

Letter of Intent:

Do's and Don'ts for Entering into Letter of Intent

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THE VIEW HOTEL

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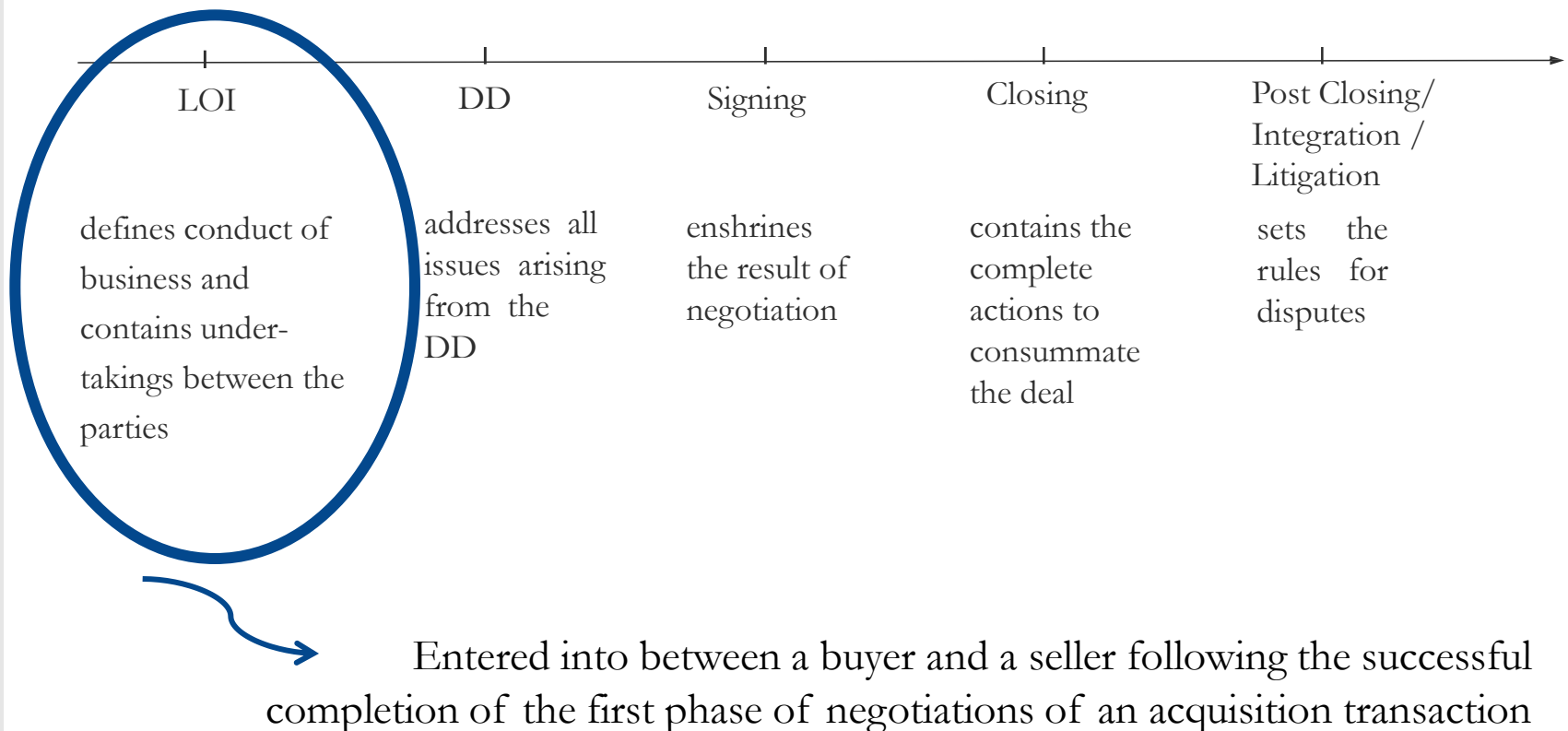
Overview

- **Purpose:** to establish a framework to govern the relationship between the parties during the due diligence process and the contractual negotiations
- **Notion and legal qualification:** delimitations and distinctions
- **Strategy:** simple letter vs. systematic presentation of the transaction and its key parameters
- **Perspective:** Buyer vs. Seller
- **Main clauses:** *amongst others* object, price, exclusivity, confidentiality, cost coverage, way-out, break up fees.
- **Content:** binding / non-binding terms
- **Litigation:** Liabilities and Remedies
- **Conclusions**



Timeline

Best illustrated by looking at the time-line of a M&A transaction





Purpose

Why enter into a Letter of Intent?

