluous and are unnecessary when an agreement includes all the elements that allow the courts to enforce the obligations that arise when the agreement has been deemed to be definite.

The precedent for this ruling is the Supreme Court Judgment of 11 November 1943 (Aranzadi Case Law Digest No. 1170 of 1943), which may call into question the analysis offered above. This judgment, without referring to specific facts or to the degree of certainty in the party's commitment to sell, supports in general terms the approach of differentiating pre-contractual agreements from definitive sales and purchase agreements and that the content of a pre-contractual agreement obliges the parties to conclude a final sales transaction, the terms of which are still to be determined. While the case did not involve a *pactum de contrahendo* , the Supreme Court interpreted the document as being a definitive agreement and granted damages as a result of the buyer's failure to pay. The same logic was applied to the Supreme Court Judgment of 16 October 1965 (Aranzadi Case Law Digest No. 4468 of 1965) on a series of agreements in which essential elements were not fully defined. Accordingly, the court viewed them as pre-contractual agreements. The subsequent Supreme Court Judgment of 26 March 1965 (Aranzadi Case Law Digest No. 1481 of 1965) considered the various interpretations of pre-contractual agreements made by the Supreme Court (namely, the Supreme Court Judgment of 11 November 1943 vs. the Supreme Court Judgment of 1 July 1950 [Aranzadi Case Law Digest No. 1187 of 1950] and concluded that both decisions were consistent given that the degree of definition within the agreements was taken into consideration in each case.

The Ruling of the Provincial Appeal Court of Coruña of 9 December 1994 (Civil Aranzadi No. 2103 of 1994) determined that, because the lessee had not been designated, there was pre-contractual agreement and not a definitive agreement. The Court held the pre-contractual agreement to be a binding preliminary agreement the obligations of which could not be avoided. As a result, if one of the parties defaulted on the agreement, the court would order compensation as the only remedy to resolve the case given the inherent nature of the liability. If the essential elements of the agreement had been fully defined in the pre-contractual agreement, the definitive agreement would have been superfluous and ineffective.

This decision provides further evidence that the court's decision to award damages is based on the incomplete nature of a pre-contractual agreement and that the agreement would have no value without this lack of definition. It is worth noting again that if the pre-contractual agreement were fully defined, it would be deemed an effective and binding agreement. In other words, the ruling provides that a pre-contractual agreement may be deemed so only if it contains a degree of

uncertainty given that the court may not fill any gaps by incorporation terms for the unresolved issues.

Finally, the Supreme Court Judgment of 28 April 2000 (Aranzadi Case Law Digest No. 2677 of 2000) is the most recent ruling of interest on this issue[49]:

The contractual provision in question sets out that: «Should the buyer exercise the option to purchase, the definitive agreement shall be signed by the parties pursuant to the duly signed sample agreement attached hereto. The clauses of the attached agreement, duly modified as required, shall serve as a model to draft the terms of the definitive agreement provided they do not contradict the content herein».

Given the lack of specificity in the agreement, the Supreme Court held that there was no evidence to support that the preliminary negotiation phase might have been concluded. Therefore, it was not a case of an optional agreement, but of a series of preliminary agreements intended to lead to a final agreement; i.e. a representation of intent without the effectiveness of a contract. The ruling does not mention if this pre-contractual agreement might have had other effects, or if the qualification as a strictly preliminary agreement negates any effectiveness or if it was entirely ineffective. The way the claim was presented did not allow for further conclusions as the claimant's unique request was that the asset be deemed transferred on the basis of the alleged purchase option. Thus, the Supreme Court did not need to analyse the issue further.

The Ruling of the Provincial Appeal Court of León of 8 February 2002 (CLA No. 113725 of 2002) resolved a case that involved the failure of the negotiation of a pre-contractual sales agreement that was in an advanced stage. An advanced stage of negotiation between the parties was inferred from the facts: «D. Lucinio R. C. reasonably relied on the representative of Banco Pastor, D. José Antonio V. (Officer of the branch in San Mamés, of this City), with whom he held the negotiations to acquire 50% of a property owned by the bank. The negotiations seemed to be in their final and conclusive stage. The statements of D. Ramiro N. A., the intermediary for the operation, have been confirmed by D. José Antonio V., who acknowledged that the claimant was to buy 50% of the property at a price of thirteen million one thousand Pesetas. The expectation of an advanced stage of negotiation was further supported by the fact that the claimant opened an account in the San Mamés branch of Banco Pastor, where he was not previously a client, for the express purpose of depositing money to be used for the purchase of the property. The operation was to be executed in part in cash and in part by a real estate leasing financed by Banco Pastor. The claimant deposited the specified amount of money into his account, and as a result he was given the keys to the premises, and had the front door lock changed. He also contracted the services of D. José Antonio C. C. (a Qualified Industrial Engineer) to work on an electrical installation project for the property and started negotiations with the company "Procoal" to perform maintenance work. This company even placed some of its equipment and material on the premises (e.g. a concrete mixer, scaffolding, sand, etc.). Documents submitted to the court (issued by the City Council of Onzonilla) demonstrate that the defendant broke off negotiations with no clear justification and suggest that he made the decision in order to take advantage of another opportunity. The property had been previously divided into two units so there was no obstacle to the units being sold separately, however negotiations to sell the other unit to a third party failed and the defendant preferred to sell both units jointly to D. José Luis G. It is certain that it had never been established that both units had to be sold simultaneously as an indispensable and essential condition. Conversely, the claimant's intention to acquire only 50% of the property was clear from the beginning. Therefore, the negotiations and the purchase price were reasonably based on such an intention». It is important to note that the seller wanted to recover an opportunity he had lost at the onset of negotiations; i.e. to sell both units jointly. This issue is key because no other rulings are so clear on the fact that the loss of negotiating opportunities accepted at the beginning could be reversible, the party cannot «recover» the options by breaking off the negotiation in the terms in which it was started.

