HOW IMPORTANT IS A LETTER OF INTENT?

The importance and impact of a letter of intent or "LOI" in a prospective transaction should not be minimized as it establishes the basic understanding of the parties, and lays out certain terms of the deal that will ultimately be included in the final documents. Despite the overall non-binding nature of a LOI, there will be certain aspects that are legally binding, which requires careful drafting of what will become the structure of the transaction. The terms of this initial document will have significant implications relating to the terms of the transactional documents. Most importantly, and to avoid legal issues, delaying or torpedoing the deal, parties of the transaction are wise to seek legal counsel in the preparation of the LOI to maintain their leverage by weighing all the issues that will flow from the LOI to the operative documents. When the LOI is carefully drafted, it will eliminate confusion and avoid unnecessary disputes during the drafting stages of the transactional documents.

Purpose Of An LOI

A letter of intent is often entered into between a buyer and a seller following the successful completion of the first phase of negotiations of an acquisition transaction. The letter generally, but not always, describes the purchase price (or a formula for determining the purchase price) and certain other key economic and procedural terms that form the basis for further negotiations. In most cases, the buyer and the seller do not yet intend to be legally bound to consummate the transaction and expect that the letter of intent will be superseded by a definitive written acquisition agreement. Alternatively, buyers and sellers may prefer a memorandum of understanding or a term sheet to reflect deal terms.

There are several reasons why letters of intent are used. A buyer and a seller frequently prefer a letter of intent to test the waters before incurring the costs of negotiating a definitive agreement and performing due diligence. If actual or suspected problems are uncovered during due diligence, the buyer may try to use that information to negotiate a lower purchase price or more favorable terms. A signed letter of intent, even if not binding, together with the buyer's inspection of the target's properties and review of its operations and books and records, often will create an expectation on the part of the target's employees, vendors, customers, lenders, or investors that a sale to the buyer will occur. The parties may also feel morally, if not legally, obligated to act on key terms once they are set down in writing. Sometimes the deal terms are sufficiently complicated. It will be helpful to put the terms down in writing to ensure that the buyer and seller have consistent expectations.

A buyer's investigation of the target may also uncover information that can be used by the buyer to compete with the target if the sale is not consummated, even if the target receives protection against the disclosure or use by the buyer of the target's trade secrets and other proprietary information. Notwithstanding these considerations, a seller is often as insistent as a buyer that a letter of intent be executed before the start of work on a definitive agreement. One reason may be that the negotiation of a letter of intent provides the seller with an excellent opportunity to negotiate certain key acquisition issues at a time when the seller possesses maximum leverage. The seller may also feel pressure to show some evidence of a prospective transaction to lenders or other interested persons. If the seller is not bound by an exclusivity provision, it may want to use the letter of intent to prompt other potential buyers to compete for the business transaction opportunity.

In addition, signing a letter of intent at an earlier stage of the acquisition process, rather than waiting for the definitive agreement, can facilitate compliance with regulatory requirements. For example, a premerger notification form can be filed under the HSR Act upon entering into a letter of intent, thereby starting the clock on the applicable waiting period. (See the discussion of the HSR Act in Section 1.1 of the Model Agreement.) A signed letter of intent may also assist the buyer in convincing prospective lenders or investors to evaluate the transaction for the purpose of providing financing.

Components Of A Properly Drafted LOI

The LOI should outline the structure of the transaction, which may also have an impact on potential tax issues, as well as the overall economics of the deal. Buying or selling a business involves either a stock or asset purchase, which may vary and cause a different economic result to the parties. Allocating risk is part of the negotiations, which ultimately impacts the purchase price and tax consequences. This is one important reason why it is critical for both parties to be represented by competent counsel having experience with respect to mergers and acquisitions. A transaction structured as a stock deal is generally more favorable to the seller for tax purposes; however, the buyer bears significant risk, which must be accounted for in the purchase price and/or escrow provisions. If the LOI does not contemplate the potential risks, it is likely that there will be an attempt to renegotiate the terms when drafting the transactional documents, which could lead to delay or withdrawal by one of the parties.