- to “*test the waters*” before incurring the costs of negotiating a definitive agreement and performing due diligence
- feel morally, if not legally, obligated to key terms once they are set down in writing
- if the deal terms are sufficiently complicated, it is helpful to put them down in writing to ensure that the buyer and seller have consistent expectations
- assist the buyer in convincing prospective lenders or investors to evaluate the transaction for the purpose of providing financing
- facilitate compliance with regulatory requirements (*eg* a premerger notification form)



Notion

- *Unrelated instruments*: comfort letters (lettre de confort, lettre de patronage, Patronatserklärung)
- *Related instruments*: Options, Confidentiality Agreements
- *Variations in Terminology*: Memorandum of Understanding, Memorandum of Agreement, Heads of Agreement, Term Sheet
- PreContractual Agreements and Promises to Contract
- Unilateral, Bilateral and Multilateral Letters of Intent

This institution enjoys or suffers an almost total absence of specific regulation in Swiss Law, while its purpose, nature and effects are often uncertain and misunderstood.



Legal Qualification

- “Full” Contract
- Synallagmatic Relationship (art. 97ff SCO) or Partnership (art. 530ff SCO)
- Promise to Contract (art. 22 SCO)
- Offer



Strategy

Short letter with basic protections (“*get the parties to the table*”) or systematic presentation of the transaction and its key parameters (“*identify and discuss key negotiation points immediately*”)?

SHORT LETTER

much shorter, less formal, and less legalistic form that might be used when one or both of the parties are very anxious to sign a letter of intent, while preserving protections against later litigation if negotiations break off

US APPROACH

BUYER BEST
OPTION

LONG LETTER

more comprehensive and legally precise form, designed to flush out many of the pertinent issues and to make very clear which elements of the letter are binding and which are not

EU APPROACH

SELLER BEST
OPTION



...Short Letter

Advantages

- can be prepared and negotiated upon very short notice
- can easily be expanded to include more details on non-binding provisions or to add binding provisions such as exclusivity
- is more user-friendly and less intimidating in the early stages of the acquisition process

Disadvantages

- leaves open many important issues to be resolved later on



...Long Letter

Advantages

- issues that are deal-breakers can be identified early in the negotiation process before substantial expenses are incurred in due diligence and the drafting of a definitive agreement
- resolution of difficult issues at the letter of intent stage facilitates the negotiation of a definitive agreement, permitting the buyer more time and energy to prepare for the transition to its ownership of the target

Disadvantages

- it may burden the negotiations with too many difficult issues too early in the process and may impede the deal's momentum or even cause a breakdown in the negotiations that may have been avoided if certain issues had been deferred



Perspective

There is often an inherent conflict between the goals of the parties in negotiating a letter of intent.

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 due diligence of the target.

SELLER

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, non-compete covenants, and other ancillary arrangements, and, most of all, will prefer to avoid, or to limit the scope of, any exclusivity commitment.

negotiation can sometimes become bogged down in detailed discussions that are generally reserved to the negotiation of the definitive agreement.



Main clauses

Non-Binding:

The letter of intent will typically state that it is non-binding, except for certain designated provisions. Usually at this stage in the acquisition process, neither the buyer nor the seller are willing to be bound to conclude a transaction. Further, the letter of intent does not contain all the terms that should be agreed upon in an acquisition. Amongst the non-binding provisions:

- **Object of the transaction:** in the first non-binding provision of the letter of intent, the parties confirm their intent to carry out the planned transaction and define the essential business points of the transaction.
- **Nature of the transaction:** share deal, asset deal, capital increase, spin off, leveraged buy-out, joint venture, etc.
- **Outline of the next steps - timetable:** in addition to defining the major business points, the letter of intent should lay down the next steps of the transaction. To avoid a misunderstanding between the parties on the stages or duration of the procedure, it is further advisable to include a timetable for the due diligence, the contract negotiations and the closing of the transaction



Main clauses

- **Description of the Due Diligence:** for the purpose of clarity, it is advisable that the parties define the extent and the duration of the due diligence.

Further, a letter of intent should clearly describe the documents and information the buyer is to receive as part of the due diligence, whether the buyer is permitted to lead discussions with the management, whether a thorough environmental analysis will be conducted, and the period of time available to the buyer to analyze the documents and information received and to complete the due diligence.

- **Price/Consideration:** will it be all cash, all or part stock, earn-out, or promissory note? Any escrow to secure the seller's indemnification obligations? If the purchase depends on the results of the due diligence, the parties sometimes do not fix a purchase price, but rather provide for a price range or a valuation method whereby the purchase price will be calculated.

