

Letters of Intent Issues in the Purchase or Sale of a Privately Owned Company

By Tom Sowers

1. Introduction.

Purchasers or sellers of businesses often engage corporate attorneys to represent their interests in a transaction after having negotiated the terms of a letter of intent on their own behalf. This usually is an attempt by the purchaser or seller to control legal fees, particularly if there is uncertainty in the mind of the purchaser or seller as to whether the transaction is likely to close. The negotiation of a letter of intent by a purchaser or seller without the counsel of an attorney is not advisable.

To begin with, there are key strategic issues involved in the negotiation of a letter of intent for which a purchaser or seller should seek counsel. Purchasers or sellers contemplating entering into a letter of intent should discuss with their attorneys which issues should be dealt with in the letter of intent or deferred to a later time, which provisions of the letter of intent to make binding or nonbinding, as well as the risks involved in entering into a letter of intent at all. The way these key strategic issues are handled can often have significant implications in the success of the overall negotiation of the transaction.

Also, it is extremely important that the parties' intention with respect to the binding or non-binding nature of the letter of intent, or certain provisions of the letter of intent, be precisely worded. In the absence of such precise language, a purchaser or seller may discover that it has entered into an enforceable agreement to buy or sell a business even though it did not intend to do so. Thus, it is important for both purchasers and sellers of businesses to have lawyers involved in the drafting of the letter of intent to ensure that such their intent with respect to the binding or non-binding nature of the letter of intent is properly represented in the language of the document.

2. Benefits of the Letter of Intent.

Obviously, the first question to be discussed between an attorney and his buyer or seller client prior to the execution of a letter of intent is whether the letter of intent should be entered into at all. Though there is no consensus on the matter, it is probably accurate to state that the majority of corporate attorneys view a letter of intent as being more favorable to buyers than sellers. There are a couple of reasons for this. First, in many letters of intent, the purchaser will negotiate a "no shop" provision into the letter that keeps a seller from negotiating with other potential purchasers of the seller's business for a specified period of time, which results in a key loss of negotiating leverage with the purchaser. Also, after the execution of a letter of intent a seller may be placed at a negotiating disadvantage due to the expectation created on the part of the seller's employees, vendors and/or customers that a transaction will be completed. This expectation that a transaction will occur, and the seller's desire not to have to deal with issues with its employees, vendors or customers in the event the seller's and purchaser's negotiations fail (including uneasy employees who may be uncertain of their job security

if an unknown purchaser enters the picture), can lead to a seller making concessions in the negotiations that it may not have otherwise made.

Despite all of the above, and despite the fact that buyers and sellers often have competing goals in connection with the negotiation of the letter of intent (see Section 3 below for a discussion of these competing goals), in most acquisitions, after the negotiations have reached a certain level of seriousness, the execution of the letter of intent is an important part of the process that has benefits for both the purchaser and the seller.

a. Parties Identify Key Issues Early On In Process. A key benefit to a purchaser and seller negotiating a letter of intent prior to negotiating the definitive purchase agreement is that it will cause the parties to identify and deal with those key transaction issues (i.e., potential “deal breaker” issues) that have yet to be discussed or agreed to by the parties prior to the expenditure of significant legal and other fees relating to the purchaser’s due diligence review of the seller’s business and the drafting and negotiation of the transaction documents.

For instance, if the purchaser and seller have not yet agreed to such terms, the letter of intent will likely cause the parties to have to deal with issues relating to the structure of the transaction, payment terms (i.e., whether the purchase price is to be paid in cash, pursuant to a promissory note, or stock in the purchaser’s company (or some combination of all of these)), employment terms if the parties intend that the seller’s owners or key employees will work for the purchaser/seller after the acquisition, noncompete issues, and indemnification issues (including whether a portion of the purchase price will be held back by the purchaser, or placed in escrow for a certain period of time). Depending on the goals, desires or financial situations of the parties, any disagreement by the parties relating to the foregoing potential issues could be significant enough to cause the parties to not want to proceed with the deal. If this is the case, for both the purchaser and the seller it is best to find this out as soon as possible.

b. Binding Provisions. Most letters of intent are drafted to include provisions that are both non-binding and binding on the parties. In general, the non-binding provisions are the deal term items such as the purchase price and employment terms. The reason these terms are non-binding is that it is usually the case that at the time the letter of intent is executed by the parties the purchaser is still conducting a due diligence investigation of the seller’s business and the parties (usually the purchaser) will want to be able to negotiate these terms based on specific issues or problems uncovered during the due diligence process.

