Dear Colleagues,

I'm so looking forward to seeing you later this month.

Attached is a recent article, Deal Momentum, on the role of non-binding agreements in mergers and acquisitions. This article is the first phase of a two-phase project.

In the next phase, I'm working with social psychologists to test, through online experiments, whether entering into a non-binding contract changes rates of adherence and satisfaction with bargains. I will present our research design and would be grateful for your thoughts, especially because this is a completely new type of research for me.

Thank you for reading!

Best,
Cathy

U.C.L.A. Law Review

Deal Momentum

Cathy Hwang

ABSTRACT

Why do parties use non-binding agreements? This Article explores the role of non-binding preliminary agreements in mergers and acquisitions (M&A) deals. It provides a modern, comprehensive account of how and why sophisticated parties use these common bargaining tools, even when they have the option of using binding contracts.

In private M&A deals, parties enter into non-binding preliminary agreements, such as term sheets and letters of intent. Once parties sign a non-binding agreement, they behave as though bound and almost always follow up with a formal contract with terms that closely resemble the non-binding agreement's terms. Scholars and courts have long treated preliminary agreements as contract-like tools that parties will enforce when counterparties breach. This Article develops an alternative explanation for why parties use non-binding preliminary agreements. These agreements are not contracts—rather, they are signposts for when enough momentum has accumulated that a deal is likely to go forward. Despite not being contracts, however, preliminary agreements' signaling, organizational, and formal functions can facilitate complex dealmaking.

Using interviews with deal lawyers, this Article provides a rich and layered account of how sophisticated parties use these agreements in modern dealmaking. Parties almost never disclose non-binding preliminary agreements publicly, so interviews offer a rare glimpse into this common, but little-understood, deal practice. This Article also differentiates, for the first time, between the formal and substantive functions of preliminary agreement-making. By focusing on these agreements' contractual qualities (their substantive functions), scholars have overlooked their useful formal functions. By reframing preliminary agreements as signposts for deal momentum, rather than as contracts, this Article highlights those functions, and discusses the implications of this reframing for contract theory, contract enforcement, and deal design.

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INTRODUCTION

In 2015, the Delaware Supreme Court awarded $113 million in expectation damages when a sophisticated party did not honor the terms of a two-page preliminary agreement.[1] Over a ten-year battle, the Delaware courts' four decisions in *SIGA Technologies Inc. v. PharmAthene Inc.*[2] stirred up a storm of interest from deal lawyers.[3] They also brought to light a long-standing and puzzling practice in dealmaking: the use of non-binding preliminary agreements. Why do parties use non-binding agreements to memorialize high-stakes deals, especially when they have the option to use formal, binding contracts?

Much of contract law scholarship has focused on questions of enforcement after a contract is breached. The ability to sue and recover damages for breach of contract ex post is understood as a way to motivate party behavior ex ante. In the absence of formal enforcement, informal

1. SIGA Techs., Inc. v. PharmAthene, Inc., 132 A.3d 1108 (Del. 2015); SIGA Techs., Inc. v. PharmAthene, Inc., 67 A.3d 330 (Del. 2013).
2. 132 A.3d 1108; 67 A.3d 330.
3. *See, e.g.*, ANDREW J. COLOSIMO ET AL., FRIED FRANK, PRACTICE POINTS FOR TERM SHEETS, LETTERS OF INTENT, AND UNDERTAKINGS TO NEGOTIATE IN GOOD FAITH—BASED ON DELAWARE SUPREME COURT'S SIGA DECISION, 1 (2016), http://www.friedfrank.com [https://perma.cc/ZVZ8-89BS] (emphasizing "the importance of clarity in a term sheet or letter of intent with respect to whether there is a binding obligation to negotiate in good faith and what the scope of that obligation is"); Patrick Klingborg, *When a "Non-Binding" Letter of Intent Is Binding After All*, LINCOLN, GUSTAFSON, & CERCOS, LLP (June 1, 2016), http://www.lgclawoffice.com [https://perma.cc/D84X-3F5C] (noting that Delaware's decision in *SIGA* was "different from the California approach" and that "[t]he best practice, therefore, is to be sure a letter of intent accurately characterizes what you intend to negotiate in good faith regardless of whether the letter of intent states it is 'non-binding'"); Philip Richter, *Negotiation in Good Faith*—SIGA v. PharmAthene, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 27, 2016), https://corpgov.law.harvard.edu/2016/01/27/negotiation-in-good-faith-siga-v-pharmathene [https://perma.cc/HNM6-CM89] ("Based on *SIGA*, as a practical matter, expectation damages will now be a real possibility in Delaware for breaches of agreements to negotiate in good faith."); *see also, e.g.*, C. THOMAS BROWN ET AL., ROPES & GRAY LLP, *Delaware Supreme Court Upholds Award of Expectation Damages in Breach of Contract Claim*, *in* ROPES RECAP: MERGERS & ACQUISITIONS L. NEWS 10, 11 (2015), https://www.ropesgray.com/newsroom/alerts/2016/February/The-Ropes-Recap-Mergers-Acquisitions-Law-News.aspx [https://perma.cc/GG7D-G4Q9] (describing the Delaware Supreme Court's decision in *SIGA* and the history of the case, and noting that in a dissent, Justice Valihura noted that the majority's decision "would move Delaware out of alignment with other major commercial jurisdictions . . . by eroding the requirement that damages be proved with reasonable certainty").

enforcement, such as damage to one's reputation, can also motivate deal parties to play by the rules.[4] What little scholarship exists about preliminary agreements also focuses on enforcement. Scholars have debated, for instance, whether a preliminary agreement creates a legal obligation to perform, and if so, whether breaching parties should be liable for reliance or expectation damages.[5] But to understand whether and how to enforce preliminary agreements, we must first address fundamental questions: Why do sophisticated parties use non-binding preliminary agreements at all? And, if these agreements are not binding, why do deal parties abide by their terms?

This Article begins the inquiry from the perspective of contract design,[6] rather than enforcement, to understand the role of preliminary agreements in

4. *See, e.g.*, Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992) [hereinafter Bernstein, *Opting Out*] (describing trade association enforcement of contractual breaches); Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 MICH. L. REV. 1724 (2001) [hereinafter Bernstein, *Private Commercial Law*] (explaining that reputation-based nonlegal sanctions create a powerful enforcement mechanism, essential to the function of the private legal system created by the cotton industry); Robert C. Ellickson, *A Hypothesis of Wealth-Maximizing Norms: Evidence from the Whaling Industry*, 5 J.L. ECON. & ORG. 83 (1989) [hereinafter Ellickson, *A Hypothesis*] (presenting evidence of informal enforcement—norms—overtaking formal enforcement in the whaling industry); Robert C. Ellickson, *Of Coase and Cattle: Dispute Resolution Among Neighbors in Shasta County*, 38 STAN. L. REV. 623 (1986) [hereinafter Ellickson, *Of Coase and Cattle*] (describing how rural cattle ranchers in Shasta County, California, abide by norms rather than rules, and how animal trespass disputes are settled by self-help, rather than formal legal enforcement mechanisms); W. Bentley MacLeod, *Reputations, Relationships, and Contract Enforcement*, 45 J. ECON. LITERATURE 595 (2007) (describing the use of informal enforcement to police contract defaults).

5. As Philip Richter explained:

> In SIGA's case, a damages award based on reliance would have led to a far better economic result than it would have received from entering into the license agreement on the contemplated terms. The real potential in Delaware for *expectation damages* for breach of an obligation to negotiate an agreement in good faith should change the calculus for a party considering whether to breach this type of obligation.

Richter, *supra* note 3.

6. Other scholars have approached contract questions from the perspective of ex ante design, rather than ex post enforcement, with interesting results. *See, e.g.*, Albert Choi & George Triantis, *Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions*, 119 YALE L.J. 848 (2010) (arguing that parties can use vague contract provisions efficiently—for example, material adverse change clauses in acquisition agreements may remain vague because they are rarely litigated); Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 YALE L.J. 814 (2006) [hereinafter Scott & Triantis, *Anticipating Litigation*] (examining the efficiency of investment in the design and enforcement phase of the contracting process, and arguing that parties can lower overall contracting costs by using vague contract terms ex ante and shifting investment to the ex post enforcement phase); Robert E. Scott & George G.

dealmaking. This inquiry reveals that parties primarily use non-binding agreements to add formality to an otherwise murky pre-contractual deal process. Preliminary agreements mark the moment when deal parties have resolved most deal uncertainty and are likely to do a deal together, whether or not they sign a preliminary agreement. Instead of causing parties to behave well, preliminary agreements merely mark the moment when parties were already primed to behave well, with or without an agreement.

Private mergers and acquisitions (M&A) deals are a helpful lens through which to understand early-stage dealmaking. In the early stages of a private M&A deal, parties often outline the material terms of their deal in a non-binding preliminary agreement, such as a term sheet, letter of intent, or memorandum of understanding.[7] These short agreements often list only a few material business terms, such as price and what is being sold, and can be signed or unsigned. In some ways, these can be understood as written versions of handshake agreements, and resemble non-binding agreements in other contexts, such as engagements to be married.

Preliminary agreements in this context are, most often, not formal contracts: They create no binding obligation under the law.[8] In fact, like the

Triantis, *Incomplete Contracts and the Theory of Contract Design*, 56 CASE W. RES. L. REV. 187 (2005) (considering the role of litigation in motivating contract design).

7. *See* RALPH B. LAKE & UGO DRAETTA, LETTERS OF INTENT AND OTHER PRECONTRACTUAL DOCUMENTS: COMPARATIVE ANALYSIS AND FORMS 5–6 (2d ed. 1994) (describing term sheets, letters of intent, memoranda of understanding and other precontractual instruments as "a precontractual written instrument that reflects preliminary agreements and understandings of one or more parties to a future contract"). In the seminal case about preliminary agreements, *Teachers Insurance and Annuity Ass'n of America v. Tribune Co.*, 670 F. Supp. 491, 498 (S.D.N.Y. 1987), Judge Pierre Leval makes a distinction between "Type I" preliminary agreements and "Type II" preliminary agreements. *See* Ronald J. Gilson et al., *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine*, 110 COLUM. L. REV. 1377, 1426 n.163 (2010) (explaining that Type I agreements are those where the parties have agreed to material terms, but intend to follow-up with a formal, binding document). This Article is concerned with Type I agreements. But Type II agreements are also possible. Type II agreements are binding preliminary agreements, where "parties agree on certain terms but leave potentially important terms open to further negotiation. This requires courts to determine *whether* such an agreement had been made, *what* the duty to bargain in good faith entails, and *which* remedy should be awarded for breach of that duty." *Id.*; *see also* Alan Schwartz & Robert E. Scott, *Precontractual Liability and Preliminary Agreements*, 120 HARV. L. REV. 661, 664 (2007) (describing a Type I agreement as one in which "the parties have agreed on all material terms and intend to memorialize this agreement in a formal document").

8. *See* Cathy Hwang, *Unbundled Bargains: Multi-Agreement Dealmaking in Complex Mergers and Acquisitions*, 164 U. PA. L. REV. 1403, 1410 n.27 (2016) (describing an "agreement" as "a written bargain that might be a contract," as contrasted with a "contract," a "binding, enforceable obligation under the law").

term sheet in *SIGA*, M&A preliminary agreements are often explicitly marked "non-binding." They are also not meant to be enforced when breached.[9] Uniquely, M&A parties have both the means and the sophistication to create binding contracts. In fact, throughout an M&A transaction, parties repeatedly demonstrate their ability to create binding contracts, which they use to govern issues both large and small.[10] Thus, these sophisticated business parties' use of non-binding preliminary agreements is presumably intentional and considered, rather than the result of lack of resources or skills.

Other scholars have explored the role of preliminary agreements in dealmaking more generally. That scholarship tends to lump preliminary agreements from many commercial contexts into one study, which means that M&A preliminary agreements, which are somewhat of an oddball in world of sophisticated contracts, are overlooked. Existing scholarship also usually assumes that preliminary agreements are a type of contract, and that their enforceability is an important part of why parties abide by them.

Robert Scott and Alan Schwartz, for instance, examined over 100 cases involving preliminary agreements to determine preliminary agreements and how they ought to be enforced by courts.[11] They argued that parties use preliminary agreements when substantial deal uncertainty makes it impossible for parties to agree to the specific terms of an intended deal. While parties investigate deal specifics, they enter a preliminary agreement outlining a deal that will later be formalized in a binding contract, or abandoned if initial investigations show that the deal is not viable.[12] Schwartz and Scott argue that, to preserve preliminary agreements' important role in efficient dealmaking, and to encourage parties to make relationship-specific investments in a deal prior to resolving uncertainty, courts ought to award reliance damages when a party breaches a preliminary agreement.[13]

9. To the extent parties include binding and enforceable provisions, they are provisions related to the process of the deal, and not to the material business terms. For example, provisions related to confidential exchange of information during initial investigation may be marked binding, and breaches may be enforceable. However, those limited binding terms are carefully noted as such in the agreement. *See* Telephone Interview with N.Y. Firm Attorney I (May 7, 2016) (noting that parties usually begin with a statement that the agreement does not constitute a binding obligation on the parties, and then lists binding provisions, such as exclusivity, confidentiality, and governing law, for instance).
10. *See* Hwang, *supra* note 8 (describing the group of contracts and agreements that parties enter into as an "unbundled bargain").
11. *See* Schwartz & Scott, *supra* note 7, at 671 (describing their case survey methodology).
12. *See id.* at 662–63 (describing how parties enter into preliminary agreements).
13. *See id.* at 703–04 (arguing that "courts have a further facilitative role: to encourage exploration of investment opportunities by protecting the promisee's verifiable

Albert Choi and George Triantis offer another explanation for why parties use preliminary agreements: to cope with deal complexity. They argue that complex deals are entered into in stages—first a preliminary agreement, then a definitive contract—because some deals are "practically impossible for the parties to execute . . . in a single meeting or over a very short period of time."[14] Preliminary agreements allow time for parties to engage experts, such as lawyers. Those experts then use their expertise to fine-tune the terms of the deal and to draft the definitive contracts.[15] Like Schwartz and Scott, Choi and Triantis note that by imposing some legal bite—for instance, by imposing a legally binding standard of good faith or reasonable efforts to the negotiation of preliminary agreements—courts may improve deal efficiency.[16]

While both of these explanations are compelling, they present some puzzles. First, neither explains why parties commonly use *non-binding* preliminary agreements. If judicial enforcement of preliminary agreements motivates parties to act efficiently, why do parties go out of their way to indicate that they do not want judicial involvement?