- **Adjustments to the purchase price:** will it be a cash-free/debt-free deal? A working capital calculation and adjustment mechanism? Treatment of severance costs and transaction fees and expenses?



... Main clauses

Binding:

- **Confidentiality – non solicitation:** the letter of intent and its terms should be agreed to be confidential and typically subject to the non-disclosure agreement between the parties.

In the due diligence phase of the transaction, the Seller will want to prevent the Buyer from disclosing or making use of sensitive business information that is disclosed to it, or from poaching the employees of the target business.

- **Exclusivity:** the scope and terms for exclusivity granted to the buyer.

Exclusivity provisions are generally sought by buyers who do not wish to compete or continue competing with third parties for a deal. As one might expect, sellers agree to exclusivity reluctantly, as doing so may reduce their ability to maximize value from the transaction by inducing competing bids. However, without exclusivity, many buyers will refuse to invest the time and resources in conducting fulsome due diligence and negotiating definitive transaction agreements.

- **Expenses:** statement that the parties each bear their own expenses or, in some instances, whether one party (usually the buyer) will cover some of the other party's expenses.



... Main clauses

Binding:

- **Way-Out:** Exclusion of liability resulting from "*Culpa in Contrahendo*", excluding a legal obligation.

To avoid that a party, in the event of a break-down of the negotiations, raises claims under the theory of "*culpa in contrahendo*", it is advisable, to state in the letter of intent that each party has the right to terminate the negotiations at any time and that the termination does not give rise to any claims of the other party. This helps to avoid unnecessary and usually fruitless discussions on damage claims.

To avoid any ambiguities, the letter of intent should clearly state which of its provisions are binding on the parties and which are non-binding. In particular, it should clarify that an obligation to carry out the transaction exists only once the parties have validly executed a written purchase agreement. A clear statement on the binding and non-binding provisions **is the most crucial point of the document** as, on the one hand, it prevents the parties from interpreting the document as an executed purchase agreement and, on the other hand, from claiming in their later negotiations that a binding oral agreement on the major points had been reached during their discussions.



... Main clauses

- **Breakup fees:** sometimes an aggressive counterpart will insist for inserting in the agreement the so called “exit fees” (more common in takeover deals)

A breakup fee (sometimes called a termination fee) is a penalty to be paid if the Seller backs out of a deal (usually because it has decided instead to accept a more attractive offer). The breakup fee is ostensibly to compensate the original Buyer for the cost of the time and resources expended in negotiating the original agreement.

A reverse breakup fee is a penalty to be paid to the Seller if the Buyer backs out of the deal, usually because it can't obtain financing. Reasons for such fees include the possibility of lawsuits, disruption of business operations, and the loss of key personnel during the period when the Buyer was "in play."

- **Conduct of the Business:** buyers sometimes insist that sellers agree to operate the selling company's business only in the ordinary course and refrain from certain material actions.

Buyer will want to restrict Sellers from shifting assets or otherwise affecting the operations of the Acquired Companies in a way that may reduce Acquired Companies' value before specific provisions are put in place in a definitive agreement. Sellers may object to these levels of restraint on the operation of the Acquired Companies' business in the absence of any binding agreement on the terms of a sale or earnest money payments by Buyer



Content

Binding / non-binding terms?

- Although the seller and the buyer will generally desire the substantive deal terms outlined in a letter of intent to be non binding 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
- What portions of the letter of intent should be binding or non-binding and the risks of entering into a letter of intent at all are important issues with a heavy legal overlay
- The level of detail in the letter of intent and which issues should be addressed or deferred are key strategic questions and their likely impact on the negotiation of the transaction should be fully explored



...Content

Did the parties intend to be bound?

In determining whether the parties intend to be bound, the courts generally examine the following factors (expression of the general principle of good faith):

- the actual wording of the document
- the context of the negotiations
- whether either or both parties have partially performed their obligations
- whether there are any issues left to negotiate (presence of the *essentialia negotii*)
- whether the subject matter of the discussions concerns complex business matters that customarily involve definitive written agreements.



...Content

Courts have consistently stated that the most important factor in determining whether or which provisions in a letter of intent are binding is the language used by the parties in the document. A detailed wording is an attempt to remove the possibility that oral communications or other actions can give rise to a binding obligation

The language of the letter of intent should, therefore, be

DEFINITE AND PRECISE

In order to avoid factual situations and subsequent communications that have led some courts to find provisions of a letter of intent to be binding despite language seemingly to the contrary in the document



...Content

Strong wording

- *“no past or future action, course of conduct, or failure to act relating to the Possible Acquisition... will give rise to or serve as a basis for any obligation or other liability on the part of any of the parties or any of the Acquired Companies”*

Weak wording

- *“subject to a definitive agreement”* (in some cases such language has been interpreted as a mere condition subsequent rather than the requisite intent not to be bound).