Thus, the ruling brings to light a jurisprudential theory which relates to damages for breaking off arrangements. Once again, the issue of ineffective classifications arises so the court is entitled to define the agreement regardless of the definition provided by the parties and the theory of pre-contractual agreement the parties may rely on. «Accordingly, the pre-contractual agreement is the final phase of the preliminary stage of arrangements, not a part thereof. Should such criteria not include all of the agreement reached within a contractual negotiation process, the outcome for this case would not differ given that the alleged memorandum of understanding between the parties would evidence agreement on certain terms which would not allow them to withdraw. However, it would be clear they should continue negotiating the remaining terms until the intended corporation is established —their freedom to contract to reach further agreements would not be affected as they would still be in the stage of preliminary negotiations which —as such— do not bind the parties to enter into a contract—. The former criterion whereby the pre-contractual agreement obliged the execution of the contract is not applicable. If the essential elements of the intended contract are not defined in a pre-contractual agreement no other agreement may be possible and there is no reason for the Court to hold that the autonomy of the parties to issue their statement of intent should be annulled (whether to formalise the contract or not). Under such circumstances, the parties are within the scope of structuring the final contract on a progressive basis which —technically— does not yet exist in legal terms. Thus, the parties are free to reach binding agreements between them save to bind themselves to a contract which has still not been created. They may break off negotiations, as shown by the appealed decision».

Compensation is given for harm caused to the claimant's interests, but not for lost opportunities or business.

8.6. COOPERATION, STATEMENT OF INTENT OR FULFILMENT (SUPREME COURT JUDGMENT OF 5 OCTOBER 1961

[ARANZADI CASE LAW DIGEST NO. 3284 OF 1961])

This ruling confirms in practice what it seems to deny in words. The Supreme Court has struggled to define the nature of pre-contractual agreements, but ended up classifying this document as a pre-contractual sale agreement given that all of its elements were specified. It bound the parties to enter into the future sale and purchase agreement, but does not create the obligations derived from it.

The Supreme Court then eliminated this ambiguity by concluding that in order to prevent double claims as a number of requests may arise simultaneously, the claimant should not request that the document be deemed a definitive agreement, but should bring a claim against the defendant for failure to fulfil the obligations arising out of the acquisition. Therefore, it is not relevant to classify a document as either a pre-contractual agreement or a sale and purchase agreement.

This ruling is important because it gives further guidance on the legal scenario resulting from an agreement in which essential elements have not been specified. Such a document is considered a pre-contractual agreement and the parties are not bound to make a statement of intent, but only to «cooperate in defining the terms of the definitive agreement» (given that the court may not supply the missing terms nor support the decision on presumed intents).

8.7. LETTERS OF INTENT: OBLIGATION TO NEGOTIATE VS. OBLIGATION TO SIGN A STATEMENT OF INTENT (SUPREME COURT JUDGMENT OF 4 JULY 1991 [ARANZADI CASE LAW DIGEST NO. 5325 OF 1991]; SUPREME COURT JUDGMENT OF 3 JUNE 1998 [ARANZADI CASE LAW DIGEST NO. 3715 OF 1998]; AND SUPREME COURT JUDGMENT OF 30 MARCH 2010 [ARANZADI CASE LAW DIGEST NO. 2538 OF 2010])

This Supreme Court Judgment of 4 July 1991 is without doubt the most comprehensive ruling relating to a Memorandum of Understanding in Spanish case law.

The parties had agreed in a letter of intent to the joint future marketing of software systems, leaving the terms to be defined in subsequent distribution contracts. The claimant later filed a lawsuit against the defendant asking the Court to set a deadline for the parties to «discuss and enter into» the distribution contracts. Both the Lower Court and the Provincial Appeal Court set a period of 15 days and ordered the defendant to compensate the claimant if they failed to comply with the letter of intent within such term. The Supreme Court upheld the appeal.

According to the Supreme Court, an MOU is not actually a contract in the strict sense as it lacks essential terms to define the final relationship. Thus, compliance may not be enforced by ancillary order, given that the court is not empowered to incorporate terms left open by the parties. However, compensation may apply if one of the parties fails to comply with the MOU for two reasons: (i) definite terms of the contract are not essential elements at this stage; and (ii) the expectation that the parties will define both the type and the terms of the agreement in the future is sufficient. According to the Supreme Court, if a pre-contractual agreement includes all of the terms required to define a relationship, the concept of pre-contract becomes meaningless; i.e. «that which is essential to a pre-contract is the lack of definition of specific essential terms and requirements of the agreement that the parties ultimately want to conclude».

Thus, two approaches are worth analysing here. First, the court held that a pre-contractual agreement was equivalent to a simple preliminary agreement with open terms. Secondly, it separated enforceability from compensation. However, the Supreme Court does not make it clear if compensation would be based on the full performance interest (positive —expectation— interest) or simple reliance losses excluding the lost profits suffered as a result of the contract not proceeding. The Supreme Court ruling seems to place more emphasis on the first approach, although it is not clear if compensation arose out of one party's failure to: (a) comply with a definite agreement; or (b) fulfil the duty to negotiate or continue negotiating in good faith. Additionally, there seems to be an inherent contradiction. The court may not order specific performance of an incomplete agreement, but may order compensation on the basis of one party's failure to comply with it given sufficient level of specificity. This ambiguity may only be eliminated if we consider that compensation is based on reliance damages and that one party has failed to comply with the duty to negotiate in good faith.