Second, neither explanation addresses why parties often behave as though non-binding agreements are binding. Why do parties tend to enter into a definitive contract after they have signed a non-binding preliminary agreement? And why does that final contract often contain terms that closely resemble the preliminary agreement's initial terms?

This Article attempts to explain the role of non-binding agreements in modern dealmaking. It shows that these agreements are signposts. They mark a moment in the deal's lifecycle when enough uncertainty and complexity has been resolved that the deal is likely to go forward, and serve signaling, formality, and organizational purposes. Reframing preliminary

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reliance"—in other words, by attaching contract liability to parties who breach preliminary agreements).

14. Albert Choi & George Triantis, *The Design of Staged Contracting* 3–4 (Feb. 22, 2018) (on file with author) ("For complex merger or finance transactions, for instance, it is practically impossible for the parties to execute a fully binding contract in a single meeting or over a very short period of time.").

15. *Id.* at 13 (noting that experts hammer out details, which "contributes significant value to the transaction." They note, for instance, that lawyers are often involved in the fine-tuning of "representations and warranties, covenants, closing conditions, remedies and termination rights" and that "these can contribute significant value to the transaction"). *Id.*

16. *Id.* at 32 (noting that "[t]he use of a standard—such as good faith or reasonable efforts—to police the negotiation process seems an appropriate mechanism for legal enforcement of midstream agreements.").

agreements as markers for the accumulation of deal momentum explains why, once parties sign a preliminary agreement, they are likely to complete a deal, and on terms close to the preliminary agreement's terms. This explanation cuts against the conventional wisdom that preliminary agreements are contracts that need to be enforced to promote efficient dealmaking. Rather, preliminary agreements are useful tools even without enforcement.[17]

This Article proceeds in three Parts. Part I uses interviews with deal lawyers to show how parties and lawyers use non-binding preliminary agreements in modern dealmaking.[18] Preliminary agreements are almost never publicly disclosed, so original interviews with deal lawyers offer a rare glimpse into a common but little understood deal practice. An important contribution of this Part is that it attempts to accurately pinpoint when, in a deal's lifecycle, parties enter into enter preliminary agreements. Existing explanations describe preliminary agreements as first steps to a potential deal. In practice, however, parties enter a preliminary agreement when the deal is already likely to move forward. Part II introduces the concept of deal momentum. This Part draws an analogy to Lon Fuller's distinction between the formal and substantive functions of consideration[19] to show that non-binding preliminary agreements inject valuable form and formality into an otherwise nebulous negotiation process. Part III considers the implications of these observations for contract theory, contract enforcement, and deal

17. Contract law scholarship generally embraces the view that enforcement is an important tool to motivate parties to comply. *See, e.g.*, Gilson et al., *supra* note 7, at 1379 ("[T]he expectation of formal enforcement creates incentives for parties to perform their obligations."); Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 546 (2003) (noting that contracts may be (a) "self-enforcing," as when "gains from breach are lower than the expected profit stream from future contracts that breach would cause to vanish;" (b) enforced informally through reputational sanctions; or (c) enforced formally); *id.*("When contracts fall outside of the self-enforcing range, however, legal enforcement is necessary to ensure performance . . . when a party's failure to perform could threaten its contract partner's survival; and when contractual surplus would be maximized if one or both parties make relation-specific investments."); Robert E. Scott, *The Law and Economics of Incomplete Contracts*, 2 ANN. REV. L. & SOC. SCI. 279, 280 (2006) ("In particular, parties wish to make credible (i.e., enforceable) promises to motivate their contracting partners to invest in jointly profitable activities.").

18. The twelve interviewees include nine senior law-firm partners, counsels, and senior associates with significant private M&A practices, and three senior in-house attorneys with significant M&A experience. Interviewees practiced at law firms or companies in New York, Silicon Valley, Chicago, and Houston. For a full list and description of interviews, see *infra* Appendix A.

19. Lon L. Fuller, *Consideration and Form*, 41 COLUM. L. REV. 799, 799 (1941) (distinguishing between the formal and substantive reasons that courts and parties attach consideration to contracts).

design. Specifically, it suggests that courts need not always enforce preliminary agreements.

The principles developed in this Article can be applied broadly. Within corporate law, this Article helps to sharpen the theoretical boundaries of the deal. More broadly, it helps to explain why parties use non-binding agreements in a variety of contexts, and sheds light on another realm where private ordering flourishes even when formal enforcement is available.

I. NON-BINDING AGREEMENTS IN MODERN DEALMAKING

Why and how do parties use non-binding preliminary agreements? This Part draws on previously unstudied sources—qualitative evidence from interviews with practicing deal lawyers—to shed new light on the question of how parties use preliminary agreements.

Subpart I.A explores existing explanations for why parties use preliminary agreements. Subpart I.B presents the findings from original interviews with deal lawyers, a survey of recent practitioners' literature, and a survey of recent preliminary agreement cases. It suggests that most preliminary agreements in M&A deals are signed but non-binding. Oddly, however, once parties sign a non-binding preliminary agreement, their deal is very likely to be consummated, and on terms similar to the ones that the parties agreed to in the initial preliminary agreement. This Article calls the combination of these two attributes "deal stickiness." Most interestingly, preliminary agreements are sticky even though there is little consequence for walking away. This final observation is particularly odd, and appears to cut squarely against the idea that consequences, such as enforcement, affect behavior. Later Parts discuss how non-binding preliminary agreements can shape behavior and add value, even in the absence of enforcement.

A. Dealmaking in Theory

There are two leading theories on why parties use preliminary agreements: to resolve deal uncertainty, or to resolve deal complexity. Both of these theories suggest that preliminary agreements make deals more efficient, and that, as with other contracts, enforcing them helps motivate parties to use these efficient tools. This Subpart outlines those leading theories after a short primer on the timing of deals.

1. The Timing of Deals

Parties enter M&A deals in stages.[20] The stages are punctuated by two major events: "signing" and "closing," which refer to the signing and execution, respectively, of a definitive acquisition agreement.[21]

In private M&A deals,[22] parties also often enter into a preliminary agreement before signing the acquisition agreement. The preliminary agreement "describes the basic terms of the proposed transaction."[23] It may include, for example, price, a description of what is being sold (such as assets or stock), and a description of deal structure (such as whether the assets will be purchased debt-free, whether the buyer will need to secure financing, and whether the deal is a merger or an acquisition). The preliminary agreement also "usually states that the document is nonbinding."[24] In particular, the agreement makes clear that the business terms, such as price, are non-binding. Provisions governing the negotiation process, however, are often binding.[25] For instance, the parties may agree that they are bound to exchange information confidentially or to negotiate exclusively with each other for a period of time.[26]

Signing the definitive acquisition agreement creates true contractual liability.[27] Parties are, at that point, legally obligated to perform the

20. Choi & Triantis, *supra* note 14, at 2 ("Complex commercial negotiations are typically sequenced, with a subset of issues being addressed at each stage and by numerous agents with different expertise.").
21. Jonathan M. Barnett, *Hollywood Deals: Soft Contracts for Hard Markets*, 64 DUKE L.J. 605, 618 (2015) (describing the timeline of a "conventional" deal, such as an M&A deal).
22. Public M&A deals are those that involve at least one public company party that is obligated by securities laws to disclose the terms of any material agreements to shareholders. Parties to public M&A deals are substantially less likely to use preliminary agreements, because they fear that entering into a preliminary agreement may trigger disclosure obligations. In contrast, private M&A deals do not trigger disclosure obligations. See George S. Georgiev, *Too Big to Disclose: Firm Size and Materiality Blindspots in Securities Regulation*, 64 UCLA L. REV. 602, 605 & n.2 (2017), for a discussion of public company disclosure obligations.
23. Barnett, *supra* note 21, at 618 ("First, after some initial discussion, the parties enter into a preliminary agreement, often called a 'memorandum of understanding' or 'letter of intent,' which describes the basic terms of the proposed transaction and usually states that the document is nonbinding.").
24. *Id.*
25. *See* LAKE & DRAETTA, *supra* note 7, at 5–6.
26. Telephone Interview with In-House Attorney II (May 25, 2016) ("I tend to say that the presumption [is that] this is a non-binding letter of intent, except for sections. Confidentiality and sometimes exclusivity."); *cf.* LAKE & DRAETTA, *supra* note 7, at 5–6.
27. Barnett, *supra* note 21, at 618 ("[T]here is a clear demarcation between the negotiation period, in which there is no risk of contractual liability, and the performance period, in

transaction.[28] There is often a gap in time of several weeks or months between signing and closing, to allow parties to complete a number of "closing conditions," such as obtaining regulatory approval or financing, reorganizing their corporate structures to maximize the deal's tax benefits, or completing due diligence of the target company.[29] After parties meet the closing conditions, they "close" the deal by, for instance, exchanging consideration for stock or assets.[30]

It is worth highlighting two common misunderstandings about preliminary agreements. First, scholars generally do not distinguish between binding and non-binding preliminary agreements—instead, they seem to assume that parties intend for preliminary agreements to be somewhat binding. This may be because scholars tend not to distinguish between different types of commercial deals—and having a binding preliminary agreement is more common in other contexts, such as in commercial lending and venture capital. In M&A practice, preliminary agreements tend be the opposite of what is studied: The vast majority of preliminary agreements are specifically *non*-binding with respect to business terms.

Second, scholars routinely misplace when in the deal's lifecycle parties enter preliminary agreements. Scholars assume that preliminary agreements are first steps,[31] which parties enter before investigation, and before making relationship-specific investments. In reality, parties usually sign preliminary agreements slightly later in the deal process, after most initial investigation is done. This subtle distinction in the deal timeline is of central importance for practical and theoretical reasons. Practically, the fact that parties sign preliminary agreements later in the process suggests that parties are fairly serious about the deal when they sign a preliminary agreement, which may

which there is clear contractual liability" and that after deal execution, "all subsequent investments are governed by contractual terms that can be enforced in court.").

28. Lou R. Kling et al., *Summary of Acquisition Agreements*, 51 U. MIAMI L. REV. 779, 781 (1997).

29. *See* Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 260 (1984) ("[M]ajor portions of a typical acquisition agreement result from the fact that many acquisition transactions contemplate a significant gap between the date on which the acquisition agreement is signed and the date on which the transaction is closed."); Kling et al., *supra* note 28, at 781 (identifying the need to secure financing as a reason for a delay between signing and closing).

30. *See* Kling et al., *supra* note 28, at 781 (describing the closing as the moment "when the acquisition actually occurs").

31. *See, e.g.*, Schwartz & Scott, *supra* note 7, at 663 ("After the parties agree on what they can, and *before* uncertainty is resolved, one or both of them make a sunk-cost investment. This pattern of commercial behavior suggests that the parties have made a 'preliminary agreement' . . . ." (footnote omitted)).

inform whether courts should hold parties liable for breach. Theoretically, a clear understanding of timing may help to define the boundaries of deals. Previous work noted that a deal's theoretical boundaries extend beyond the definitive acquisition agreement and should encompass other contemporaneous ancillary agreements.[32] Mapping the nuanced contours of the early deal timeline helps contract and corporate law scholars understand whether a deal begins with preliminary agreements.[33]

2. Preliminary Agreements and Deal Uncertainty

In a series of influential papers about preliminary agreements, Alan Schwartz and Robert Scott argue that parties use preliminary agreements to resolve deal uncertainty, and that enforcing breaches of these agreements motivates parties to use then efficiently.

At the core of Schwartz and Scott's argument is the observation that in complex deals, parties may not be able to resolve enough uncertainty before entering into a full, detailed, and definitive acquisition agreement. In order to resolve uncertainty and determine whether the deal is feasible and worthwhile, parties need to make relationship-specific investments that cannot be recouped if the deal does not materialize.[34] Relationship-specific

32. Hwang, *supra* note 8, at 1451.

33. In *The Nature of the Firm*, Ronald Coase argued that firms grow larger that is, firm boundaries grow—if it is cheaper to produce a particular component internally. Firm boundaries do not grow if it is cheaper to purchase that component from outside the organization. R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 393–98 (1937). This theory has been used to explain why some firms are highly integrated (and large), and others are more specialized (and rely on outside suppliers to produce most components). It is possible to think about complex contracting in an analogous way. Contract drafters can choose to write all of a deal's terms into one single contract, or to parcel out the terms into separate contracts. In previous work, I argued that the boundaries of the deal extend beyond the central, definitive acquisition agreement. *See* Hwang, *supra* note 8, at 1410. Even though a deal can span several agreements and contracts, the theoretical boundary of the deal extends beyond the physical acquisition agreement, and encompasses contemporaneously entered ancillary agreements. *Id.* This Article argues that the boundaries of the deal can also be extended temporally—that is, the deal can begin earlier in time than the central acquisition agreement. *See infra* Part III. For a more modern discussion of Coase's theory, see Peter G. Klein, *The Make-or-Buy Decision: Lessons From Empirical Studies*, *in* HANDBOOK OF NEW INSTITUTIONAL ECONOMICS 435 (Claude Ménard & Mary M. Shirley eds., 2008), which surveys the empirical literature on firms' vertical integration, and providing a summary of Coase's theory of the firm.