Another key benefit to the parties’ use of a letter of intent in a transaction is that the parties are able to memorialize their understanding as to the binding agreements of the parties relating to the acquisition process. For instance, both sides will typically want to set forth in the letter of intent their agreement as to the allocation of expenses relating to the transaction, including legal fees and brokers’ fees. Also, issues concerning the purchaser’s continuing due diligence investigation can be handled in the letter of intent.

The purchaser will typically want a provision in the letter of intent stating that the seller will cooperate with the purchaser and its investigation of the seller's business and that the purchaser will have reasonable access to the seller's books and records. Related to this, if the parties have not already signed a confidentiality agreement, the parties will want a provision in the letter of intent obligating the other to keep confidential the information received by the parties in connection with their discussions.

Other key binding provisions in a letter of intent include the previously mentioned "no shop" provision, as well as a break up fee provision, which specifies the amount that one party will pay the other if the party walks away from the deal. Please see Section 3 below for a discussion of these provisions.

c. Creates Momentum. Another important benefit to the use of the letter of intent in an acquisition is that many times the execution of the letter of intent by the parties helps create a momentum to the process that get deals to the finish line that may not otherwise have gotten there. This is because in the minds of many buyers and sellers the execution of the letter of intent the psychological hurdle that signifies that the other party is serious about doing the deal. In addition, if it has been the case that a buyer and seller have been reasonable and fair with the other party throughout the negotiation of the letter of intent, the parties are able to proceed with more confidence that future issues arising under the acquisition documents will be handled in a similar manner, which helps create a momentum to finalize the transaction. Finally, the letter of intent often sets forth specific dates for the completion or accomplishment of certain events (for example, the purchaser's receipt of financing, the purchaser's completion of due diligence, the delivery of an initial draft of the purchase agreement, and the closing of the transaction), which if not met will enable the parties to walk away from the deal without any liability to the other party. The inclusion of these dates helps ensure that the parties proceed diligently to complete the transaction.

d. Financing Concerns. In an acquisition where a purchaser is financing a portion of the purchase price, a signed letter of intent is often required by lenders prior to issuing a commitment letter to finance the transaction. In addition, in almost all instances, buyers will not want to pay the commitment letter fee to the lender unless a signed letter of intent is in place.

3. Competing Goals of Purchasers and Sellers.

As stated above, though in most cases the execution of a letter of intent benefits both parties to an acquisition, purchasers and sellers generally having competing goals when entering into a letter of intent. It is important, therefore, that the seller and purchaser discuss with their respective attorneys their main concerns in connection with the transaction, so that the attorney can protect against these concerns with the inclusion of certain provisions in the letter of intent.

a. Purchaser's Goals. In general, a purchaser is most interested in provisions relating to the seller's conduct after the execution of the letter of intent. For example, in

almost all instances a purchaser will want to negotiate into the letter of intent a “no shop” provision. Basically the purchaser wants to know that it is not going to go expend a lot of time, energy and money to review the seller’s business, and to start to prepare legal documents for the acquisition, only to have the seller accept an offer from another party, or attempt to renegotiate deal terms with the added leverage of a potential new buyer in the picture.

Purchasers will also want to insure that after the execution of the letter of intent by the parties that the seller continues to operate the seller’s business in the ordinary course. The concern for the purchaser after the execution of the letter of intent is that the seller may take actions that reduce the value of the business that the purchaser is purchasing and for which the parties have preliminarily agreed to a purchase price. Obvious examples of actions that a seller could take that would reduce the value of the seller’s business post-acquisition are selling of assets of the seller or making distributions or paying dividends to the owners of the business.

b. Seller’s Goals. In general, the seller’s negotiating leverage with the purchaser will be the greatest at the early stages of the negotiation. To begin with, at the early stages of the negotiation, the purchaser will likely not have been through an extensive due diligence review of the seller’s business. If this is the case then negotiations between the parties regarding deal terms, such as the purchase price, will have taken place prior to the purchaser’s due diligence exposing the existence of any faults with the seller’s business. Also, the seller may lose some leverage later in the acquisition process if its customers or vendors are being contacted, or if its employees become aware of the potential acquisition. As discussed in Section 2 above, the expectation on the part of seller’s customers, vendors and employees that the acquisition will occur may make it more difficult for the seller to walk away from the deal if any major issues arise late in the acquisition process. If this happens, the seller may find itself making concessions that it might not otherwise have made early on in the parties’ discussions.