The ruling provides an intermediary position between an order to compensate for losses and damages and an order to enforce a binding obligation. The purpose of the claim and the ruling is that of reaching a final agreement between the parties (a real «agreement to agree»). This is the only Supreme Court Judgment in Spanish case law that has provided a third approach between specific performance of the obligations of a final agreement and monetary compensation.

The Ruling of 3 June 1998 is quite different and further complicates the situation in that it did not consider the case law analysed above.

The parties involved agreed to a «commitment of intent» to set up a company. They agreed on the percentage of ownership and the directors of the business, but did not define its share capital. One of the signatories agreed to provide land and the other agreed to incur marketing and building costs. They agreed that such expenses would equal the value of the land, and that a proportion of the company's initial income would be used to finance the costs of both the building and the land. They further stated that both parties would «carry out the necessary steps to fulfil the purposes of this document at their earliest convenience». Sometime later, one of the signatories raised a claim and demanded that the other party agree to set up the

company and to provide the land. The defendant had provided ten million Pesetas as a guarantee.

Following proper consideration, the Supreme Court rejected the qualification as a binding pre-contractual agreement given that the subsequent actions of the parties were not consistent with such intention and that there was no evidence that they took the appropriate steps towards concluding a final agreement. Therefore, there was no legal relationship between the parties as the company had not been set up pursuant to Article 7 of the SA Companies Act: «the court may not issue an ancillary order». Accordingly, a document that lacks the essential elements of a deed of incorporation may not be deemed a pre-contractual agreement, so further agreements would be required. Additionally, although the MOU sets out certain binding obligation (provisions that prevent the parties from walking away from the negotiation), they would need to continue defining the remaining terms required to set up the company: «Their freedom to reach further agreements would not be affected; as they would still be at the stage of preliminary negotiation which as such does not bind the parties to enter into a contract (...). Therefore, the parties are free to reach binding agreements but they may not require the fulfilment of obligations which do not yet exist and they are free to withdraw from their agreement».

The ruling is especially important for a number of reasons. First, this case involved a contractual relationship in which the definitive agreement was subject to certain formalities in accordance with Article 7 of the SA Companies Act. The Supreme Court did not consider that the pre-contractual agreement (if one had existed) would have had to be formalised as final agreements are. Indeed, given that the agreement of intent was reduced to the level of a commitment of intent, it did not require the formalities of an effective agreement. Secondly, although the Supreme Court did not classify the document as a pre-contractual agreement, it seemed to admit that binding partial agreements might arise during the preliminary agreement stage. The Supreme Court did not make it clear whether these partial agreements require the consent of the parties as to the entire legal relationship, or if they were effective regardless of the outcome of the negotiation. Neither did it define any special consequences that would result from not honouring the commitments in an MOU; in fact, the claimant did not request compensation, but the performance of those commitments. Nor did the court analyse if such agreement bound the parties to continue negotiating in good faith.

In summary, the conclusion to be drawn is confusing. Unlike earlier rulings, the Supreme Court determined that it could neither supply incomplete terms of the agreement nor could it order compensation for losses and damages, given that the party did not provide full consent. Nor did it reach any conclusion on the duties to continue negotiating in good faith. The Supreme Court considered that the document in question was an agreement to agree with no binding effects, a decision that may be supported on grounds of fairness (which is not obvious). Indeed, the surprising factor is that after more than half a century of evolution of case law, the last decision of the Supreme Court resorted to the all or nothing rule.

The issue of enforcing an «option to purchase» arose again in Spanish case law and was resolved by the Supreme Court Judgment of 30 March 2010, and which provides a counterpoint to the Ruling of 1998. The seller had instructed the bank to initiate a process to have its shares approved for listing and the parties had agreed that upon approval the bank would subscribe for a percentage of the offering. However, before the seller had issued the new shares, the bank stated that it would not buy them. The seller filed a claim requesting performance of the purchase obligation as well as ancillary compensation for breach of contract. The shares were issued, but their acquisition could only be executed if the bank stated its intention to buy. The issue was whether the bank had already made such statement in advance, so that its effective fulfilment depended only on a condition precedent. Alternatively, was the first commitment a mere preliminary agreement to provide specific consent in the future and execute the purchase? The three courts favoured the first approach and found for the claimant. The court stated that the appeal decision did not alter the order assigned to the parties for the execution of the anticipated agreement. After affirming the party's failure to comply with the agreement, the court ordered that by having «stated its intent to subscribe» Banco de Santander Central Hispano, SA was obliged to execute the purchase. Pursuant to the claim presented, the Court of Appeal could have ordered the breaching party to pay monetary compensation in lieu of fulfilling its obligations under the agreement —under the maxim «no one can be compelled to a specific act» [*nemo praecise cogi potest ad factum*]—. Therefore, the court ordered the appellant, «in the event that consent is not given», to pay the amount requested by the claimant; i.e. thirty million fifty thousand six hundred five Euros.