34. *See* Schwartz & Scott, *supra* note 7, at 663 ("The parties do not agree and, indeed, may never have attempted to agree on important terms such as the price. After the parties agree upon what they can, and *before* uncertainty is resolved, one or both of them make a sunk-cost investment.").

investments also create space for parties to behave opportunistically. For example, Party A might walk away from a deal after Party B has sunk significant costs into relationship-specific due diligence. Preliminary agreements, backed with a bit of enforcement bite in the form of reliance damages, are an efficient way to motivate parties to make relationship-specific investments to resolve uncertainty, and also to deter opportunism.[35]

In M&A deals, parties, in some ways, use preliminary agreements in just the way Schwartz and Scott described. Suppose that the buyer and seller can agree that the buyer will acquire all of the seller's business for $50–70 per share of stock. The parties enter into a preliminary agreement that notes the price range. The buyer then conducts due diligence on the seller to better understand the seller's business's financial health, which will allow the buyer to propose a specific price within the agreed-upon range. The buyer's due diligence on the seller is a relationship-specific investment—it is specific to the deal at hand, and information gained in that process cannot usually be used in another deal if the current one falls through.

Schwartz and Scott argue that, in order to motivate buyers to undertake relationship-specific investments like the expensive due diligence process, parties must face the threat of enforcement for breaching the preliminary agreement.[36] Without the threat of enforcement, sellers might walk away from the deal at any time, even when buyers have already made significant investments. When sellers can legally behave opportunistically, future buyers will be more hesitant to make relationship-specific investments, which would mean that many efficient deals simply would not take place. Enforcement also protects sellers. The threat of enforcement against buyers deters buyers from walking away, which is important if sellers often begin the deal process by granting a period of exclusive access to a particular buyer.

3. Preliminary Agreements and Deal Complexity

An alternative theory for preliminary agreements, advanced by Albert Choi and George Triantis, suggests that deal parties use preliminary agreements because the sheer complexity of a deal might make it impossible to complete in one stage. Preliminary agreements can thus help parties deal

35. *Id.*
36. *Id.* at 667 ("A reliance recovery will encourage parties to make preliminary agreements and will deter some strategic behavior.").

with the cognitive load of negotiating many issues at once,[37] or allow parties to buy some time to engage experts to weigh in on the most complex parts of deals.[38] For example, parties may agree to basic business terms during the preliminary agreement stage and, in later stages, engage lawyers, accountants, and others to work through the details.[39] Preliminary agreements, then, are a way to modularize complex deals—to break complex transactions into smaller pieces, for the purpose of making them easier to handle.[40]

Choi and Triantis suggest that although some deals are too complex to complete in one step, they are nonetheless worth doing. Using preliminary agreements allows parties to complete deals they would otherwise not be able to do if they were constrained to one-step deals. Like Schwartz and Scott, Choi and Triantis also argue that courts ought to enforce preliminary agreements—at least a little bit. In particular, they note that enforcement—although "something short of the full contract enforcement"—strikes a good balance between incentivizing investment and maintaining deal flexibility.[41] Some enforcement of a preliminary agreement means that parties can rely on their preliminary bargains as they engage in the costly process of solving deal complexity. Like Schwartz and Scott, Choi and Triantis argue that attaching some enforcement to preliminary agreements encourages efficient dealmaking and deters opportunism.

4. Enforcement as a Motivator

Both existing explanations for why parties use preliminary agreements rely on formal enforcement as an important part of the story. This is not a

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37. Choi & Triantis, *supra* note 14, at 12 (noting that "[t]here is a tradeoff between the benefit of being able to logroll across issues to exploit differences in preferences and endowments, and the cognitive load of doing so." (citing HOWARD RAIFFA ET AL., NEGOTIATION ANALYSIS: THE SCIENCE AND ART OF COLLABORATIVE DECISION MAKING (2002)).
38. *Id.* at 2 (noting that "[c]omplex commercial negotiations are typically sequenced, with a subset of issues being addressed at each stage and by numerous agents with different expertise."). Choi and Triantis also note that parties engage experts to work out details. For instance, "lawyers hammer[] out representations and warranties, covenants, closing conditions, remedies and termination rights . . . ." *Id.* at 13.
39. *Id.*
40. Henry E. Smith, *Modularity in Contracts: Boilerplate and Information Flow*, 104 MICH. L. REV. 1175, 1176 (2006) (describing modular contracting as a way to break down complex systems into smaller, easier-to-understand chunks); *see also* Hwang, *supra* note 8, at 1418 (describing the practice of breaking out complex, regulatory-heavy parts of a deal into a module so that experts can weigh in on those parts).
41. Choi & Triantis, *supra* note 14, at 30.

surprise. Much of law is based on the assumption that enforcement can motivate behavior. Enforcing a criminal law, for instance, is thought to deter citizens from committing crimes.[42] Similarly, imposing damages in products liability cases is meant to deter unlawful behavior.[43] In contract law, the same conventional wisdom holds: Imposing consequences for breaching a contract is meant to deter parties from breach and motivate parties to adhere to contract terms.

In the business law context, the idea of enforcement as motivation for compliance is also closely related to the idea that business contracts (and contracts in other contexts) have two distinct stages. In the first stage, the ex ante contract design stage, parties negotiate and agree to terms.[44] In the second stage, the ex post enforcement stage, parties who breach contracts have to pay to litigate the case, and many ultimately pay damages.[45]

Sophisticated parties make a thoughtful trade-off between incurring costs in the design phase or incurring costs in the enforcement phase.[46] If parties invest more time and money in the design stage, their contracts presumably become clearer and more precise, less likely to be litigated, and easier to resolve when litigated.[47] As a result, the enforcement phase is less

42. Bidish Sarma, *Using Deterrence Theory to Promote Prosecutorial Accountability*, 21 LEWIS & CLARK L. REV. 573, 596 (2017) (describing deterrence as "a justification for punishment premised on the theory that the threat of punishment can deter individuals from breaking the law").

43. *See, e.g.*, Dmitry Karshtedt, *Causal Responsibility and Patent Infringement*, 70 VAND. L. REV. 565, 620–21 (describing the role of enforcement in deterring unlawful behavior in both products liability and patent infringement).

44. *Cf.* Choi & Triantis, *supra* note 6, at 852 ("[D]rawing on the line of scholarship that analyzes the rules-standards dichotomy in the design of legal rules, recent work frames the choice between vague and precise contract terms as a tradeoff in information costs: precise contract provisions raise contracting costs on the front end, but reduce enforcement costs at the back end."); Richard A. Posner, *The Law and Economics of Contract Interpretation*, 83 TEX L. REV. 1581, 1583–84 (2005) (defining the cost of a contract as the ex ante negotiating and drafting costs, plus the probability of litigation multiplied by the sum of the parties' litigation costs, the judiciary's litigation costs, and judicial error costs).

45. Choi & Triantis, *supra* note 6, at 852.

46. *See id.* (noting that contract provisions are sometimes intentionally vague because "[i]f a provision matters only in remote contingencies, . . . then the back-end costs should be discounted by that remote probability, and it may be correspondingly efficient to save front-end costs by using a standard (or a vague term) rather than a rule"); *see also* Posner, *supra* note 44, at 1587; Scott & Triantis, *Anticipating Litigation*, *supra* note 6, at 817; Steven Shavell, *On the Writing and the Interpretation of Contracts*, 22 J.L. ECON. & ORG. 289, 298 (2005).

47. *See* Scott & Triantis, *Anticipating Litigation*, *supra* note 6, at 835 ("When contracts scholarship is concerned with front-end (transaction) costs, such as the cost of

costly. However, parties may also choose to spend less time drafting an agreement in the design phase—which results in a vague, boilerplate, or not-as-thoughtfully constructed agreement—on the belief that an enforcement action is unlikely.[48] Other scholars have described situations where expending relatively little time in design is rational. For example, material adverse change clauses in acquisition agreements are vague, but so rarely enforced that parties often choose not to expend too much effort making them specific in the design phase.[49] On the other hand, too little investment in design can also backfire in the enforcement phase. In the recent *Martin Marietta Materials, Inc. v. Vulcan Materials Co.*[50] case, for example, M&A deal parties entered into a fairly standard confidentiality agreement without much negotiation.[51] In the subsequent enforcement phase, the agreement cost the buyer the opportunity to close a $5.5 billion hostile takeover (which was enjoined), and cost both parties significant legal fees.[52] Regardless of whether parties choose to allocate their resources to design or to enforcement, however, they are trying to minimize overall costs associated with the contract, which is the sum of costs from the design phase and the enforcement phase.[53]

When formal enforcement is unavailable or not preferred, parties can substitute with informal enforcement. For instance, some tight-knit communities, such as those of whalers, diamond merchants, and cotton merchants, have opted out of formal judicial enforcement for contract breaches.[54] Instead, when a breach occurs, parties turn to trade-association sanctions or reputational damage.

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negotiating and writing contracts, vague terms reduce these costs by letting the enforcing court complete the contract.").

48. Choi & Triantis, *supra* note 6, at 852.
49. *Id.* at 852–53.
50. 68 A.3d 1208 (Del. 2012).
51. *See id.* at 1210–11. See Sasha S. Hahn, Note, *"Between" a Rock and a Hard Place:* Martin Marietta v. Vulcan *and the Rise of the Backdoor Standstill*, 65 HASTINGS L.J 1393 (2014), for a detailed analysis of the *Martin Marietta* case.
52. Hahn, *supra* note 51, at 1409.
53. *See* Posner, *supra* note 44, at 1583–84.
54. *See* George Baker et al., *Relational Contracts and the Theory of the Firm*, 117 Q.J. ECON. 39 (2002); Bernstein, *Opting Out*, *supra* note 4; Bernstein, *Private Commercial Law*, *supra* note 4 (describing how sales contracts for domestic cotton are not consummated under the Uniform Commercial Code or enforced in courts—rather, they are drafted under private contract default rules and disputes are arbitrated in merchant tribunals); Ellickson, *A Hypothesis*, *supra* note 4 (describing the norms that high-sea whalers use to resolve disputes over the ownership of harvested whales); Ellickson, *Of Coase and Cattle*, *supra* note 4 (describing the extra-legal, norms-based dispute resolution between cattle ranchers in rural Shasta County, California).

As with formal enforcement, informal enforcement relies on the threat of punishment for breach to curb parties' behavior. Without enforcement, either formal or informal, there seems to be little incentive for parties to play by the rules. Scholarship on preliminary agreements aligns with contract theory in general in suggesting that enforcement plays an important role in motivating parties to play by the agreed-upon rules.

B. Dealmaking in Practice

The conventional wisdom that parties rely on preliminary agreements to resolve complexity and uncertainty, and that the threat of enforcing those agreements through reliance damages is what makes parties abide by their terms, is incomplete.[55]

This Part presents an alternative view. Previous work in this area has focused on surveys of enforcement outcomes. This Article relies, instead, on original interviews with practicing deal lawyers and previously unexamined practitioners' literature from the front lines of deal design. It also supplements these with a traditional survey of court cases in common business jurisdictions.[56]

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55. Contracts create a binding obligation to perform. Those who breach a contract obligation are usually obligated to pay expectation damages. *See* L.L. Fuller & William R. Perdue, Jr., *The Reliance Interest in Contract Damages: 1*, 46 YALE L.J. 52, 61 (1936) ("Since the expectation interest furnishes a more easily administered measure of recovery than the reliance interest, it will in practice offer a more effective sanction against contract breach."). It is worth underscoring the fact that an award of expectation damages is a significant sanction. Expectation damages are designed to put a non-breaching party in the same position it would have been if the deal had been completed. *See* Gilson et al., *supra* note 7, at 1424 n.158 ("Expectation damages purport to put the injured party in the position she would have been in had the collaborative exploration not only been successfully concluded, but a joint project also agreed upon and realized."). In their seminal work on reliance damages, Lon Fuller and William Perdue identify a spectrum of possible damages, ranging from no damages to expectation damages. *Reliance damages* represent one point along that spectrum: reliance damages are designed to compensate a non-breaching party who has suffered a harm as a result of relying on the breaching party. Fuller and Perdue describe reliance as a remedy when:

> [T]he plaintiff has in reliance on the promise of the defendant changed his position. For example, the buyer under a contract for the sale of land has incurred expense in the investigation of the seller's title, or has neglected the opportunity to enter other contracts. We may award damages to the plaintiff for the purpose of undoing the harm which his reliance on the defendant's promise has caused him. Our object is to put him in as good a position as he was in before the promise was made. The interest protected in this case may be called the *reliance interest*.

Fuller & Perdue, *supra*, at 54.

56. For more on methodology, see *supra* Appendix A.

This Part begins by showing that preliminary agreements are sticky—that is, they *appear* to have strong influence on parties' behavior. Then, it shows that stickiness persists *despite* weak enforcement for breach. Stickiness in the absence of enforcement presents a rather odd result. If this is true, this might suggest that enforcement, either formal or informal, has a much smaller role in motivating behavior than previously thought. This puzzle sets the stage for Part II, *infra*, which introduces the concept of deal momentum to explain why unenforced, non-binding preliminary agreements appear have such a hold on parties' behavior. In short, non-binding preliminary agreements do not cause commitment—rather, they mark a comment in a deal's lifecycle when parties are already committed to the deal.