Although the seller and the buyer will generally desire the substantive deal terms outlined in a letter of intent to be nonbinding expressions of their then current understanding of the shape of the prospective transaction, letters of intent frequently contain some provisions that the parties intend to be binding. As discussed more fully below, the binding provisions of a letter of intent generally relate to the process of conducting the negotiations proceeding towards a definitive agreement.

Furthermore, a letter of intent often covers how expenses of the acquisition and negotiations, such as fees and expenses of brokers, attorneys, and other advisors will be paid, and limits the rights of each party to publicize the acquisition or negotiations without the consent of the other party. A letter of intent may establish the time frame for conducting due diligence and closing the acquisition, along with certain other milestones and pre-conditions prior to the execution of a definitive agreement or the closing of the transaction.

Reasons To Forgo An LOI

Although letters of intent are common, no consensus exists among business lawyers regarding their desirability. Many lawyers advise their clients that the great disadvantage of a letter of intent is that provisions intended by the parties to be nonbinding may later be found by a court to be binding. There is often an inherent conflict between the goals of the parties in negotiating a letter of intent. The buyer generally is most interested in securing exclusivity or other standstill types of provisions from the seller while seeking to maintain great flexibility regarding the purchase price and other key provisions that may be impacted by the results of the buyer's acquisition review of the target. The seller, on the other hand, generally will attempt to define more clearly the purchase price, limitations on its exposure with respect to the representations that will be part of the definitive agreement, and key terms of employment agreements, noncompete covenants, and other ancillary arrangements. If possible, the seller will prefer to avoid altogether, or to limit the scope of, any exclusivity commitment.

The negotiation of a letter of intent can sometimes become bogged down in detailed discussions that are generally reserved to the negotiation of the definitive agreement. Because of these twin concerns, the possible, but unintended, binding nature of the letter of intent and the risk that the negotiation of the letter of intent will become mired in endless detail, lawyers often advise their clients to forgo a letter of intent and commence negotiation of a definitive agreement.

At the onset, it is helpful to determine the client's desires as to whether a letter of intent is binding. For example, the acquisition may be so economically or strategically attractive that the client is willing, as a business decision, to risk being bound at this initial stage. The parties might also intend to be bound if the acquisition review has been completed and all economic issues have been settled. However, a fully binding letter of intent can lead to problems and unexpected results, if the parties later are unable to agree to the terms of a definitive agreement.

Most often, many terms have not even been considered, much less discussed or settled. Moreover, due diligence is rarely completed at this stage and quite often not even commenced, and both parties may be oblivious to many potential pitfalls. Accordingly, the buyer may want to avoid specifics on many business deal points. This strategy may enhance the buyer's negotiating position by deferring discussions on these key issues until after the buyer has completed its due diligence and the seller's negotiating position has been compromised by executing a letter of intent. The seller, on the other hand, will want, in most cases, to resolve all important issues at the letter of intent stage when the seller may have its greatest negotiating leverage. For example, the seller may want to negotiate limitations with respect to its indemnification obligations in the letter of intent by providing for a cap, a basket, an expiration of the indemnification obligations, reliance on the indemnity provisions as the buyer's exclusive remedy, or some combination of these concepts.

The seller may also seek to avoid guaranties and draconian escrows at the outset by facing these issues at the letter of intent stage. When parties to a letter of intent have clearly identified that certain provisions are binding (such as exclusivity) and others are not, courts will enforce the binding provisions as bargained-for agreements and, not likely, read in unstated exceptions.

In Closing

Each business transaction is a unique situation containing a myriad of complex factors. Whether you are the buyer or the seller in the transaction, you should consult with an attorney experienced in mergers and acquisitions before entering into a letter of intent. The level of detail in the letter of intent and which issues should be addressed or deferred are key strategic questions that should be discussed and explored as they can impact on the negotiation process. Importantly, a lawyer can advise you on what portions of the letter of intent should be binding or nonbinding and the risks of entering into a letter of intent, all important issues with a heavy legal overlay.

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