The ruling does not mention Article 708 of the Spanish Law of Spanish Civil Procedure Act. The court ordered the appellant, as a consequence of the fundamental breach by the bank, to issue a declaration of intent in the future when the counterparty fulfilled an optional condition, which was not certain to occur. Under such terms, the declaration of intent (the subject matter of the ruling), could not be executed because the court may not substitute the reluctant intention to buy, unless the conditions had already been met at the time the claim was submitted. But how can it be that a statement of intent to enter into an agreement is as essential as the purchase agreement? Would it not be more consistent to consider that the bank had already made a commitment and that only the obligation to pay for the shares was pending? The rationale behind the ruling by the Lower Court and the Supreme Court was not clear: had the consent to buy already been provided (and payment was to be made once the conditions were met)? If not, the court could not order the party to provide such consent. Thus, two alternatives arise: the Supreme Court had deemed an agreement to agree enforceable, or the contractual consents had been provided fully in advance and only payment remained pending. The second is preferable. However, the decision was as stated above, with the absurd consequence that the seller could not directly enforce the decision as if it were an order to pay, but instead as an order to perform a personal obligation and then, only secondarily, request the «transfer» of ownership as part of the execution of the sentence, thereby violating the terms of Article 709 of the Spanish Law of Civil

Procedure.

8.8. IMPOSSIBLE PERFORMANCE (SUPREME COURT JUDGMENT OF 19 JULY 1994 [ARANZADI CASE LAW DIGEST NO. 6698 OF 1994])

In this case the parties had made ambiguous statements and commitments that were impossible to fulfil. Although the parties defined the documents as pre-contractual agreements, the Supreme Court did not order specific enforcement or compensation, as the agreement lacked effect.

Although the decision does not provide detailed analysis, the Supreme Court held that no enforcement or compensation may be ordered if the agreement was sufficiently ambiguous so as to prevent a ruling on compliance. Perhaps it was decisive that some of the future commitments agreed were not likely to be fulfilled. However, this should not be an obstacle if we consider the legal theory supporting the Supreme Court Judgment of 4 June 1991 (Aranzadi Case Law Digest No. 5325 of 1991) because ultimately it is necessary to determine which party is responsible for the lack of compliance, in which case, the agreement would not be null but breached.

8.9. POTENTIAL LIABILITY OF ONE OF THE PARTIES (SUPREME COURT JUDGMENT OF 28 DECEMBER 1995 [ARANZADI CASE LAW DIGEST NO. 9402 OF 1995] AND RULING OF THE PROVINCIAL APPEAL COURT OF VALLADOLID OF 9 NOVEMBER 1998 [CIVIL ARANZADI NO. 8974 OF 1998])

According to the Supreme Court, the so-called pre-contractual agreement as defined by the parties lacked the minimum essential elements required to define the intended legal relationship, which in this case was the construction of a building to be sold to the claimant. What was certain was that the buyer had already paid a deposit on the future purchase. The Appeal Court and the Supreme Court found for the claimant and ordered compensation, which amount was assessed under Article 1454 of the Civil Code; i.e. twice the amount paid as a deposit.

The legal theory supporting this ruling only makes sense if the agreement is part of an effective contract. An amount equal to twice the deposit was awarded because the seller (under Article 1454 of the Civil Code) breached a contract that the parties had already signed. However, if the pre-contractual agreement had not been binding, the seller may have not been held liable for any breach. Certainly, the deposit paid was part of the final price and it may not be interpreted that the future seller breached the contract. Thus, the rationale behind the ruling may be construed out of other reasons than those provided by the Supreme Court. In addition, the compensation order requiring the defendant to pay twice the amount of the deposit is questionable under the rules of unjust enrichment. If there had not been any binding agreement, the amount paid by the buyer would not have been justified for any reason and he could have requested reimbursement of the same. A compensation order may only be imposed if the pre-contractual agreement created binding obligations; i.e. requirements beyond the obligation to negotiate in good faith given that one of the parties had already starting fulfilling their obligations. The claimant requested that the defendant deliver the subject matter of the agreement rather than continue negotiations towards the sale and purchase agreement.

This ruling once more provides evidence of the third approach in Spanish Law between the obligation to negotiate (or continue negotiating) in good faith and the contractual obligations that arise from a contract with full force and effect. Compensation may be ordered by the court if one of the parties has broken off negotiations and if the following two conditions are met:

a) There is a supporting agreement that establishes the minimum conditions of the future legal relationship; and

b) One of the parties has already fulfilled some of the obligations.

On the other hand, the Ruling of the Provincial Appeal Court of Valladolid of 9 November 1998 is different and worth analysing.

There is evidence that the parties had not reached a definitive agreement because the creditor had requested a guarantee before agreeing to provide the land as stipulated in the exchange agreement. However, the claimant had initiated activities pursuant to this incomplete agreement and had commenced sales and marketing operations for the properties that would be built on the land at a later stage. The Appeal Court did not order compensation for breach with these preliminary arrangements.

The outcome of the ruling is appropriate if we analyse the facts considered. Each party carried the risk of their own investments during the negotiation stage, provided that «damage» was not caused by the arbitrary conduct of the defendant, but the marketing strategy of the claimant, who had not provided the contribution to which the counterparty had made final consent, conditional. It is not worth considering whether these requirements are fair relative to the economic impact or the exchange of mutual obligations. If the requirements and relative interests of the one of the parties are clear, the failure to meet the demand means that the counterparty will assume the costs of the failed negotiations.

8.10. MULTIPLE CONSENTS AND IMPLIED CONDITIONS (SUPREME COURT JUDGMENT OF 14 OCTOBER 1996 [ARANZADI

CASE LAW DIGEST NO. 7560 OF 1996])

This ruling does not deal with the issue of a document as a pre-contractual agreement or preliminary agreement, but it is worth considering as it deals with a case of failed negotiations and the assumption of risks when an operation is not concluded as agreed to in the initial terms.