1. Stickiness

Once signed, preliminary agreements appear to have exceptional practical binding power in two ways. First, once parties sign an agreement, they tend to follow up by entering into a definitive acquisition agreement. Deals with preliminary agreements also are likely to close. Second, parties tend not to stray too far from the business terms agreed to in the preliminary agreement, even though those terms are specifically deemed non-binding.[57] This Article describes these two characteristics, together, as preliminary agreements' "stickiness."

Stickiness in preliminary agreements is surprising. First, since scholars describe preliminary agreements as tools that parties use specifically when they do not have enough information to sign a definitive contract, it is odd that once parties sign preliminary agreements, they then often sign a definitive contract. In theory, in the process of resolving uncertainty through due diligence, parties should sometimes discover information that scuttles a deal by revealing that the deal is not economically worthwhile, or that the other party is not an ideal partner. The fact that preliminary agreements almost always lead to the signing of definitive documentation suggests that parties rarely find information in due diligence that changes their decisions about whether to do a deal. This, too, would be a surprise. It would suggest that due diligence is expensive and time-consuming, but largely useless—and

57. Dealmakers with a wide breadth of experience—at firms and in-house, working with repeat players and one-off deal parties, in private and public deals, in a variety of firms and cities, representing financial parties and strategic parties—report that preliminary agreements have exceptional binding power. For a full list and description of interviews, see *infra* Appendix A. *See supra* note 18.

yet, it is a common practice in which sophisticated parties continue to engage. In other words, if parties use preliminary agreements when deals are uncertain, it seems odd that uncertain deals tend to lead to definitive contracts and deal completion.

Second, it is a surprise that parties tend to hew closely to the business terms initially agreed to in the non-binding preliminary agreement. Parties are generally required to negotiate in good faith toward a definitive deal. That duty to negotiate in good faith does not require parties to adhere to the specific business terms outlined in a preliminary agreement,[58] but parties nevertheless appear to feel bound by those terms. If parties do need to renegotiate business terms, they tend not to do so without at least offering a reason for the deviation.[59]

Stickiness is particularly puzzling in light of the lengths to which parties go to ensure that, as a legal matter, preliminary agreements are neither binding nor enforceable. For example, parties routinely include the words "non-binding" on every agreement page and add provisions that allow parties to walk away from the agreement without consequences.[60] To avoid even the inference that a preliminary agreement is binding, some deal lawyers advise their clients not to sign the agreements.[61] Nonetheless, the agreements' business terms stay sticky.

2. Weak Enforcement

While preliminary agreements tend to be sticky, liability for breaching a preliminary agreement appears to be limited and weak. A comprehensive survey of preliminary agreement litigation between business parties reveals that very few preliminary agreement cases were litigated to opinion in those jurisdictions.[62]

58. Telephone Interview with In-House Attorney I (May 23, 2016) ("[G]ood faith [is] such a low standard, it seems ridiculous that there's an M&A process where there isn't a good faith reason for getting out of the deal.").
59. *Id.* ("[A]nything that you try to renegotiate from the term sheet, you always try to come with some good reason.").
60. *See* Barnett, *supra* note 21, at 618 (noting that a letter of intent or term sheet in a conventional deal "describes the basic terms of the proposed transaction and usually states that the document is nonbinding"); Telephone Interview with In-House Attorney I, *supra* note 58 ("Pretty much on every page we have something that says that this is a non-binding agreement—this is non-binding except exclusivity/no shop, confidentiality, governing law, fee sharing.").
61. Telephone Interview with N.Y. Firm Attorney II (May 17, 2016) ("Typically, we advise people not to sign term sheets.").
62. *See infra* Appendix AIII.A.

One important exception is the *SIGA* case, which wound its way through the Delaware Chancery and Supreme Courts twice in a decade-long litigation over a letter of intent.[63] Each time the courts concluded a significant chapter of the *SIGA* litigation, law firms issued client alerts and memoranda[64] that dissected the meaning of the decision for preliminary agreement-making in M&A deals. A survey of this practitioner literature shows that lawyers were surprised by the Delaware courts' decisions to enforce a preliminary agreement that had been marked "non-binding."[65] Preliminary agreements are rarely litigated—and parties are almost never found liable for expectation damages—so when they are found liable for expected damages, practitioners find the result unusual.

In interviews with deal lawyers, deal lawyers also noted that enforcement for preliminary agreement breach is rare. This is despite the fact that deal lawyers, in general, showed a sophisticated understanding of the enforcement options available to them. Most of the deal lawyers interviewed understood that preliminary agreements obligated parties to negotiate in good faith toward a definitive agreement, and that breaching that duty could result in an award of reliance damages.[66] Despite clearly understanding that

63. *See* SIGA Techs., Inc. v. PharmAthene, Inc., 132 A.3d 1108 (Del. 2015); SIGA Techs., Inc. v. PharmAthene, Inc., 67 A.3d 330 (Del. 2013).
64. This Article calls client alerts and memoranda "practitioner literature."
65. The *SIGA* case was litigated to an opinion four times: the Delaware Chancery Court issued opinions twice, and the parties appealed those decisions to the Delaware Supreme Court twice. Each time the Delaware courts issued an opinion, law firms that advised clients in M&A deals issued a flurry of client alerts and memoranda, the issuance of which indicated that the SIGA decision was out of the ordinary and worth highlighting. With regard to SIGA I, see, for example, Robert Burwell & Howard Miller, *When a Non-Binding Term Sheet Becomes Binding*, MINTZ LEVIN COHN FERRIS GLOVSKY & POPEO PC: CORPORATE & SECURITIES (July 8, 2013), https://www.mintz.com/newsletter/2013/Advisories/3203-0713-NAT-COR/index.html [https://perma.cc/H8M5-LFUB], which notes that the Delaware Supreme Court's decision in SIGA I may require breaching parties to pay expectation damages to non-breaching parties in preliminary agreement cases, and "propos[ing] ways to mitigate the risk that a court might award expectation damages based on a 'non-binding' term sheet or letter of intent." Also see Morrison & Foerster LLP, *Delaware Supreme Court: Bad-Faith Attempt to Renegotiate Term Sheet May Create Liability for 'Benefit-of-the-Bargain' Damages*, CLIENT ALERT (June 10, 2013), http://www.jdsupra.com/legalnews/delaware-supreme-court-bad-faith-attemp-60366 [https://perma.cc/DNA4-C8ZQ], which notes that in SIGA I, the Delaware Supreme Court's "message to negotiators is clear: Don't agree to a term sheet unless it is explicitly non-binding or you are prepared to continue negotiations in good faith, consistent with the term sheet." With regard to SIGA II, see, for example, Richter, *supra* note 3. Also see *supra* note 3 and accompanying text.
66. Telephone Interview with In-House Attorney I, *supra* note 58 ("We are aware of weird DE cases that talk about duty to negotiate in good faith."); Telephone Interview with

enforcement was available, however, deal lawyers nonetheless presented a very different account of how enforcement plays out in practice.

First, deal lawyers describe actively trying to avoid enforceability in their clients' preliminary agreements. Most lawyers said that they regularly drafted provisions stating that parties could walk away from a preliminary agreement at any time, for any reason.[67] Some lawyers took this further, and described provisions in which the parties agreed that they have no obligation to negotiate in good faith.[68] Lawyers also described taking exceptional care to ensure that their preliminary agreements are "non-binding" and "non-enforceable." To do so, they might include document footers stating that an agreement is "non-binding," advise their clients not to sign the agreements (so that the agreements do not look like contracts), and include additional provisions specifying that some provisions are enforceable (usually confidentiality, exclusivity, and one or two others) and others are not (the business terms).[69] For example, one lawyer said that letters of intent are, "as a general proposition, non-binding," and another described them as presumptively non-binding but with some binding provisions, like those governing exclusivity or confidentiality.[70] One lawyer noted that "pretty

Silicon Valley Firm Attorney II (June 2, 2016) ("I know there's case law out there saying that [parties] have been sued for walking away [from a preliminary agreement].")

67. Telephone Interview with Silicon Valley Firm Attorney I (May 31, 2016) ("Usually, you'll have an express statement that's the opposite [of a duty to negotiate in good faith] in the letter of intent—that parties can walk away for any reason at all. [You] contract away that obligation."); *see also* Telephone Interview with In-House Attorney I, *supra* note 58 (noting that his company uses a letter with language that "represents that we will negotiate in good faith the terms of the letter. However, notwithstanding, we can terminate this letter for any and all reasons any time"); Telephone Interview with In-House Attorney II, *supra* note 26 ("[O]ccasionally, I have put in that the parties do agree to negotiate in good faith. So there are times when it's talked about, and we say each have a right to walk away.").

68. Telephone Interview with Silicon Valley Firm Attorney I, *supra* note 67.

69. Telephone Interview with Silicon Valley Firm Attorney II, *supra* note 66 ("Some clients take the approach that they do want to have some binding provisions in the term sheet [meaning confidentiality or exclusivity]. It's not uncommon to see some binding provisions in the term sheet. People are pretty clear about what's binding and not binding."); Telephone Interview with Silicon Valley Firm Attorney III (June 15, 2016) (noting that although "[f]rom a legal standpoint, I like to keep the binding and non-binding documents separate," he has "moved to using non-binding term sheets along with binding exclusivity"); Telephone Interview with In-House Attorney III,(June 20, 2016) (noting that term sheets are "normally signed, because the term sheets are non-binding, but some things are binding, such as confidentiality provisions, governing law").

70. Telephone Interview with N.Y. Firm Attorney I, *supra* note 9 ("LOIs are, as a general proposition, non-binding."); Telephone Interview with In-House Attorney II, *supra*

much on every page, we have something that says that this is a non-binding agreement," while another noted that he went through "great pains to put in the agreement in ten different ways" that it was non-binding.[71] One lawyer described entering into a binding term sheet only once, and also mentioned that in drafting that particular term sheet, he could find almost no precedent for a binding term sheet within his law firm.[72]

Second, deal lawyers also expressed that even if preliminary agreements *could be* enforced as a legal matter, they are so rarely enforced that enforcement is not considered a real possibility. Lawyers expressed several reasons for this view. First, they believe that the duty to negotiate in good faith is an extremely easy duty to meet, and that proving a breach of that duty in a litigation would be extremely challenging.[73] One lawyer, for instance, noted that "sometimes people do disavow what's in the term sheet because of a change in circumstances . . . . I wouldn't necessarily consider that bad faith."[74] When asked about the duty to negotiate in good faith, the same lawyer replied, "good luck proving failure to negotiate in good faith."[75] Another lawyer notes:

> I've seen plenty of deals where buyers walk—they find something better, the numbers don't play out, they haven't had much faith the management team. Deals fall apart all the time before an [acquisition] agreement. But as far as bad faith, I've not been involved in any situation where the seller thinks the buyer is trying to steal [confidential information].[76]

Third, when asked about their experiences with preliminary agreement enforcement, only two of the twelve lawyers interviewed had even heard of a

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note 26 ("I tend to say that the presumption [is that] this is a non-binding letter of intent, except for sections. Confidentiality and sometimes exclusivity.").

71. Telephone Interview with In-House Attorney I, *supra* note 58 ("Pretty much on every page we have something that says that this is a non-binding agreement . . . ."); Telephone Interview with In-House Attorney II, *supra* note 26.

72. Telephone Interview with N.Y. Firm Attorney IV (May 26, 2016). This lawyer's firm employs several hundred deal lawyers and is a leading deal firm.

73. Telephone Interview with N.Y. Firm Attorney I, *supra* note 9 ("It may be binding, but good luck proving failure to negotiate in good faith."); Telephone Interview with In-House Attorney I, *supra* note 58("[G]ood faith [is] such a low standard, it seems ridiculous that there's an M&A process where there isn't a good faith reason for getting out of the deal.").

74. Telephone Interview with N.Y. Firm Attorney I, *supra* note 9.

75. *Id.*

76. Telephone Interview with Silicon Valley Firm Attorney V (June 20, 2016).

threatened litigation over a preliminary agreement.[77] One Silicon Valley lawyer noted that she has never been in a situation where there have been ramifications for walking away from a term sheet.[78] None had worked personally with a client on a preliminary agreement that was later litigated, none had threatened to enforce preliminary agreements against others, and none had been on the receiving end of such a threat.

The lack of appetite for formal enforcement makes economic sense. Commercial litigation between sophisticated parties is exceptionally expensive.[79] Even though parties make relationship-specific investments during the preliminary agreement phase, the cost of commercial litigation—even just the beginning phases of litigation—may easily eclipse the amount that parties lose by walking away from the preliminary agreement. Moreover, litigation distracts management and may prevent the company from pursuing other promising transactions. One lawyer described the loss of having a party walk away from a preliminary agreement as a "sunk cost":

> Generally, there's nothing you can do [if the parties walk away from a preliminary agreement]. [The preliminary agreement] will usually say this expressly that either party will walk away for any reason or no reason. Unless you can show fraud or some other behavior that is otherwise actionable on a standalone basis, you view it as a sunk cost in your business.[80]

The decision to avoid costly litigation is particularly reasonable because the expected recovery of winning a preliminary agreement contest is low: In most cases, at best, the winning party can hope to recover reliance damages.