Thus, because the seller’s negotiating leverage with the purchaser is often the greatest at the early stages of the parties’ negotiation, sellers are generally more interested in defining as many deal terms as possible in the letter of intent, including purchase price and the terms of employment if the seller will continue to work for the seller’s business after the closing. Though these terms will almost always be non-binding on the parties, the seller will likely have a much easier time negotiating favorable deal terms prior to any major warts being exposed concerning its business.

4. Key Binding Provisions of the Letter of Intent. Below is a brief discussion of some of the key binding provisions of a letter of intent that a purchaser or seller will want to talk over with its attorney to determine how best to handle these issues in the letter.

a. “No Shop” Provision. As previously discussed, many purchaser will attempt to negotiate into the letter of intent a “no shop” provision, particularly if the purchaser intends to perform significant due diligence on the seller’s business. In the

event a “no shop” provision makes its way into the letter of intent, the seller should be sure to place an outside date certain to the provision after which time the seller’s exclusivity obligation terminates. The outside date will help ensure that the seller is not left in a position of being unable to market its business for sale for an extended period of time if the purchaser does not diligently proceed to a closing of the transaction.

b. Break Up Fee Provision. Many purchasers attempt to include a break up fee provision in the letter of intent that obligates the seller to pay the purchaser a specified amount of money if the seller attempts to walk away from the deal in violation of the letter of intent. The rationale behind the provision is that the purchaser should be entitled to recoup some of its expenses if the seller has a change of heart or finds a better deal. Sellers may want to attempt to negotiate into the letter of intent a similar provision if the purchaser is unable to or fails to close. A seller’s ability to negotiate a purchaser break up fee provision into the letter of intent becomes a lot stronger when the purchaser insists that the seller be bound by a “no shop” provision (i.e., the rationale is that the break up fee is a way to compensate the seller for its lost marketing opportunity while it was subject to the “no shop” provision).

c. Conditions to the Parties’ Obligations to Close. Both parties will want to set forth the conditions that must be satisfied in order for the parties to be obligated to have to proceed with the transaction. In other words, if certain specified contingencies are not met then the parties will not be required to close the transaction. Conditions to closing that are commonly set forth in a letter of intent include a financing condition (i.e., the purchaser must have received adequate financing by a date certain) and the satisfactory completion of a due diligence investigation by the purchaser.

d. Confidentiality/Non-solicitation Obligations. If a separate agreement has not been entered into by the purchaser and seller prior to the execution of a letter of intent, then it will be in both the purchaser’s and seller’s interest to include a provision in the letter of intent obligating the parties to hold in strict confidence the proprietary information of the other party received by the parties in connection with their discussions regarding the proposed transaction. In addition, both the purchaser and the seller may want to include in the letter of intent a provision which prohibits the other party from soliciting for employment the employees of the other party. If a transaction fails to close, neither the purchaser nor seller will want its key employees lost to the other party.

5. Binding/Non-binding Nature of Letter of Intent.

It is rare for the purchaser and seller to intend for the letter of intent to obligate the parties to proceed with the transaction prior to the execution of a definitive purchase agreement between the parties. In almost all instances, the parties intend not to be bound to one another, except as to certain specific provisions governing the conduct of the parties prior to the closing of the transaction (see Sections 2(b) and 4 above).

Assuming that the parties intend not to be bound to proceed with the transaction prior to the execution of a definitive purchase agreement, it is important that the letter of

intent be properly worded to express this intent. It is also important that the letter of intent be properly worded to express the parties' intention that certain of its provisions be binding on them, which often include the provisions described in Section 4 above.

The most important factor for any court reviewing a letter of intent to determine whether the provisions of a letter of intent are binding will be the language of the document. This is one of the reasons why it is important for buyers or sellers to have their attorneys involved in the drafting of the letter of intent. Even a seemingly innocent provision such as "The parties agree to negotiate in good faith toward the execution of a definitive agreement" could cause a court to construe provisions that were intended by the parties to be nonbinding as binding.

6. Summary.

It is not advisable for the purchaser or seller of a business to attempt to negotiate a letter of intent for the purchase or sale of a business on its own behalf. There are many key strategic decisions associated with entering into a letter of intent for which a purchaser or seller should seek counsel, including the decision as to whether the letter of intent should be entered into at all. Once the decision has been made that a letter of intent makes sense for a particular transaction, then it is important for both purchasers and sellers of businesses to have lawyers involved in the drafting of the letter of intent to ensure that such their intent with respect to the binding or non-binding nature of the letter of intent is properly represented in the language of the document.