Although it is not clear whether the parties had reached an agreement or had only reached a stage within the negotiation process, the ruling deals with a case in which seven individuals were to be joint and several guarantors but only two effectively signed the agreement, in which case the signatories would not be not bound, as the guarantee of the others would have been an implicit condition.

Unlike other contracts, a guarantee is not expressly required to be in writing provided it is not of a commercial nature in accordance with Article 440 of the Commercial Code, but this issue was not argued in the case. Certainly, this ruling would not be correct if the seven guarantors had reached an agreement in advance. If an agreement did exist, the failure to sign would be only an issue of evidence, not an issue of enforcement; unless all of the parties involved (including the creditor) agreed that any negotiation prior to the signing was only considered to be a preliminary arrangement. Given the difficulty of evidence with a non-written acceptance, it is possible to consider that like the case of commercial guarantees, these contracts are only enforceable once they are signed. If the individuals who did not sign the contract were not obliged as co-guarantors, why should the others be? Certainly, as indicated in the ruling, it is very important for joint and several co-guarantors to know the exact number of co-guarantors obliged to execute a collection action after payment under Article 1844 of the Civil Code. As this is undeniable, an implied condition is that contractual consent may not be separated (it is a condition of the contract). However, this is not always the case as demonstrated in Article 587 of the Civil Code involving the case of an easement agreement that failed in relation to some of the co-owners.

In summary, if the number of persons involved in the negotiation and the binding nature of their obligations are indivisible pursuant to the intent of the contracting parties; and if the negotiations collapse due to some of them, the entire «agreement» is ineffective for all of the parties, even if some consents have been provided.

However, the scope of the intention of the parties when signing the agreement remains to be defined. How much time may elapse without the condition precedent taking place and yet the signatories remain bound by the agreement? Would they be obliged to make the others sign? Could they be held liable if they prevent the others from signing? The answer is almost certainly no. Thus, this ruling illustrates an implied theory that, unfortunately, is not expressed as a rule in this judgment. If this type of agreement is generally entered into in writing, any oral consent or partial written consent provided is not binding, even for those who have signed, given that the definitive written document has not been signed by all of the individuals involved.

8.11. FAULT IN THE CONCLUSION OF A CONTRACT (SUPREME COURT JUDGMENT OF 16 MAY 1988 [ARANZADI CASE LAW DIGEST NO. 4308 OF 1988]; SUPREME COURT JUDGMENT OF 14 JUNE 1999 [ARANZADI CASE LAW DIGEST NO. 4105 OF 1999]; AND RULING OF THE PROVINCIAL APPEAL COURT OF NAVARRA OF 31 JULY 1999)

The Supreme Court Judgment of 16 May 1988 is the first court decision in Spain to determine pre-contractual liability when one of the parties breaks off negotiations[50)].

An employee of a bank was to be relocated to Miami and held a number of conversations with the directors regarding the transfer. He and his wife incurred expenses and made irreversible property arrangements believing that the agreement was final, all of which proved to be worthless when the transfer did not occur.

Although the parties had not entered into a definitive agreement, the Supreme Court ordered the defendant to pay all of the claimant's costs associated with the «failed» relocation under the principle of «fault in the conclusion of a contract» [*culpa in contrahendo*].

This is the first time the Supreme Court had interpreted that there is pre-contractual obligation pursuant to the general principle of *«alterum non laedere»* [to not wound each other] as set out in Article 1902 of the Civil Code. The Spanish Supreme Court did not need any express provision (as does Italy with Article 1337 of the Italian Code), neither did it resort to the principle of good faith in the pre-contractual stage as set out in Article 1258 of the Civil Code. With this decision the Supreme Court did not establish the principle of fault in conclusion of a contract as an exclusive principle to define liability but simply limited its decision to the application of Article 1902 of the Civil Code.

However, this broad rationale of «not to wound each other» is not sufficiently precise to determine whether such liability may apply in other cases. As the decision was not supported by a more technically precise principle of good faith, it does not predict when liability will arise. Alternatively, its application may result in a disproportionate application of pre-contractual liability in the event that someone raises a claim for damages related to failed preliminary arrangements. On the other hand, although Article 1902 of the Civil Code may be used to support liability claims, it does not provide an approach that can be used to determine if damages for the breach of preliminary arrangements are unfair, unless it is ultimately held that any such damage is actually unfair.

One last note about this case is that the use of the principle of fault in conclusion of a contract was unnecessary as there was already an employment contract between the parties. Almost certainly, it was a case of failure to comply with an effective agreement.

For the purposes of this analysis, the Supreme Court Judgment demonstrates that there is a principle of liability relating to the breach of preliminary arrangements, but does not define its application. Thus, the issue in question is not an academic or legal opinion about a tacit agreement, but pre-contractual liability as applied to the concept of unfair damage, as set out in Article 1902 of the Civil Code. Therefore, two major issues arise:

a) The need to define a «standard of unlawfulness» to help determine if damages are unfair with no certainty as to the outcome of the proceeding; or

b) The concept of holding the party in default liable due to the mere existence of damage.

Therefore, it is not possible to explain to parties engaged in a negotiation what criteria are followed in Spanish case law to determine liability resulting from failed negotiations.

The Supreme Court Judgment of 14 June 1999 also resolved a case of broken preliminary arrangements, although it ruled against the claimant; the City Council.

The City Council bought land for the operation of a slaughterhouse. It agreed to sell the land to the defendant who would be in charge of building the slaughterhouse on the condition of receiving public subsidies. In response to the claim raised, the defendant stated that he was not granted the subsidies and that «given the current situation in our sector, such an investment would be unfeasible even if subsidies were granted». The Appeal Court held that there was extra-contractual liability for breaking preliminary arrangements.