Not only is formal enforcement of preliminary agreements weak, but informal enforcement is also weak. Prior scholarship suggests that in settings where informal enforcement is effective:

> [P]erformance is encouraged and breach penalized by the cancellation of expected future dealings with the counterparty, by the loss of reputation (with the resulting reduction in future business with other potential counterparties in the relevant economic and social communities), or by an individual disposition

77. Only N.Y. Firm Attorney II and Silicon Valley Firm Attorney V had heard of a threat of litigation. *See* Telephone Interview with N.Y. Firm Attorney II, *supra* note 61; Telephone Interview with Silicon Valley Firm Attorney V, *supra* note 76.
78. Telephone Interview with Silicon Valley Firm Attorney II, *supra* note 66.
79. Telephone Interview with N.Y. Firm Attorney I, *supra* note 9 (noting that it is "not typical to sue someone else to enforce an obligation to negotiate in good faith" and that that would be "fact-intensive, expensive litigation").
80. Telephone Interview with Silicon Valley Firm Attorney I, *supra* note 67.

> toward reciprocity (and thus a willingness to reward cooperation and punish defection)."[81]

In other words, as in formal enforcement settings, those who do not play by the rules are punished. They earn a reputation for operating outside of the norm, and their future dealings are suspect. Even when parties do not expect to encounter the same party again in a business setting, they may be deterred from bad behavior if they do not want to suffer reputational consequences within their *community* that may later translate to a loss.[82]

The community of M&A parties, however, is not like the tight-knit communities of diamond merchants or rural cattle ranchers, where informal enforcement works well. For one thing, the community of M&A parties is not particularly tight-knit. While certain subsets of M&A parties are repeat players—for example, serial acquirers or private equity firms—many M&A parties rarely enter the market. As a result, their reputations, good or bad, are less well-formed (and are less important, as they will not be using them in a future transaction).

Moreover, when interviewed, deal lawyers report, at most, mixed reputational consequences for parties who back out of preliminary agreements. One Silicon Valley lawyer, for instance, noted that companies that serially breach preliminary agreements *do* gain a bad reputation:

> In the tech world, [if] some serial buyer approaches the sellers, . . . one phone call and [the sellers] know the buyer and kind of know what to expect. If one buyer has a bad reputation, like a reputation for reneging the purchase price at the eleventh hour before signing the [definitive acquisition] agreement, that will be taken into account."[83]

Most other lawyers, however, noted that parties with reputations for backing out of preliminary agreements are only minimally punished on the market, if at all. For instance, a New York lawyer began by noting that "if

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81. Gilson et al., *supra* note 7, at 1379.
82. As scholars have explained:

> Even where the particular parties do not expect to deal with each other in the future, the tit-for-tat informal enforcement structure will still work if a misbehaving party expects to trade with others in the future—i.e., if trade will be multilateral rather than bilateral—so long as that party's reputation—i.e., the collective experience of others who have previously dealt with that person—becomes known to future counterparties. The actions of future counterparties then serve to discipline the misbehaving party.

Id. at 1392–93.

83. Telephone Interview with In-House Attorney I, *supra* note 58.

there was someone who routinely didn't get deals done, that would become market knowledge, and be taken into account when thinking about whether the deal will go through."[84] He immediately qualified the statement, however, by noting the deals are very fact-specific, and that "the color of [the serial breacher's] money is the same as everyone else's."[85] Another Silicon Valley lawyer made a similar statement: "There are buyers that have a reputation for being willing to renegotiate some of the terms. But it's often based on stuff that they find in due diligence. Everyone knows going into the term sheet [that] it's all subject to the buyer's due diligence."[86] In other words, even when a party breaches a preliminary agreement, it is often thought to be the result of legitimate, good-faith changes in facts and circumstances, rather than the breaching party's bad faith. The same Silicon Valley lawyer also noted that bad reputation has only a small effect on future deals: "It's certainly possible in circumstances where a company is selling itself and there are multiple different people [who] are interested in it, that if they get two bidders who were very close in price, there may be . . . [an] inclination to go for the other one [the bidder who does not have a reputation for breach]."[87] She notes, however, that management must still look out for investors' interests.

In light of weak formal and informal enforcement for breach, then, what accounts for deal stickiness? Part II attempts to explain this phenomenon.

II. DEAL MOMENTUM

This Part presents a theory of deal momentum to explain why M&A parties adhere to non-binding preliminary agreements despite the fact that there is little consequence for breach. In short, by the time parties enter a preliminary agreement, they have already resolved enough uncertainty that momentum pushes the deal forward, even in the absence of a preliminary agreement. Thus, preliminary agreements are better understood as signposts for the accrual of deal momentum, rather than as contract-like devices.

Part II.A shows how accurately pinpointing deal timing is important to understanding how parties use non-binding preliminary agreements. Instead of using them as first steps to a deal, as scholars previously thought, parties use preliminary agreements only after they have completed initial due diligence. Based on a more accurate understanding of deal timing, Part

84. Telephone Interview with N.Y. Firm Attorney III (May 26, 2016).
85. *Id.*
86. Telephone Interview with Silicon Valley Firm Attorney II, *supra* note 66.
87. *Id.*

II.B offers an alternative explanation for why parties use preliminary agreements. Specifically, it posits that these agreements have both formal and substantive functions. While the literature has focused exclusively on substantive functions—preliminary agreements' resemblance to contracts, and the need to enforce them as such—preliminary agreements are largely valuable because they formalize an otherwise unstructured dealmaking phase. In other words, preliminary agreements are not very useful as contracts, but quite useful in that they can help parties signal, organize, attach moral suasion, and build trust.

A. Not-So-Preliminary Agreements

Perhaps the first place where the literature on preliminary agreements deviates from modern practice is in its description of *when* parties enter into a preliminary agreement. For the most part, the literature describes the preliminary agreement as the first step in dealmaking. It seems to envision, for instance, that two CEOs meet for coffee, decide that they wish to do a deal, and write down some broad terms (such as price ranges) that might suit them both. After forming this extremely basic plan for doing a deal—which is what the literature considers a preliminary agreement—the parties then separate to resolve uncertainty about the deal through due diligence. After some time, the CEOs then reconvene to hash out the details of their deal.[88]

In practice, however, the deal timeline looks a little bit different. The literature is accurate in that a large quantity of due diligence occurs between the signing of the preliminary agreement and of the definitive agreement.[89] M&A due diligence is as an expensive and labor-intensive undertaking: It "is not simply first-year lawyers looking through boxes of documents. The

88. Choi & Triantis, *supra* note 14, at 2 ("Complex commercial negotiations are typically sequenced, with a subset of issues being addressed at each stage and by numerous agents with different expertise.") *see* Schwartz & Scott, *supra* note 7, at 662–63 (describing the initial process of dealmaking).

89. Douglas Godfrey, Charles Fox, and Edward C. Harris describe the due diligence process:

> [It is] not just first-year associates looking through boxes of documents. The process also includes experts in various areas looking at any subject that the buyer, in the case of an acquisition, is interested in. . . . Thus, the due diligence process as a whole covers any issue that a buyer or an investor would possibly care about.

Douglas Godfrey et al., *Transactional Skills Training: All About Due Diligence*, 10 TRANSACTIONS: TENN. J. BUS. L. 357, 359 (2009); *see also* Telephone Interview with Silicon Valley Firm Attorney II, *supra* note 66 ("Most term sheets are finalized before the real due diligence begins.").

process also includes experts in various areas . . . . [It] covers any issue that a buyer or an investor would possibly care about."[90]

What the literature overlooks, however, is the important distinction between the *quantity* of due diligence and the *materiality* of due diligence. Indeed, in the time between signing the preliminary agreement and signing the acquisition agreement, parties engage in a high quantity of due diligence process—both the literature and deal lawyers agree on that point. That quantity, however, does not represent the process's importance in determining the deal's business terms. For instance, many lawyers note that, despite the quantity of the diligence done between the preliminary and definitive agreements, the information discovered in that diligence only "sometimes" causes the parties to renegotiate business terms.[91] This suggests that this phase of due diligence is only sometimes material.

While the bulk of due diligence is performed between signing the two agreements, most of the material diligence is complete before the parties sign the preliminary agreement. Consider a company that is auctioning itself. In preparation for accepting bids, that company will make much of its relevant financial information available in a physical or virtual data room so that potential bidders can begin to conduct due diligence.[92] That early due diligence is the most important—it is the information on which the potential buyer determines the most important business terms.[93] One publication by non-lawyer deal advisors, for instance, describes the due diligence process as largely being completed in the pre-preliminary agreement phase. That publication describes post-preliminary agreement diligence as "final diligence" that "generally serves to confirm the consistency and material accuracy of representations made by the target company."[94] While the buyer will

90. Godfrey & Fox, *supra* note 89, at 359.
91. Telephone Interview with In-House Attorney III, *supra* note 69 ("Some of the legal stuff gets renegotiated based on diligence."); Telephone Interview with Silicon Valley Firm Attorney II, *supra* note 66 ("There are buyers that have a reputation for being willing to renegotiate some of the terms. But it's often based on stuff that they find in due diligence.").
92. Michael D. Benson & Jeffrey S. Shippy, *The M&A Buy Side Process: An Overview for Acquiring Companies*, STOUT RISIUS ROSS, Aug. 2013, at 5 ("Shortly after the management presentation is concluded, the target will typically provide the acquirer with access to an online information 'datasite' where select legal, financial, operational and other information on the business can be found so that the acquirer can determine an appropriate valuation to submit a [letter of intent].").
93. *Id.* ("The [letter of intent] highlights the acquirer's intention to acquire the target and sets forth the proposed purchase price along with all relevant key terms, in much greater detail than did the [indication of interest].").
94. *Id.* at 5–6.

"often . . . uncover information that will warrant [it] to revise its valuation,"[95] the message is clear: From the perspective of bankers and businesspeople, who set the deal price and negotiate the preliminary agreement's material business terms, the material diligence is done before the preliminary agreement. The voluminous diligence that lawyers do between the preliminary and definitive agreements is high in quantity and important, but it is also confirmatory, rather than material, in nature.

Distinguishing the quantity of due diligence from the materiality of due diligence suggests modifying the conventional understanding of when parties enter into a preliminary agreement. The conventional understanding is that parties enter into preliminary agreements at the very beginning of the deal. In practice, however, parties enter into preliminary agreements after finishing most material due diligence. Thus, preliminary agreements are not very preliminary, since they are entered into when enough material has been examined to determine, with some certainty, important business terms like price.[96]

Another way to think about bulk and materiality of diligence is to reframe the deal timeline from the perspective of bankers and businesspeople. As Choi and Triantis note, the time period between the preliminary agreement's signing and the definitive agreement's signing is characterized by the addition of experts—such as lawyers—to work out the details of the deal.[97] This suggests that lawyers often become heavily engaged in the deal only after the parties have signed the preliminary agreement. From a deal lawyer's perspective, then, the real work of the deal begins after the preliminary agreement. From the perspective of bankers and businesspeople, however, the deal is finalized in broad strokes at the preliminary agreement stage. This explains why preliminary agreement terms remain largely unchanged after

95. *Id.* at 6.
96. Of course, this separation demands an answer to another question: If the material diligence is done, what is the bulky diligence that is being done after the preliminary agreement is signed? Much of the post-preliminary agreement diligence involves reviewing contracts for "change of control" or "assignment" provisions, that is, determining which supplier contract, for instance, will be automatically terminated when control of the target company changes over from the seller to the buyer. In examining those kinds of contracts, material information can be found that changes price terms. For instance, the buyer might discover that, while the target has been profitable for many years, it will soon become less profitable because particular lower price terms will take effect. *See id.* at 6 (describing "full due diligence," in which the buyer examines the target's "financial statements, operating reports and other private and confidential company documents (both financial and non-financial in nature)").
97. Choi & Triantis, *supra* note 14, at 13 (noting that "the second stage consists of lawyers hammering out representations and warranties, covenants, closing conditions, remedies and termination rights").

the agreement's signing: They are business terms that are negotiated by bankers and businesspeople, who have already completed the bulk of their relevant diligence prior to the agreement's signing.

B. Preliminary Agreements as Signposts for Deal Momentum

Pinpointing when parties enter preliminary agreements presents an interesting puzzle: If preliminary agreements are not meant to be early contractual tools that help parties resolve uncertainty,[98] why do they exist? And if deal terms are close to being finalized by the time parties sign the preliminary agreement, why do parties divert from the process of negotiating the definitive agreement and expend time and resources to draft a non-binding preliminary agreement?

This Subpart offers an explanation for why and how parties use preliminary agreements in M&A deals. It begins by distinguishing between an agreement's formal and substantive functions, in much the same way other scholars have distinguished between the form and substance of consideration. Then, it suggests that preliminary agreements are not primarily powerful because of their resemblance to contracts, but because they help make an otherwise unstructured phase of the negotiation process more formal. They are thus better understood as signposts for when sufficient deal momentum has accrued, rather than as contracts. In other words, there comes a moment in a deal's lifecycle when the parties have resolved enough uncertainty that they are likely to do the deal. The preliminary agreement marks that moment.

98. Schwartz and Scott, for instance, note that a preliminary agreement is entered into when "[t]he parties do not agree and, indeed, may never have attempted to agree on important terms such as the price. After the parties agree upon what they can, and *before* uncertainty is resolved, one or both of them make a sunk-cost investment." *See* Schwartz & Scott, *supra* note 7, at 663. Similarly, Choi and Triantis describe preliminary agreements as mid-stream contracts. They deviate slightly from Schwartz and Scott in the reasons that parties enter into preliminary agreements—they note that "staging of negotiations is often necessary because of the complexity of the transaction" and that after parties "agree[] on main deal terms—particularly price and structure," they then engage "costly lawyers, accountants, architects and other experts" to sort out details. *See* Choi & Triantis, *supra* note 14, at 3, 13. In other words, preliminary agreements are described as putting in place some initial terms to which the parties agree. Then, within the boundaries of those terms, parties negotiate and agree to final terms. *See* Choi & Triantis, *supra* note 14, at 13.

