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Green-Lighting the Deal: Practical Tips for Drafting and Negotiating Letters of Intent

Overview

The letter of intent establishes fundamental terms of the business transaction that are determined during early phases of negotiation. The process of arriving at key terms in a letter of intent often allows negotiations to proceed on a faster time frame by avoiding the drafting time and expense that are required for full legal documentation. It also enables the parties to negotiate high-level terms without having to take a position on the multitude of issues that a complex transaction presents. This not only allows transacting parties to minimize legal costs by saving time, but also may prevent a buyer or seller from taking a stance on a point under one deal structure that it seeks to change at a later date under a new structure. The letter of intent also serves other useful functions. For example, it is a summary of the deal that can be provided to a board of directors or legal, accounting, or other business advisors needing to review the transaction. A signed letter of intent may also assist in the acquisition of transaction financing by enabling lenders to evaluate a transaction agreed to in writing by the parties.

Provisions

A letter of intent typically includes two categories of provisions: key business terms of the transaction and provisions that set forth the ground rules of the parties during negotiations. Key deal terms may include:

- description of the business transaction (*e.g.*, asset or stock deal);
- purchase price and payment terms (*e.g.*, cash, earn-out, debt);
- identification of important employment and non-competition agreements; or
- certain representations and warranties, covenants and indemnities.

These terms are generally non-binding and often evolve over the course of negotiations. However, it is important to state clearly whether there is an intent to be bound or not in every letter of intent. Nearly every letter of intent includes an overview of the structure of the transaction and a provision addressing the purchase price or purchase price formula. Other specific provisions may be included in the letter of intent, rather than waiting for the definitive agreement, as determined by the unique needs of a party to the transaction. For example, when representing a seller, it may be particularly helpful to address, within the letter of intent, indemnities and other issues that should be considered when agreeing upon a purchase price.

The provisions that govern the negotiation process typically address:

- access to the company, personnel, property, and books and records for due diligence purposes;
- exclusive dealing;
- break-up fees;
- conduct of business (*i.e.*, ordinary course);
- confidentiality;
- non-disclosure (*i.e.*, no public comment); and
- allocation of expenses.

These components of the letter of intent usually are intended to be binding upon the parties as they proceed toward a definitive agreement; of course, the parties should be unambiguous about such intent.

Disadvantages

In some cases, a letter of intent can be disadvantageous. A letter of intent may cause transacting parties to build momentum without working through all of the issues that inevitably will have to be resolved prior to closing. If certain points are set out in the letter of intent, it can be more difficult for a party to adjust the terms because of the social norms associated with negotiation practice. Such circumstances reduce a party's bargaining leverage and may result in a deal that is ultimately less acceptable to that party.

Public Companies

If a public company is party to the transaction, a letter of intent can raise difficult disclosure issues under the securities laws. SEC rules require disclosure when there is an affirmative disclosure obligation, such as an annual or quarterly report filing, or other specific disclosure event. Depending on the context and content of the disclosure, not disclosing a potential deal can be seen as an omission. Because letters of intent are an indication of intent to enter into a transaction, they are frequently not used in the public company context.

Conclusion

Whether or not to use a letter of intent is something that lawyers should discuss early on with their clients, making sure the client understands the strategic impact of signing a letter of intent. If a buyer ultimately decides not to use a letter of intent, it is recommended that the buyer enter into a stand-alone no-shop agreement with the seller to prevent the seller from soliciting other buyers while the buyer is expending resources to evaluate the transaction. In all cases, parties need not feel bound to a rigid formulation; the content of the deal should drive the content of the letter of intent.

Sources

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