Pursuant to the Supreme Court, four elements should be present to determine liability: (i) a reasonable level of expectation and reliance that a final agreement will be concluded; (ii) an unjustified breach of the preliminary arrangements; (iii) effective damage; and (iv) a causal relationship. According to the Supreme Court there was no such reliance given that the City Council bought the land knowing the operation was dependent on public subsidies, and the Council had pre-emptively bought the land in any event.

The decision does not provide detailed reasoning and seems to follow a rigid «standard» to determine that there was no liability. The court should have considered what the defendant stated; i.e. that the project was not feasible even if the subsidies had been granted. In other words, the defendant did not have any other intention but to recover an option that he had waived at the onset of the negotiation. Thus, under the principle of good faith, this waiver implied that unfavourable market conditions would be a risk already «assumed» by the defendant. In addition, he did not notify the City Council of any negative conditions in the market, of which he had better knowledge, before the claimant proceeded with the investment. It is difficult to believe that the reliance of the City Council on the defendant would not been have sufficient grounds, given the typically cautious and slow procedures public administrations adopt when making transactions with third parties. This case is even more serious given the opposing interpretations of the Appeal Court and the Supreme Court.

Although the lack of reliance by the defendant is sufficient for the Supreme Court to order against the claimant, it is not clear what «justification» may apply if the breach of preliminary agreement gives rise to liability if reliance existed. Similar to the decision of 1988, there are no standards to set a general rule.

The Ruling of the Provincial Appeal Court of Navarra of 31 July 1999 (Civil Aranzadi No. 1906 of 1999) resolves a case of an alleged action in contrary to good faith during a negotiation.

Article 516 of the Compilation of Civil Law of Navarra expressly recognises that an open agreement during a negotiation stage may be binding; in other words, a consensual agreement in anticipation of a future definite agreement is binding even if it does not include all of the essential elements required to conclude the final agreement. This ruling holds that misleading behaviour by one of the parties during the negotiation stage, which is alleged to be contrary to good faith, would mean that there would not be a consensual agreement even though it may be partially specified. Breaching the rule of good faith in preliminary arrangements voids nonspecific pre-contractual consent (although not subject to an order of enforceability, it may give rise to compensation). Given that the court did not distinguish between compensation for reliance loss and compensation of positive interest, it is not possible to determine if breaching the rule of good faith in the negotiation stage in extra-contractual liability is equivalent to breaching a quasi-contractual agreement partially specified.

8.12. AGREEMENTS AND CONSENSUAL PRE-CONTRACTUAL AGREEMENTS OF REAL CONTRACTS (RULING OF THE PROVINCIAL APPEAL COURT OF BALEARES OF 12 MAY 1997 [CIVIL ARANZADI NO. 1144 OF 1997]; RULING OF THE PROVINCIAL APPEAL COURT OF MADRID OF 4 JUNE 1998 [CIVIL ARANZADI NO. 1420 OF 1998] AND SUPREME COURT JUDGMENT OF 20 APRIL 2001 [ARANZADI CASE LAW DIGEST NO. 5282 OF 2001]

The Ruling of the Provincial Appeal Court of Baleares analysed the case of a preliminary agreement of a commitment to offer collateral, whose object was fully specified in the agreement. Under these circumstances, the Appeal Court a specific

action consistent with the granting of the pledge.

Binding pre-contractual agreements of future real contracts are the only preliminary agreements with their own meaning and purpose, even if their essential elements are entirely determined. Regardless of their level of specificity, they do not give rise to specific action, as is the case with a definitive real contract. It is important that the judgement limits itself to an action; i.e. the issuance of a statement of intent and the delivery of the object, whether it be a personal obligation or not. The purpose of a preliminary agreement is often different from that of the intended contract; a situation which gives the pre-contractual agreement its own meaning and purpose.

The Ruling of the Provincial Appeal Court of Madrid is similar to the case cited above. It deals with a consensual preliminary agreement to enter into a future loan agreement. Although the specificity of the preliminary agreements is not clear, in the view of the court the lender had created sufficient expectation for the borrower, but the expectation was not fulfilled, as the loan was not granted. It is worth noting that the latter had already initiated construction of the property that was to be financed by the loan. Pursuant to the Appeal Court, unspecified and unfulfilled expectations arose and had to be compensated regardless of whether the document was a consensual definitive loan agreement or a pre-contractual agreement to enter into a future loan agreement.

Thus, ambiguity arises once again as to the assessment of compensation.

i) Compensation for reliance loss (the so-called negative interest): The claimant sought compensation for costs incurred in securing an alternative loan (loss incurred in reliance of the pre-contractual negotiation that failed).

ii) Compensation for performance interest such as loss of prospective profits (the so-called positive interest): This claim would not be successful as almost certainly the essential elements of such an agreement were not entirely specified, and there was only an unjustified breach of preliminary arrangements.

The Supreme Court Judgment of 20 April 2001 rejects compensation for the breach of preliminary arrangements to grant a refinancing loan. It was a complex operation in which a bank would grant a loan to refinance debt by paying off the loan of another preferred mortgage bank. The offer of the financing bank to the preferred bank was subject to the condition of suspending the second auction, which was still held in spite of the absence of any qualifying bids. In addition, the preferred bank, in its response to the financing bank, reduced the amount of the loan to be postponed. And finally, the operation was conducted by the director of an office but was not approved by his superior. The debtor raised a claim against the financing bank for breach of a pre-contractual agreement seeking compensation equal to the lower value at which the property would have be sold to prevent foreclosure. The Supreme Court «rejected» compensation because it interpreted that there was no effective consent to a pre-contractual loan agreement. The Supreme Court held the view that this would be the only possible reason for pre-contractual liability. It did not support the view that broken preliminary arrangements are in themselves a sole source of liability.