1. Form and Substance in Preliminary Agreements

In his seminal article *Consideration and Form*, Lon Fuller argued that there are both formal and substantive reasons to attach consideration to contracts. Fuller notes that enforcing "gratuitous promises"—that is, promises without consideration—"is not an object of sufficient importance . . . to justify the expenditure of the time and energy necessary to accomplish it."[99] This, Fuller notes, is a substantive objection, because it relates to the significance of the promise made: Promises without consideration are not substantively important. In contrast, most arguments about the need for consideration relate to the importance of form. Fuller identifies three broad categories that characterize the functions performed by legal formalities: the evidentiary function (creating evidence of a contract), the cautionary function (forcing parties to consider the contract more carefully), and the channeling function (signaling to the outside world that the contract is enforceable).[100]

Preliminary agreements, too, have both formal and substantive functions. So far, other scholars have focused on the substantive aspects of preliminary agreements. In particular, the literature attributes a preliminary agreement's usefulness to the threat of potential remedies for breach (i.e., the award of reliance damages). Like in contracts, the threat of enforcement of a preliminary agreement is meant to incentivize adherence. But conversations with deal lawyers suggest that the primary contribution of a preliminary agreement is not its substance, but its form, and the formality it lends to the negotiating process. By going through the formalities of drafting and signing a preliminary agreement, parties can signal seriousness to each other and attach moral suasion to their non-binding agreement. Through the form of a preliminary agreement, parties can organize their early collaboration, and introduce lawyers, who act as a set of reputational gatekeepers, to help them further solidify their certainty in the deal.

99. Fuller, *supra* note 19, at 799 (distinguishing between the formal and substantive reasons that courts and parties attach consideration to contracts).
100. *Id.* at 800–01 (describing the functions performed by legal formalities).

2. Signaling

In the early stages of deal negotiation, parties make very few promises to each other, formal or otherwise.[101] They do, however, begin sinking costs into investigating each other as potential deal parties, and begin considering the value of the potential deal.[102] At some point, material due diligence is largely complete, and parties are positioned to begin the expensive process of negotiating a detailed definitive agreement. But before then, parties enter into a non-binding preliminary agreement.

An important reason that parties incur the expense of entering into non-binding, unenforced preliminary agreements is to signal to one's deal counterparty that one is a good deal partner. One of the most puzzling interview results is that the deal lawyers interviewed reported seemingly contradictory information about the consequences for a preliminary-agreement breach. On one hand, they almost uniformly reported that breaching a preliminary agreement had little or no effect on a non-repeat-player deal party's reputation.[103] At the same time, deal lawyers also reported that parties, even (or especially) those that were not repeat players in the M&A market, cared about "their word," or having a reputation as an "integrity player."[104] These observations seem almost diametrically opposed:

101. Parties may enter into a confidentiality agreement, in which they agree to keep the information they exchange confidential. However, after the confidentiality agreement is signed, there are few other promises.

102. *See* Benson & Shippy, *supra* note 92, at 3–4 (describing the valuation process).

103. Telephone Interview with N.Y. Firm Attorney III, *supra* note 84 (remarking that "[i]f there was someone who routinely didn't get deals done, that would become market knowledge, and be taken into account when thinking about whether the deal will go through," but that everything was "so facts and circumstances" and that ultimately "the color of their money is the same as everyone else's"). But that is not the case in certain tight-knit subsets of the M&A community. Silicon Valley Firm Attorney V, for instance, noted that reputations may matter in venture capital deals. Telephone Interview with Silicon Valley Firm Attorney V, *supra* note 76.

104. Telephone Interview with N.Y. Firm Attorney I, *supra* note 9 ("There is certainly moral suasion to [a preliminary agreement]. I think that most people—there are exceptions—in the business world, even if they aren't repeat players in the market, most players want to be seen as integrity players."); Telephone Interview with In-House Attorney I, *supra* note 58 ("One of the lawyers I worked with in Virginia always he thought about the term sheet as a gentleman's agreement. He would say, 'You gave me your word, and now you're trying to walk away from your word?'"); Telephone Interview with N.Y. Firm Attorney IV, *supra* note 72 ("[Parties] felt morally obligated not to ask for a bigger escrow because they'd asked for a smaller one [in the term sheet]. They can suffer though this problem or they cannot go back on their word. The business people want to not go back on their word.").

Why do non-repeat players care about their reputations, especially if breaching a preliminary agreement has little effect on their reputations?

One explanation is that even non-repeat players, who do not care about their reputation on the broader M&A market, care about their reputation within that particular transaction. M&A dealmaking is a multi-stage process: After the preliminary agreement, there is more exchange of information, a more thorough round of deal negotiations, and potentially weeks or months of daily or near-daily interaction with one's deal partner.[105] In each stage, there is an opportunity for additional negotiation and interaction. And, if the deal is actually completed, many of those who interacted during the M&A process may continue to work together indefinitely as part of the merged company. After the deal is done, for instance, the same employees who negotiated the deal on behalf of the seller often continue to work for the buyer for a period of time, or indefinitely. Individuals may become repeat players within the context of one particular deal, because they must interact numerous times with the other side during the dealmaking process.

When an M&A deal is understood as a multi-step process, it becomes clear why deal parties might care about their reputations, even if the corporate entity—the buyer or seller—is not a repeat player on the broader M&A market. A preliminary agreement is one of the deal parties' first opportunities to interact with each other, and to prove that they are trustworthy deal parties. Adhering to deal terms, especially non-binding terms, helps to build one's reputation within the context of that deal and to smooth the transaction process going forward, both for the corporate entity and for the individual employees who work for them.

Preliminary agreements may also serve a different signaling function. Because parties sign them when there is enough deal momentum for a deal to go forward, signing a preliminary agreement might also be a way to signal that they have reached that tipping point. One lawyer, for instance, drew an analogy between preliminary agreements and giving gifts when dating: "You go on dates, . . . but that doesn't mean you're getting married. But you give gifts sometimes. It means some level of commitment."[106] In other words, preliminary agreements may be a "gift" to signal that one is interested enough and serious enough to undertake the expense of negotiating and signing a preliminary agreement. Signaling seriousness to one's counterparty may be

105. Benson & Shippy, *supra* note 92 (describing the multiple rounds of interaction, due diligence, and negotiation that are involved in the dealmaking process).
106. Telephone Interview with N.Y. Firm Attorney II, *supra* note 61.

positive for a number of reasons: one's counterparty could be more receptive to special requests during the negotiation process, for instance.

Thus, even though parties can legally walk away from a preliminary agreement or deviate from its terms, adhering to the terms may serve important signaling functions to one's deal partner. This means that, independent of its substantive uses, entering into and playing by the rules of a preliminary agreement may be attractive steps to take.

3. Organization

The formal process of entering into a preliminary agreement also serves organizational purposes. One deal lawyer, for instance, described having a central document to focus on as the primary reason for having a preliminary agreement:

> It helps me and the deal team focus on whether there's a deal to be had. Too many times the business people come and they think they have a great idea. Like, I'm going to put my chocolate in your peanut butter. You have to sit back and be like, that's great, but who's going to pay for the packaging? The marketing? How about employees? [A term sheet] helps both sides knock out the material terms and figure out if there's a skeleton to get the deal done.[107]

Other deal lawyers described a similar purpose for using preliminary agreements: to "mak[e] sure there's a meeting of the minds on fundamental deal provisions,"[108] to use as a "[r]oadmap for people drafting documents,"[109] to "make sure the parties are in the same ballpark,"[110] and "even though it's non-binding, . . . to solidify whether there's a meeting of the minds on the material agreements."[111]

Similarly, preliminary agreements can be a tool for getting the attention of upper management by creating a central document on which the board of directors can vote. Lawyers also note that having a tangible document, even if unsigned or specifically marked non-binding, helps management feel "comfortable that this is a real offer" and that there is a basic agreement that justifies "getting the bankers spinned up and the attorneys spinned up and getting the internal people and the accounting [and] finance people

107. Telephone Interview with In-House Attorney II, *supra* note 26.
108. Telephone Interview with N.Y. Firm Attorney III, *supra* note 84.
109. Telephone Interview with Silicon Valley Firm Attorney IV (June 13, 2016).
110. Telephone Interview with N.Y. Firm Attorney III, *supra* note 84.
111. Telephone Interview with N.Y. Firm Attorney I, *supra* note 9.

involved."[112] In other words, even though the preliminary agreement is non-binding, preliminary agreements can be a useful tool around which upper management can have discussions and focus their efforts.

In addition to aiding internal organization, parties might use a preliminary agreement to organize external affairs. For instance, lawyers report using preliminary agreements to begin the antitrust review process, or to solidify financing for a leveraged deal.[113]

4. Attaching Moral Suasion

Deal parties and deal lawyers also use preliminary agreements to impose a sense of moral obligation or moral suasion on the other party in a preliminary bargain. Moral suasion is the process through which actors are encouraged to act a certain way not because of material incentives, but because of normative, or moral, appeals. Regulators, for example, sometimes appeal to private actors' sense of morality or altruism in order to ensure compliance, rather than ensure the same through formal sanctions. Moral suasion can also compel parties to act in ways that are not economically in their best interest.

Many lawyers report that even non-repeat players care about hard-to-quantify factors such as morality and integrity. One deal lawyer notes that "even if [M&A parties] aren't repeat players in the market, most players want to be seen as integrity players. At the time they enter into the [preliminary agreement], they have a good faith intention to do the deal."[114] Multiple deal lawyers reported that preliminary agreements created some kind of integrity bond. They noted, for example, that a deal party might not ask for a change in a term sheet's business terms because "they cannot go back on their word" and because an M&A deal party's business people, who negotiated the preliminary agreement's terms, "want not to go back on their word."[115] Another lawyer described having a senior colleague explain to him that a term sheet is a "gentleman's agreement" and if someone backed out, the senior colleague "would say, 'you gave me your word, and now you're trying

112. Telephone Interview with In-House Attorney I, *supra* note 58.
113. Telephone Interview with N.Y. Firm Attorney III, *supra* note 84 ("Often times the existence of a [letter of intent] or [memorandum of understanding] that is not binding will be simply done for execution purposes. For example, you can make a Hart-Scott filing on a [letter of intent].").
114. Telephone Interview with N.Y. Firm Attorney I, *supra* note 9.
115. Telephone Interview with N.Y. Firm Attorney IV, *supra* note 72.

to back away from your word?'"[116] Repeatedly, lawyers called preliminary agreements "handshake agreements"[117]—terminology which belies a belief that these agreements create moral suasion even though they are non-binding.[118] Since the amount of legal obligation that parties take on when they enter a preliminary agreement is very small, this moral suasion may actually play a greater role in motivating parties to adhere to the bargain than the role played by legal obligation.

In preliminary agreements between M&A parties, moral suasion is particularly important for two reasons. First, because deal parties do not think of their agreements as formally enforceable, as a legal matter, moral suasion allows parties to add seriousness and heft to agreements that otherwise have none. Second, moral suasion in this context motivates party behavior in a way that informal enforcement usually cannot. Most informal enforcement works by depriving a bad actor of future interactions. For example, if Angela breaches an agreement with Brian, Brian's informal-enforcement recourse is to refuse to interact with Angela in the future, or to damage Angela's reputation so that others will not interact with her in the future. M&A deal parties, however, are often not repeat players, so they are, in a way, judgment-proof from informal sanctions. Attaching moral suasion, a non-forward-looking riff on informal sanctions, allows M&A deal parties to motivate their counterparties to behave well, even when none of the parties are repeat players. Although deal lawyers never said as much, they seemed to imply that feeling guilty about not being an integrity player motivated parties to behave well, even if parties felt no threat of a future economic or reputational loss.

5. Verification

Although deal lawyers generally report that serial preliminary-agreement breachers suffer from few, if any, reputational consequences, the

116. Telephone Interview with In-House Attorney I, *supra* note 58.

117. As one attorney from Silicon Valley describes:

> There's a moral obligation to live up to the handshake agreement. Most people try to live up to that. And honestly there has to be some trust. If there's not trust between the parties, no deal gets done. They shake hands at that price and they both behave that they will a certain way.

Telephone Interview with Silicon Valley Firm Attorney I, *supra* note 67; *see also* Telephone Interview with In-House Attorney I, *supra* note 58 (describing non-binding preliminary agreements as "gentlemen's agreements").

118. Telephone Interview with N.Y. Firm Attorney I, *supra* note 9 ("There is certainly moral suasion to [a preliminary agreement].").

same may not be true of deal advisors. Where deal parties themselves are immune to informal enforcement, the reputation of related repeat players, such as the investment bankers and lawyers that advise on the deal, may play a role.

Deal advisors can be thought of as gatekeepers—independent entities that serve as an outside monitor, "who screen[ ] out flaws or defects or who verifies compliance with standards or procedures."[119] The role of gatekeepers in curbing bad behavior is well developed in the corporate governance literature. Gatekeepers have two different roles: They can be in a position "to prevent wrongdoing by withholding necessary cooperation or consent," or they can be "reputational intermediar[ies] to assure investors as to the quality of the 'signal' sent by" another entity. In the literature, auditors are "the paradigmatic examples of 'gatekeepers'—that is, independent professionals who are interposed between investors and managers in order to play a watchdog role that reduces the agency costs of corporate governance."[120]

In M&A deals, deal advisors can play the role of reputational intermediaries. For example, a handful of elite law firms advise most M&A deal parties, and even when their clients are not repeat players, the law firms are.[121] Thus, even when deal parties are not concerned with reputational losses from breaching preliminary agreements, their lawyers will be concerned, and may advise their clients to think carefully both during the entry of the preliminary agreement and before walking away.