Advisable to avoid

- Worded e-mails
- oral statements such as *“Looks like we have a deal!”*
- Handshakes
- Phrases like *“must”, “shall”, “is obliged to”, “has a right to”*



...Content

Sample wording

- Incipit: “*the Buyer hereby confirms **its interest in pursuing**, directly or through one or more of its affiliates that is acceptable to Seller, **the acquisition of the Target** (as more fully described herein)”*”
- Price determination: “*Subject to completion of satisfactory due diligence, the total consideration offered by the Buyer for the Transaction **will be up to...***”
- Definitive agreements to be drafted: “*Concurrent with completion of Buyer’s due diligence review, **and provided that such due diligence review is satisfactory to the Buyer**, the parties will finalize the Definitive Agreements for the Transaction, all of which shall reflect the principles set forth in this Letter of Intent and such other matters as the parties may agree”*”
- Internal approval: “*The Definitive Agreements and consummation of the Transaction will require **approval from each party’s Board of Directors** in accordance with its respective internal regulations, to be granted prior to the signing of the Definitive Agreements. Such approval shall in all cases be **subject to the negotiation of mutually acceptable Definitive Agreements** based on the principles of this Letter of Intent”*”



...Content

- Exclusivity: *“The Sellers undertake that until [date] it will not solicit, in any manner whatsoever, directly or indirectly, offer for, or participate in negotiations with, any other person with respect to the disposition of any part of the capital stock or of the assets of the Target”*
- Binding Provisions: *“Section ..., Section ... etc. **hereof are binding and shall survive any expiration or termination of this Letter of Intent...** All other provisions of this Letter of Intent are non-binding”*
- Nature: *“This Letter of Intent shall not be interpreted and/or construed as, or shall constitute, an obligation of the Buyer to purchase or to enter into any agreement ... Unless and until the parties execute and deliver the Definitive Agreements and subject to the foregoing, **no party shall have a binding or enforceable obligation with respect to the Transaction**”*
- Termination - No liabilities: *“Either party may terminate negotiations with respect to the Transaction at **any time for any reason or no reason at all, ... without liability to either party hereto**”*



Litigation

Contractual Liabilities and Remedies

To the extent that a letter of intent can be considered a contract, with binding effects, if performance does not occur, the creditor may, pursuant to Art. 97ff SCO:

- (i) demand that the obligation be carried out (*specific performance*) and claim damages for late performance ("*first option*");
- (ii) waive his right to require performance and either (a) claim damages for non-performance ("*positive interest*"), and (b) claim the damage it would not have incurred if the negotiations had never taken place ("*negative interest*")

Occasionally, the parties may expressly provide for liability in the event of breach and for the consequences thereof, for example in the form of conventional penalties. Where they have not, the practical consequences of contractual liability might vary considerably and will therefore be assessed on a case by case basis, which might prove to be extremely difficult.



Litigation

Pre-Contractual Liabilities and Remedies

A Letter of Intent can have legal effects even if does not qualify as a contract.

Obligations derive from the rules of good faith (art. 2 and 3 SCC) on the basis of the *culpa in contrahendo* principles: as soon as the parties start to negotiate they must observe pre-contractual duties (qualified good faith).

Pre-contractual duties include: (i) a duty to act honestly (with the intent to conclude an agreement); (ii) a prohibition to deceive (fake auction process); and (iii) a duty to inform (facts which have an impact on the decision to enter into the deal, particular knowledge of a party, parallel negotiations); and (iv) a duty to advise.

Unlike contractual liability, *culpa in contrahendo* entitles the parties to negative interest only



Conclusion

A well-drafted letter of intent can increase the likelihood of an acquisition successfully closing, on optimal terms.

To avoid any ambiguities, the letter of intent should clearly:

- (i) state which of its provisions are binding on the parties and which are non-binding
- (ii) clarify that an obligation to carry out the transaction exists only once the parties have validly executed a written purchase agreement



THIS IS THE MOST CRUCIAL POINT OF THE DOCUMENT AS, ON THE ONE HAND, IT PREVENTS THE PARTIES FROM INTERPRETING THE DOCUMENT AS AN EXECUTED PURCHASE AGREEMENT



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