8.13. MEMORANDA OF UNDERSTANDING AND PRE-CONTRACTUAL AGREEMENTS WITH CONDITION SUBSEQUENT (SUPREME COURT JUDGMENT OF 24 JULY 1998 [ARANZADI CASE LAW DIGEST NO. 6393 OF 1998])[51)]

The parties entered into an agreement whereby one of them stated the intention to partner with the other to set up four cinema theatres on premises owned by the counterparty. One of the parties would construct the four theatres upon completion of the relevant legal procedures although they had already agreed that any change imposed by competent authorities in connection with the number of rooms and other characteristics, would be accepted in advance. Such facilities «would be of an acceptable average quality». However, the final project was to be subject to approval by the counterparty. The operating costs of the theatres would be divided equally between the parties. «The parties hereto agree that each of them owns 50% of the premises and of the business. To such effect, should the parties deem it reasonable or necessary in the future, they shall set up a company and each party shall own 50% of the shares thereof». The agreement was also subject to the condition that the party providing the premises would deliver them vacant of tenants. If it were not possible to achieve the objective of the agreement, it would become null and void, and each party would be responsible to pay 50% of the costs incurred. Once the conditions were met, the responsible party would have a period of 18 months to construct the theatres. If at the end of that time the theatres were not completed, the agreement would be terminated as a matter of law, and the premises would revert to the owner without any right to claim for compensation for the improvements made. Six years after the agreement was signed, the premises were still occupied by tenants. The premises were then sold to a third party by the owner. The counterparty to the previous agreement claimed compensation: 50% of the value of the premises plus 50% of the business whose operation had been hindered by the defendant.

The Supreme Court did not consider the parties had entered into simple agreements, preliminary arrangements or non-binding memoranda of understanding, but instead a pre-contractual agreement or a definitive agreement of a *de facto* partnership [sociedad irregular] under a condition precedent. Article 1118 of the Civil Code was applied by analogy given that the parties had not defined the allowable period to fulfil the positive condition (similarly to Supreme Court Judgment of 5 October 1996 [Aranzadi Case Law Digest No. 7041 of 1996]). It was ruled that the defendant did not fail to comply with the agreement as the agreement was deemed ineffective because the condition precedent had not been met.

The Supreme Court Judgment reached the same conclusion as the Provincial Court whereby the agreement was deemed to be a mere non-binding commitment of intent. The issue was not raised as to the potential classification as an agreement or a pre-contractual agreement (although a definitive agreement requires specific formalisation to be effective). Nor did the court consider either the liability of the party whose actions had prevented the condition precedent from taking place or the impact of the actions taken by each party in the time that lapsed between the definition of the arrangement and its final execution or the failure of negotiations. This decision once again demonstrates the confusion of concepts.

In its analysis, the Supreme Court «mixed» various theories on pre-contractual agreements and reached a different conclusion. The court even confused the date the agreement came into force with its effectiveness by stating that the agreement had not entered into effect before the condition was performed. The decision also revealed the insignificance of classifying a document as a definitive or pre-contractual agreement. Historically the analysis has been based on whether an agreement is binding or non-binding (i.e. if subsequent obligations are enforceable), with the issue of whether the binding obligations arise from a pre-contractual or definitive agreement being irrelevant.

8.14. OFFERS, PRE-CONTRACTUAL AGREEMENTS AND INCORPORATION OF TERMS BY A THIRD PARTY (SUPREME COURT JUDGMENT OF 29 NOVEMBER 2000 [ARANZADI CASE LAW DIGEST NO. 9245 OF 2000])[52)]

A shareholder gave notice to the President of a private company of its intention to sell shares. Two shareholders responded to the offer, but did not agree to the requested price. The selling shareholder did not accept the counteroffer, but agreed to submit to arbitration pursuant to the company's articles of association and granted a 15-day period to subscribe for the shares. The claimant submitted a draft arbitration agreement to the company and the buyers stated that they would only accept an arbitrator if conducted by a major auditing firm with recognised capability. Given that the arbitration agreement was not formalised, the seller notified the President in writing that he would withdraw the offer. The Provincial Appeal Court considered the entire negotiation process to be mere preliminary arrangements and ruled against the shareholders who requested the execution of the share acquisition. Pursuant to one of the clauses of the articles of association «Should there not be agreement on the price, it shall be determined by three independent arbitrators in equity duly appointed pursuant to Law No. 36/1988 on Arbitration». The Supreme Court reversed the decision and considered that there was a formal agreement as the price was to be determined by the arbitration of a third party pursuant to Article 1447 of the Civil Code. Although the articles of association referred to them as arbitrators, this was not the case as they resolved an issue of a non-legal nature linked to a legal relationship between the parties, relying on the Supreme Court Judgment of 10 March 1986 (Aranzadi Case Law Digest No. 1168 of 1986).