* * * *

In short, the power of preliminary agreements comes not from the fact that they allow parties to attach formal sanctions, as contracts do. They are also more than frameworks in which parties can resolve deal uncertainty, because most material uncertainty is resolved before parties sign a preliminary agreement. Rather, preliminary agreements are useful because

119. JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 2 (2006).

120. John C. Coffee, Jr., *The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and the Governance of Accounting* 2 (Columbia Law Sch. Ctr. for Law & Econ. Studies, Working Paper No. 191, 2001), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=270944&rec=1&srcabs=447940&alg=1&pos=4.

121. Elisabeth de Fontenay, *Law Firm Selection and the Value of Transactional Lawyering*, 41 J. CORP. L. 393, 396 (2015) (arguing that law firms add value because certain elite law firms "repeatedly engage in the same type of high-stakes transactions [and] acquire private information about the range of plausible deal terms and their current market prices that other players cannot replicate").

they are central documents that parties can use as references or to organize their affairs, either internally or externally. They mark a moment in time when parties have resolved enough uncertainty that a deal is likely to occur, whether or not parties actually set forth their dealmaking intent on paper in a preliminary agreement. In other words, preliminary agreements are not necessary to get a deal done, but they are a step that some parties take when a deal is all but inevitable.

One easy way to see the lack of necessity for preliminary agreements is to compare private and public M&A deals. Preliminary agreements are very common in private M&A deals—deals in which parties do not need to disclose the deal to securities regulators—and quite uncommon in public deals.[122] The broad strokes of the deal contracting process remain the same, whether the deal is private or public: Parties perform due diligence, sign a contract, and then close the deal.[123] In public deals, however, preliminary agreements are rare because parties do not wish to trigger the need to make a securities filing. Nonetheless, public deals are completed, which suggests that preliminary agreements are not a necessary step in dealmaking.[124]

III. IMPLICATIONS FOR ENFORCEMENT AND DEAL DESIGN

This Part discusses implications for deal design and contract enforcement. It also builds on previous work,[125] which began the process of trying to understand the theoretical and contractual boundaries of the deal. Subpart III.A argues that enforcing preliminary agreements may not be necessary, and may in fact deter efficient use of preliminary agreements. This contravenes the conventional wisdom that some enforcement is necessary to induce efficient use. Subpart III.B discusses the implications of how changing enforcement of preliminary agreements can and should change how deal parties use preliminary agreements. In particular, deal parties can more

122. Telephone Interview with Silicon Valley Firm Attorney II, *supra* note 66.
123. *See supra* note 105 and accompanying text.
124. One might argue that in public deals, there is enough readily-available information about the target that parties do not need a preliminary agreement in order to create a framework for more thorough diligence of the target. This argument, however, does not account for the fact that even in deals where public companies acquire private ones in deals of sufficient size to trigger securities filings for the public acquirer, the parties try not to use preliminary agreements. In these types of public-private deals, there is not sufficient information about the private target to resolve uncertainty about the target. Nonetheless, the parties do not need to enter a preliminary agreement in order to do a deal.
125. *See generally* Hwang, *supra* note 8.

freely embrace preliminary agreements as organizational tools, rather than as contracts.

Finally, Subpart III.C explores how preliminary agreements fit into a discussion of the boundaries of a complex bargain. A previous article introduced the idea that the boundaries of a deal might exceed the four corners of an acquisition agreement, and, in fact, exist also in the many ancillary agreements that parties sign.[126] This Subpart suggests that perhaps the boundaries of a deal can also be stretched temporally, to the preliminary agreement phase. Just because the theoretical boundaries of a deal extend temporally, however, does not mean that enforcement must map on to the deal boundaries. In fact, enforcement to the edges of a deal's boundaries may crowd out efficient private ordering.

A. Enforcement

By understanding how preliminary agreements work in practice, courts may be better equipped to interpret and enforce agreements and contracts between sophisticated parties. In the case of preliminary agreements, sophisticated parties appear to use preliminary agreements in such a way that they need not always be formally enforced. In fact, there are instances where formal enforcement may disincentivize parties from making efficient deals.

A central tenet of contract theory is that enforcement (or the threat of it) affect parties' behavior. Moreover, the more negative an enforcement, the better it should be at curbing bad behavior. But observations about enforcement often miss an important point: that the *probability* of the negative outcome also plays a role in affecting parties' behavior.

Consider this scenario: Jane and Anne are parties to a contract. They agree that, if Anne breaches the contract, Jane will take all of Anne's personal belongings and set them alight on the sidewalk. That enforcement outcome is very negative—a breach might result in the loss of all of Anne's personal belongings in a public, traumatizing, and perhaps humiliating way. However, Anne may know that if she breaches, there is only a one percent chance that Jane will actually burn her belongings. Even if she breaches, she can rest assured that Jane is very unlikely to enforce.

Thus, when Anne is considering whether to breach a contract, the anticipated cost of breach is not that she loses her belongings. Rather, the anticipated cost of breach is the probability of enforcement—in this scenario,

126. *See generally id.*

one percent—multiplied by the negative utility of the enforcement. In other words, Anne considers the expected value of breach, rather than assuming that Jane will certainly enforce to fullest extent that she can. In this scenario, then, the expected cost of breach is close to zero. Thus, even though the enforcement outcome is very negative, Anne can breach often and with impunity, safe in the knowledge that most likely, her belongings will be spared from a fiery end.

When the probability of enforcement is close to zero, even very negative enforcement outcomes do little to motivate parties to adhere to contract terms—and that also appears to be true in the case of preliminary agreements. This observation is not new, although it is has received limited attention in the literature. What analysis exists is situated in research about the use of rules and standards in particular contract provisions. For example, Choi and Triantis made a related observation in an earlier article on the strategic vagueness of material adverse change clauses in acquisition agreements.[127] In their article, they note that to parties, the cost of a contract provision is the sum of its ex ante negotiating and drafting costs, and its ex post enforcement costs. There is a trade-off between the two: more investment on ex ante drafting makes a provision clearer, which reduces ex post enforcement costs by eliminating some litigations and abbreviating others. Choi and Triantis note that material adverse change clauses have a very low probability of enforcement, especially to judgment.[128] That low probability might explain why those clauses are vague: Parties rationally choose not to invest the high cost of ex ante negotiation and drafting, on the theory that the expected ex post cost of enforcement is low.

In the context of preliminary agreements, breaching parties can expect the cost of breach to be particularly low. For one thing, preliminary agreements are rarely enforced, which means the probability of enforcement is close to zero. Even when enforced, moreover, the breaching party pays only reliance damages, which is a very low cost. In other words, parties to a preliminary agreement can breach with impunity, with the understanding that the expected cost of that breach is close to zero. This means, of course,

127. Choi & Triantis, *supra* note 6, at 852 (noting that the authors "draw[] on the line of scholarship that analyzes the rules-standards dichotomy in the design of legal rules, recent work frames the choice between vague and precise contract terms as a tradeoff in information costs: precise contract provisions raise contracting costs on the front end, but reduce enforcement costs at the back end").

128. *Id.* at 877 (suggesting that there are few cases where courts have found material adverse change conditions to have occurred); *id.* at 896 (suggesting that few material adverse change cases are pursued to judgment).

that ex post enforcement of preliminary agreements already does very little to deter bad behavior from parties.

One thing to note, however, is that the *threat* of enforcement may deter parties from using preliminary agreements' useful, non-contract features, even if the enforcement outcome itself is not very negative. That deterrence may not be a good thing. For example, the threat of enforcement may deter parties from using preliminary agreements as an organizational tool. Even attaching the possibility of reliance damages to a breach may already have deterring effect. Parties have already demonstrated that they will behave differently because of the consequences of writing down a preliminary agreement. In public company deals, for example, parties almost never involve a preliminary agreement, because they fear that writing down the preliminary agreement will trigger onerous disclosure obligations.

While a preliminary agreement is certainly not necessary to dealmaking, it may still be helpful, and the law ought to incentivize the use of helpful tools, such as preliminary agreements. Dialing back the threat of formal enforcement may mean that parties feel more comfortable writing down their preliminary agreements, which means that parties are more incentivized to be organized in early dealmaking.

Moreover, making formal enforcement an available remedy, even if it is rarely used, is not costless to the public. The cost of formal enforcement is borne by both private parties (who incur litigation costs) and the public (through the expenditure of judicial resources in adjudicating these disputes).[129] Few preliminary agreements are litigated to opinion, but it is hard to say how many preliminary agreements litigations are commenced. As soon as litigation commences, the public incurs costs. Reviewing complaints, setting motion schedules, and adjudicating motions to dismiss tie up judicial resources that could be spent elsewhere.

Although it may make sense to dial back on preliminary agreement enforceability, this Article does not argue, of course, to do away entirely with enforcing contracts between parties. Here, it is important to highlight a distinction between preliminary agreements (between sophisticated parties) and formal contracts (between the same). Preliminary agreements are not contracts—they are signposts and organizational tools. When parties sign a preliminary agreement, they do not mean to create an obligation to perform. Rather, they intend to organize their thoughts and actions. However, the moment that parties can organize their thoughts on paper happens to

129. Posner, *supra* note 44, at 1583.

coincide with the moment when parties have already done enough diligence on each other and on the potential deal that the deal is likely to go through. The fact that these moments occur at the same time creates the illusion that preliminary agreements work like contracts—that parties agree on something, and then they perform because they are obligated to do it. However, because parties mean to create no legal obligation, their performance is not motivated by any legal obligation.

In contrast, contracts create a binding and enforceable obligation under the law. When parties sign a contract they do mean to create an obligation to perform. Their performance of a particular agreed-upon term after the fact is because they are obligated to perform. The key, then, is parties' intent: In a preliminary agreement, parties do not intend to create an obligation, so they ought not be punished for failing to meet that non-obligation. In a contract, parties do intend to create an obligation, so they ought to be liable when they fail to meet that obligation. And, as discussed here, the punishment—through formal enforcement and award of appropriate damages—is what motivates parties to perform the obligation they previously agreed to. Thus, keeping enforcement intact when parties intend to create obligations, and making that enforcement powerful, is important to motivating parties to keep their promises.

B. Deal Design

If preliminary agreements are not enforced as contracts, parties will be more likely to use them in deals, which is a positive outcome. In particular, this means that more parties can use preliminary agreements as valuable organizational tools.

A preliminary agreement can help to focus deal teams around a common deliverable. One lawyer, for example, noted that he went through "great pains to put in the [preliminary] agreement in ten different ways" that it was not binding, but still liked to use a preliminary agreement because "it helps me and the deal team focus on whether there's a deal to be had."[130] Preliminary agreements are so useful as organizational tools that one lawyer described using them even when they were not shared with the other side—in other words, even when they were unilateral and bore no resemblance to contracts. That lawyer noted that a "[t]erm sheet might be prepared even just

130. Telephone Interview with In-House Attorney II, *supra* note 26.

for internal use," to be used for talking points, and that it "may form the basis for the discussion at an early stage."[131]

A preliminary agreement can also help to ensure that parties are in general agreement at the start of the deal, which helps parties establish whether there is enough agreement to move forward in the deal. For instance, several lawyers loosely described a preliminary agreement as a way to ensure that there was a "meeting of the minds"[132]—although they also seemed adamant that preliminary agreements were not contracts. One lawyer noted that he used preliminary agreements because "[y]ou want some kind of meeting of the minds before you get the bankers spinned up and the attorneys spinned up and getting the internal people and the accounting/finance involved."[133] Another described preliminary agreements as a way to save money and save time by ensuring that there was a "meeting of the minds on fundamental deal provisions" before engaging advisors and beginning diligence."[134] He noted that a preliminary agreement was a way to "make sure the parties are in the same ballpark."[135] Still another lawyer noted: "You generally want to make sure there's a meeting of mind on both sides before you crank out."[136]

Finally, a preliminary agreement can help to minimize the costs of renegotiation. As parties move forward toward signing definitive documentation, they might genuinely forget previously agreed-to terms, or disingenuously "forget" deal terms in order have a chance to renegotiate them. A preliminary agreement, which functions as written (and possibly signed) evidence of how the parties agreed to proceed, can help to stop some of those renegotiations before they become too costly. One lawyer, for instance, noted that "[i]f someone tries to renegotiate something in a term sheet, and if I'm not trying to renegotiate, then I'll point to the term sheet. I'll say 'we entered into this term sheet for a reason.'"[137]

Although preliminary agreements are valuable organizational tools, they are under-utilized in public deals. At present, deal lawyers use preliminary

131. Telephone Interview with N.Y. Firm Attorney III, *supra* note 84.
132. Telephone Interview with In-House Attorney I, *supra* note 58; Telephone Interview with N.Y. Firm Attorney I, *supra* note 9; Telephone Interview with N.Y. Firm Attorney III, *supra* note 84; Telephone Interview with Silicon Valley Firm Attorney V, *supra* note 76.
133. Telephone Interview with In-House Attorney I, *supra* note 58.
134. Telephone Interview with N.Y. Firm Attorney III, *supra* note 84.
135. *Id.*
136. Telephone Interview with Silicon Valley Firm Attorney V, *supra* note 76.
137. Telephone Interview with In-House Attorney I, *supra* note 58.

agreements almost exclusively in private deals. Deal lawyers shy away from using preliminary agreements in public deals, for fear that signing a preliminary agreement will trigger a public disclosure obligation.[138] There are many reasons to avoid public disclosure of a preliminary agreement. For one thing, filing a public disclosure requires additional cost. For another, preliminary agreements are, by nature, preliminary and subject to change. Disclosing their terms before the parties have fully vetted each other through the diligence process can send incorrect signals to the public, and cause the market to react in ways that are unforeseen—and, in the parties' eyes, inaccurate. Perhaps most importantly, parties might fear that a change in the preliminary agreement after it has been publicly disclosed will be received poorly by the market. For instance, after the parties sign a preliminary agreement, the buyer may cancel the deal because it is unable to secure financing, or because it has changed its business plan. The public, however, might interpret the deal cancelation as evidence of a defect in the target company. Fear of these misinterpretations causes parties in public deals to avoid, rationally, the risks associated with filing a preliminary agreement.

