Should a Dispute Under a Letter of Intent Be Arbitrated?

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Introduction

This article will explore some issues concerning arbitration of disputes arising under a letter of intent (an “LOI”). Arbitration clauses are often included in the final transaction documents but are rarely found in an LOI. Although [the party (the “Offeror”) offering a deal summarized in an LOI to the counterparty (the “Offeree”)] the parties may be reluctant to burden the LOI with a dispute resolution provision, it may nevertheless be a good idea to consider whether arbitrating such disputes is appropriate.

Although one can debate the advantages of arbitration, final transaction documents, especially in cross-border transactions, often provide for arbitration as a means to avoid the inhospitable courts of a foreign jurisdiction, to better ensure confidentiality, and because an arbitration award may more easily be enforceable in some countries than a foreign judgment. The same considerations apply to a dispute arising out of an LOI. Such disputes include whether the LOI is binding, if a deposit is refundable when the deal collapses or whether a party failed to negotiate in good faith or deliberately failed to fulfill a condition to the transaction as a means of aborting the transaction.

The answer to the question whether such disputes should be arbitrated may depend on whether the question is asked of the Offeror or the Offeree. The Offeror may not need arbitration to pursue a claim against the Offeree if retention of a deposit is the Offeror’s sole remedy or if the Offeror is less likely to assert a claim than the Offeree. Absent arbitration, the Offeree would have to assert its claim against the Offeror in a court having personal jurisdiction over the Offeror. If the Offeror is comfortable that a court in the Offeree’s home country will not have jurisdiction over the Offeror, the risk of litigating in the Offeree’s jurisdiction is reduced.

If Arbitration Is Not Desired

Avoiding arbitration is simple: a party can only be compelled to arbitrate pursuant to a binding, written (not necessarily signed) agreement to do so. If the LOI contains no arbitration clause and none can be inferred, there will be no basis for arbitration.

If Arbitration Is Desired

To provide for arbitration, the LOI must include an arbitration clause or effectively incorporate one by reference from another document binding on the parties. The first draft LOI can simply provide that “All disputes arising out of or related to this LOI shall be resolved in New York City, New York by arbitration in accordance with the rules in effect on the date of this LOI of the [specify the arbitration tribunal – e.g. the International Centre for Dispute Resolution].” Although such an abbreviated clause will leave issues unresolved about the arbitration, brevity may nevertheless be appropriate in an LOI because it is less obtrusive than a “full blown” arbitration clause and if not objected to, it should be sufficient to get the dispute and resolution of the omitted matters determined by the arbitrator in accordance with tribal rules.

When signed by both parties, an LOI containing an arbitration clause will ordinarily create a binding agreement to
arbitrate. Even LOIs providing that the parties will only be bound by final transaction documents often specify that some LOI terms are binding, such as the provisions concerning payment and refund of deposits and fees, confidentiality and perhaps a “no-shop” provision. An arbitration clause can easily be included in this list.

**The Risk of the Unintentional Arbitration Clause**

One can have a binding arbitration agreement embedded in a non-binding LOI because in determining whether there is a binding agreement to arbitrate, the arbitration clause will generally be treated as a separate contract.\[1\] Suppose the Offeror sends a non-binding LOI that includes an arbitration clause and the Offeree does not strike or object to it, but instead provides comments to other provisions in the LOI, pays the deposit to the Offeror and proceeds with negotiations for the definitive documents before the deal collapses with each side blaming the other.\[2\] Although these facts, without more, should not give rise to an enforceable arbitration agreement, the result may not be certain and there could be a question of whether the existence of a binding arbitration agreement will be decided by an arbitrator. The party receiving a draft containing an arbitration clause should strike or otherwise indicate its rejection of the clause if it does not want to arbitrate LOI disputes. At least by so doing, the issue of arbitration can be discussed along with the other business terms at the LOI stage.

Under New York and U.S. federal law, absent a contrary agreement, the question whether a binding arbitration contract exists is a question of law to be decided by the court, not by an arbitrator.\[3\] However, absent a contrary agreement, the specification in the arbitration clause of the tribunal selected to act as arbitrator invokes the rules of that tribunal and may result in the arbitrator deciding the question whether a binding arbitration agreement exists.\[4\] Article 15 of the International Dispute Resolution Procedures of the ICDR provides that “[t]he Tribunal shall have the power to rule on its own jurisdiction, including any objections with respect to the existence, scope or validity of the arbitration agreement.” To the same effect are Rule 8(a) of the AAA Commercial Arbitration Rules, Article 23 of the Rules of the London Court of International Arbitration, and Article 6.2 of the Rules of Arbitration of the International Chamber of Commerce.

**Conclusion**

Arbitration clauses are not often included in an LOI, but arbitration might make sense in some situations. Parties should be clear in expressing their intent regarding the existence of an arbitration agreement to avoid the need for a court or an arbitrator to decide whether a binding arbitration agreement exists concerning disputes arising out of the LOI.

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\[2\] The same question arises if the Offeror sends an LOI without an arbitration clause and the Offeree sends a marked-up draft of the LOI back to the Offeror that adds an arbitration clause. A discussion of the extent, if any, to which Section 2-207 of the Uniform Commercial Code (the so-called battle of the forms section relating to sales of goods) applies to a determination under these facts of whether there is a binding arbitration agreement is beyond the scope of this article.

\[3\] See Three Valleys Municipal Water District v. E.F. Hutton & Company, Inc., 925 F.2d 1136 (9th Cir. 1991) (U.S. federal law); 5 N.Y. Jur. 2d., §§ 69–70 (New York law). The Federal Arbitration Act of the United States (9 U.S.C. § 1 et seq.) governs arbitration of disputes arising *inter alia* under contracts affecting interstate commerce and preempts more restrictive state law. See, e.g., 5 N.Y. Jur. 2d., § 69. Almost any finance, lease or sale transaction relating to an aircraft will be deemed to “affect interstate commerce.” But since there is no inconsistency between New York State and federal law on this issue, there should be no federal preemption.

\[4\] Apollo Computer, Inc. v. Helge Berg, et al., 886 F.2d 469 (1st Cir. 1989); In re Application of RD Mgmt. Corp., 196 Misc. 2d 579, 766 N.Y.S. 2d 304 (Sup. 2003) (relating to the scope, not existence, of an arbitration agreement). The party opposing arbitration will probably not want to have the dispute resolved by an arbitrator who gets paid only when there is a controversy to arbitrate, and who is not necessarily bound to follow governing law. But even court decisions are often based on a policy that strongly favors arbitration.

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