It is clear that the articles of association contain inappropriate provisions, as it should not establish that the Law on Arbitration serve the function of supplying terms to an incomplete agreement. However, the Supreme Court Ruling does not seem to be clear. The «arbitrators» were not appointed by the parties and no other procedure had been considered other than that set out in the law. Under Article 1447 of the Civil Code, the court is not empowered to supply missing contractual terms in order to enforce the appointment of arbitrators if the parties do not agree on the qualities and requirements that they should meet. Consider how strange it would be if the courts were empowered to supply the terms, given that the Civil Code has not provided them with the power to supply terms that arbitrators are not willing or able to define —in which case «the agreement would become ineffective»—. It may be understood that the intention of the parties is to agree that the court integrate an incomplete statement of intent (apparent dissent) by applying the analogous Law on Arbitration. However, the questionable issue is that the law accepts this outcome and that the court may incorporate terms to incomplete agreements resulting from deliberately unfinished negotiation (excepting cases of hidden disagreement or a hidden lacuna) or that contain a clear disagreement on a specific issue. The Ruling of the Provincial Appeal Court of Barcelona of 30 November 1998 (Civil Aranzadi No. 2352 of 1998) had already affirmed (even though not clearly) that parties may bring a case of an incomplete negotiation directly to the court in order to have the missing terms supplied without having to resort to arbitrators as set out in Article 1447 of the Civil Code. It seems to me that this legal theory is questionable and I would refer to the Supreme Court Judgment of 24 June 2003 (Aranzadi Case Law Digest No. 4258 of 2003).

To conclude, this analysis does suggest that the ruling may not have been appropriate. If the issue related to an arbitration clause, the claim would be rejected given that the parties agreed to the document and therefore, it would be effective. While there is no agreement on the price, the articles of association include an arbitration clause that sets out an arbitration procedure subject to the Law on Arbitration (Articles 38 et seq.). Thus, the lack of agreement is not a disagreement but a «conflict» arising from a definitive agreement. There is no other option: if an agreement on the price had been required, the arbitration clause would not have arisen.

8.15. CONCLUSIONS

A number of conclusions are worth drawing from the most relevant Spanish case law discussed above. However, it should be noted that none of the statements relating to the legal practice of the Courts will be definitive, but at least it may be possible to analyse case law trends which are more than occasional. Spanish case law is rather incoherent and is often driven by improvisation. Therefore, it is advisable not to reach fixed conclusions.

i) It is not possible to determine clearly the limits of the powers granted to the courts to incorporate terms into

incomplete agreements. Sometimes substitutions of incomplete statements of intent are only a formality given that the parties have already expressed their intention wholly and effectively at a prior stage. However, not only do courts substitute for fully documented consent, but incorporate missing terms into agreements provided essential terms have already been agreed by the parties.

ii) The Supreme Court has not definitively supported one or other theory on the concept of the pre-contractual agreements. The key focus has always been placed on the degree of specificity defining the commitment for which compliance was claimed. Historically, Spanish courts have struggled to explain the various theories of pre-contractual agreements, to put forward appropriate criteria or to criticise other approaches. However, it has always been an unnecessary effort in the way to find the real criteria to resolve the claims.

iii) If statements of intent are sufficiently developed, the courts proceed directly to «final» compliance rather than ordering the parties to provide further consent, regardless of the definition given by the parties to such agreement. A statement of intent is sufficiently developed or «anticipated» if defined pursuant to Article 1273 of the Civil Code (i.e., the court may rule in favour of compliance with no need for a new agreement), when there are no outstanding conditions precedent yet to be fulfilled (even conditions affecting the authority of the parties) provided there are no counterstatements or exceptions on the degree of the binding or non-binding nature of the commitment given.

iv) Spanish courts may uphold the view that a commitment is not sufficiently specified to request specific performance. However, such an event may not prevent the party from claiming compensation non-compliance. This legal practice is not logically self-consistence though. Inconsistency stems from the fact that in order to claim for compensation for breach of an agreement, firstly there should be an effective agreement in place. This is only possible if it is sufficiently defined —thus, enforceability should also apply—. It may be thought that breaking off negotiations in good faith automatically leads to an independent source of liability, other than breach of contract. However, such criteria are not found in the court rulings ordering compensation for non-performance of agreements which in turn are not sufficiently defined.

v) Although there is some case law relating to pre-contractual liability in the event of failure to comply with arrangements at the preliminary negotiation stage, there is no precise definition of the source of law, content and limits of the duty to negotiate in good faith. There is no defined relationship between memoranda of understanding and the duty to negotiate in good faith.

vi) Compliance or failure to comply with a memorandum of understanding is deemed substantial by the court if a party has made irreversible investments or property transfers in good faith towards the execution of the agreements.

vii) Typically, the courts may classify a relationship as being a memorandum of understanding in order to exclude effects —even to prevent claims for compensation for damages—.

viii) The Supreme Court has stated only once that the *negotiation of a contract* may be considered a valid obligation. Thus, the party in default may be ordered to do so.

8.16. FINAL NOTE ON SECTION 708 OF THE SPANISH CIVIL PROCEDURE ACT/2000

Surprisingly, a procedural law defines the concept and scope of pre-contractual agreements in Spanish Law: Article 708 of the Spanish Law of Civil Procedure/2000.

If the party fails to issue a statement of intent ordered by a court decision, the court may supply the term «provided that the essential elements of the agreement were defined previously». If non-essential terms were not agreed, the court shall define them «pursuant to the usual legal or commercial practice». If essential terms of the agreement lack specificity «compensation for losses and damages shall apply».

It is worth highlighting the new criteria introduced by this article[53]. Firstly, the courts may incorporate statements of intent into contractual agreements even if the terms defining the subject matter have not been entirely defined. Secondly, even if terms are not incorporated into an agreement because the parties have not agreed on the essential elements, compensation for damages may nevertheless still apply if a party refuses to complete negotiations. However, as mentioned above, procedural law restricts most of the practical effect which was originally intended. Although the rule requires a prior decision of the court ordering the party to issue a statement of intent, it does not set out the substantial conditions required for making such an order.