But deals, whether public or private, face similar organizational challenges. In fact, public deals may be harder to organize than private deals—for instance, public-company disclosure and reporting requirements add another layer of complexity to deals. Already, lawyers in both public and private deals use some of the same tools to address organizational complexity. For example, deal lawyers use signing and closing checklists to keep track of the deal's many tasks and documents.[139] These detailed to-do lists outline each step of the deal, who is responsible, and the status of completion.[140] Deal lawyers in both types of deals also use working group lists, which help parties organize and identify the many players involved in the transaction, including deal lawyers representing all parties, regulatory specialists, and in-house point people, among others.[141]

Preliminary agreements can be another useful organizational tool in a deal lawyer's toolkit. Making a clearer distinction between preliminary

138. Telephone Interview with Silicon Valley Firm Attorney II, *supra* note 66 (noting that public companies usually do not want to use letters of intent because they do not want to trigger disclosure obligations).
139. Hwang, *supra* note 8, at 1413 (describing the M&A deal checklist, which keeps track of all deal documents and action items).
140. *Id.*
141. Matthew Jennejohn, *The Private Order of Innovation Networks*, 68 STAN. L. REV 281, 319–20 (2016) (describing cross-firm collaborations).

agreements and contracts is a first step toward incentivizing deal parties to use preliminary agreements as organizational tools.

C. The Temporal Boundaries of the Deal

Previous work argued that, contrary to conventional assumptions, deal boundaries are not defined by the definitive acquisition agreement.[142] Rather, a deal is struck through many contemporaneous agreements that interact with each other, and a deal's theoretical boundaries must expand to include those. Previous work further argued that if a deal consists of many contracts, contract disputes involving one contract should perhaps be considered with reference to related contracts within the same deal.

Of note, however, is that previous work studied only contracts that are entered into at the same time as the acquisition agreement. It did not consider non-contract agreements, and agreements and contracts entered into non-contemporaneously with the acquisition agreement. In other words, it clearly defined contemporaneous contracts as within the boundaries of the deal, and noted that other contract-like tools were too difficult to categorize without further study.

Through an investigation of preliminary agreements, this Article tries to understand whether those non-contemporaneous, non-contract agreements can be considered within a deal's boundaries. More clearly defining which documents are within the deal's boundaries can aid in contract interpretation. Judges, for instance, can look to other documents within the deal's boundaries to help sharpen their understanding of the deal, or to help interpret vague provisions.

Preliminary agreements are a particularly interesting part of the deal-boundary puzzle. On one hand, a preliminary agreement bears strong resemblance to the document at the very center of a deal: the acquisition agreement. Unlike an ancillary agreement, which contains provisions that supplement an acquisition agreement's provisions, the preliminary agreement covers the same substantive territory as many acquisition agreement provisions. Because preliminary agreements bear such a close resemblance to acquisition agreements, preliminary agreements appear very much at the center of deals, and therefore firmly within the deal's boundaries. Placing the preliminary agreement so firmly within the deal's boundaries, however, has consequences that appear, plainly, to be against the intent of the drafting parties. For

142. Hwang, *supra* note 8, at 1449.

example, if preliminary agreements are at the center of deals, their terms might be useful in interpreting ambiguities in the acquisition agreement. But parties clearly intend for preliminary agreements not to be binding, which means that parties intend to leave room for acquisition agreement terms to sometimes, by design, deviate from the preliminary agreement's terms. Thus, it seems unreasonable to use the preliminary agreement to interpret ambiguities in the acquisition agreement.

While preliminary agreements do look very much like acquisition agreements in some ways, they also deviate quite substantially from the other documents that are clearly within the boundaries of the deal. Employment contracts for key employees, for instance, are clearly within the boundaries of the deal, but preliminary agreements are not very much like employment agreements at all. For example, employment agreements are often necessary to the deal and preliminary agreements are not. Employment agreements also provide supplemental provisions to the acquisition agreement, and may make explicit reference to or incorporate by reference the acquisition agreement's terms, which suggests that employment agreements and acquisition agreements ought to be read together. In contrast, preliminary agreements are not supplemental to the acquisition agreement, and do not incorporate the acquisition agreement by reference. Perhaps the most important difference, however, is that employment agreements, and most other ancillary agreements that are clearly within the boundaries of the deal, are contracts. Although preliminary agreements may look like contracts, this Article has made the case they are not.

On balance, it appears that preliminary agreements ought not to be considered part of the bargain. Perhaps one important principle that can be distilled from this Article's investigation into preliminary agreements is that only deal contracts ought to be eligible to be considered part of the bargain. Preliminary agreements, which are prone to change, are not contracts, so they should not be used to interpret other parts of the deal.

One important note, however: although preliminary agreements are not signed at the same time as the acquisition agreement, it is not this timing mismatch that makes preliminary agreements not part of the bargain. In fact, there are other contracts signed before the acquisition agreement that might, pending further investigation, fit into the boundaries of the deal. Confidentiality agreements, for example, are binding contracts, and they are often incorporated by reference into the acquisition agreement. Their incorporation by reference suggests that parties intend for them to be part of the deal even though parties enter into them well in advance of the acquisition agreement.

Exclusivity agreements—and even the binding exclusivity provisions of otherwise non-binding preliminary agreements—fall into the same category. They are far removed, temporally, from the acquisition agreement. However, because they are contracts, and because parties show clear intent for them to be part of the bargain, they clearly are part of the bargain. In contrast, non-contract documents, no matter their temporal proximity to the signing of the acquisition agreement, seem to be outside the boundaries of the bargain.

CONCLUSION

This Article investigates the role of non-binding preliminary agreements in M&A deals. It argues that non-binding preliminary agreements are better understood as signposts for the accumulation of deal momentum, rather than as contracts. Non-binding preliminary agreements contribute to dealmaking through their formal, rather than substantive, functions. They help parties organize their bargains, introduce reputational intermediaries to the dealmaking process, and attach moral suasion. Enforcing these agreements, however, even with reliance damages, might deter parties from using them.

APPENDIX: A NOTE ON METHODS; INTERVIEWS

Existing scholarship on preliminary agreements has also focused on the results of enforcement, that is, reported opinions from cases that are litigated to a decision. But these enforcement surveys are necessarily incomplete, because most commercial litigation settles out of court,[143] unaccompanied by reasoned judicial opinions that shed light on the circumstances of particular deals.

This Article brings previously un-surveyed qualitative data to the debate in order to close this gap in the literature. In this Article, I rely on three types of inquiry, which are described in more depth below. First, I surveyed literature from practicing lawyers, such as client alerts and memoranda. Then, I reviewed preliminary agreement cases in jurisdictions with high volumes of complex business litigation. Finally, I conducted a series of interviews with practicing deal lawyers. Each method of inquiry is described in more depth below.

A. Practitioners' Literature Survey

Law firms with corporate practices often publish client alerts and memoranda. In the ten years that it took the *SIGA* cases to wind through the Delaware courts, for instance, many practitioners issued alerts and memoranda to update their clients on the results of the case. Because practitioners publish this literature in order to generate business, these alerts do not stop at summaries of the case: They also include high-level opinions and advice about how a case will shape the legal landscape, or how a case should inform practices and norms going forward.

This practitioners' literature is often overlooked as a research source, but is in fact a rich source of information. In the case of preliminary agreements, practitioners' literature provides a rough proxy for large-scale survey or interview data. To survey the practitioners' literature on preliminary agreements, I relied primarily on the digital archives of the Bloomberg database, which attempts a comprehensive collection of practitioners' literature. In addition, a general search of practitioners' literature was conducted. This yielded results from, for

143. *See* David S. Coale, *Settle When the Time Is Right*, 8 A.B.A. SEC. LITIG., COMM. ON COM. & BUS. LITIG. 1, 1 (2007), https://apps.americanbar.org/litigation/committees/newsletter_gratis/commercial_business_litigation.pdf [https://perma.cc/79V4-HSMS] ("Most civil lawsuits settle.").

instance, the Harvard Corporate Governance Law Forum and the law firm Fried Frank's analysis archives, both of which are oft-cited and respected sources for practitioners and academics alike.

B. Litigation Survey

A comprehensive survey was conducted of litigation in all state and federal courts in New York and Delaware relating to preliminary agreement dispute in large business transactions. This Article focused on New York and Delaware because of the relatively high number of business disputes between sophisticated parties that are litigated in those forums. The survey of these cases found that there were fewer than fifty opinions published between the ten-year period from 2007 to 2017. This is a very small number compared to the overall volume of private M&A deals. While the exact number of private M&A deals is hard to count—precisely because they are private, and therefore not always disclosed—overall deal volume provides a rough benchmark. In 2014—one of the years surveyed—companies announced 9802 deals.[144] Another survey suggests that, in just the last month of 2016, 106 private equity deals were alone announced.[145] The very small number of opinions during the surveyed period supports interviewees' accounts that very few preliminary agreements are disputed, and those that are disputed are very rarely litigated to opinion.

C. Interviews

At the heart of this Article are the original interviews. Preliminary agreements are used in private M&A deals, where the terms of the deals and the preliminary agreements are not disclosed to the public. Moreover, preliminary agreements are rarely litigated, so information about preliminary

144. DELOITTE, M&A TRENDS REPORT 2015, at 4 (2015), https://www2.deloitte.com/content/dam/Deloitte/au/Documents/mergers-acqisitions/deloitte-au-ma-2015-trends-240415.pdf [https://perma.cc/SSE5-EHG2] ("In 2014, merger and acquisition activity accelerated meaningfully with those factors well entrenched. The number of deals in the U.S. rose 10 percent to 9,802.").

145. FactSet Research Sys. Inc., *US M&A News and Trends*, FACTSET: FLASHWIRE US MONTHLY, Jan. 2017, at 1, 1, https://insight.factset.com [https://perma.cc/2HQG-8LTD] ("U.S. private equity activity decreased in December, down 2.8% from November. There were 106 deals in December compared to 109 in November."). While not all private equity deals are private, many are. In the absence of data on the number of private deals, data on private equity deals, like data on overall deal volume, provides a benchmark that shows that 21 cases is a very small fraction of deals.

agreements is hard to find in opinions or filings. Original interviews are the best source for understanding this common deal practice.

Interviews were conducted with twelve deal lawyers. Most of the deal lawyers interviewed were trained in and practiced in New York or California, although a few interviewees were trained in or practiced in Virginia, Texas, or Illinois. Seven of the interviewed deal lawyers had more than 20 years of experience advising M&A clients. The interviewee with the fewest years of experience—seven—primarily advises clients on private M&A deals, which is the most relevant type of M&A deals for a study of preliminary agreements.

All interviews were conducted by telephone, on a confidential basis, on the dates indicated. All interviewees are attorneys whose primary practices are M&A, or who had many years M&A experience before moving into general corporate or hybrid M&A/business roles in-house. All interviewees practiced at or were trained at Vault 50 firms. For brevity and confidentiality, each attorney is identified within the text of the Article by reference to a reference term, which is noted below.

Date	Interviewee	Reference Term
New York Attorney Interviews		
May 7, 2016	Recently retired from top legal position at investment bank; previously M&A partner in New York; 25+ years of experience	N.Y. Firm Attorney I
May 17, 2016	Senior M&A associate with experience in New York and Chicago; 12+ years of experience	N.Y. Firm Attorney II
May 26, 2016	Senior M&A associate in New York; 15+ years of experience	N.Y. Firm Attorney III
May 26, 2016	Senior M&A associate in New York; 7+ years of experience	N.Y. Firm Attorney IV
Silicon Valley Attorney Interviews		
May 31, 2016	M&A partner in Silicon Valley; 20+ years of experience	Silicon Valley Firm Attorney I
June 2, 2016	M&A partner in Silicon Valley; 25+ years of experience	Silicon Valley Firm Attorney II
June 15, 2016	M&A partner in Silicon Valley; 25+ years of experience	Silicon Valley Firm Attorney III
June 13, 2016	M&A partner in Silicon Valley; 25+ years of experience	Silicon Valley Firm Attorney IV
June 20, 2016	M&A partner in Silicon Valley; 25+ years of experience	Silicon Valley Firm Attorney V
In-House Attorney Interviews		
May 23, 2016	In-house counsel at Silicon Valley company; previously M&A attorney practicing in Silicon Valley and Virginia; 10+ years of experience	In-House Attorney I
May 25, 2016	In-house counsel at Texas company; previously senior corporate associate practicing in Texas (firms in-house); 20+ years of experience	In-House Attorney II
June 20, 2016	In-house counsel at Silicon Valley company; previously senior M&A associate at Silicon Valley firm; 10+ years of experience	In-House Attorney III