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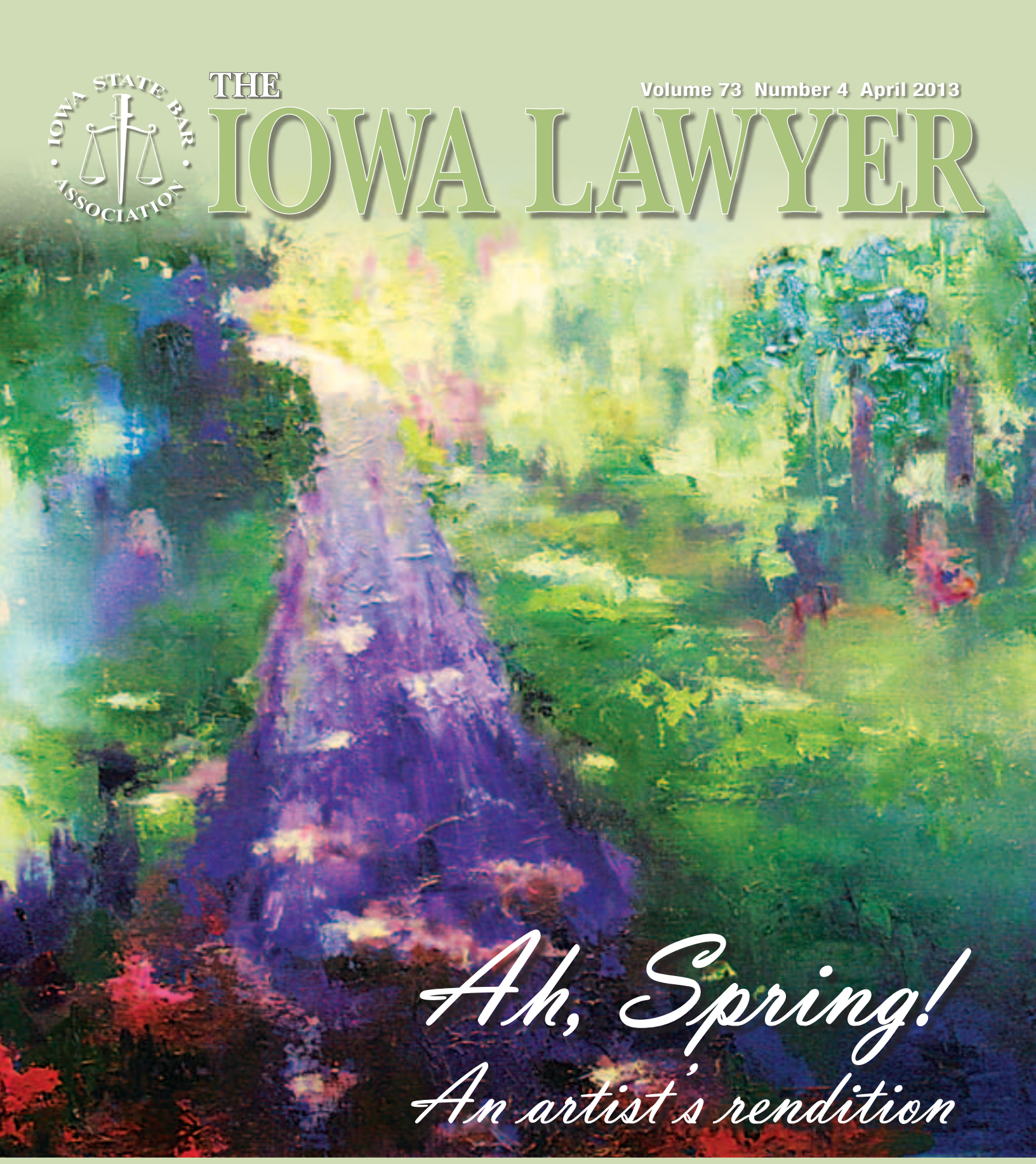

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Letters of intent constitute the best first step in buying or selling a business

*By Michael J. Dayton**

Ah . . . Spring! I assume it is spring, as I am writing this article at the end of February. Remember the storm of the century that never materialized that was followed by the actual storm of the century about which we had no warning? The latter is going on right now. Memories.

Anyway, with the change in seasons comes a change in focus. As much as I enjoy shareholder disputes [see February Iowa Lawyer article] and forming entities [see March Iowa Lawyer article], my true passion is helping clients buy and sell businesses. For the corporate lawyer, unless you are your client's de facto general counsel, there is no better way to get to know your client and your client's business. Whether you are helping a selling client draft disclosure schedules or assisting a purchasing client in due diligence, you get an in-depth look at your client's business, and prospective future business, that you cannot obtain through one-off projects.

At the same time, you are pushed to your legal and organizational brink, negotiating with respect to 15 to 20 areas of the law where semantics mean everything, and moving so many pieces it's like you're Bobby Fischer playing 10 games of chess at once. The late nights, impending closings, last minute roadblocks to demolish, last minute problems to solve . . . honestly, I'm getting tingles (it might be an ulcer).

Before I get too far ahead of myself, I want to bring us back to the beginning — at least the likely beginning for you as the lawyer in the transaction — the letter of intent (LOI). A letter of intent should be, though it is not always, a set of "non-binding" key deal terms and a set of binding ancillary and boilerplate terms for the transaction. Which terms to include and which to exclude will largely be dependent upon whether you are counsel for the seller or the buyer and the specific nuances of the transaction. An LOI, if one is used at all, is usually signed once certain key terms have been agreed to but prior to substantial due diligence by the potential buyer.

Clients probably feel that the letter of intent is something contrived by corporate attorneys to pad their wallets. Their reasoning might be: "before we negotiate a 50-page agreement, let's spend an equal or longer amount of time negotiating a five-page agreement." This may explain why clients will attempt to draft letters of intent on their own (which can turn out very badly).

Though letters of intent are not always necessary, they do serve a purpose. The purposes for the potential buyer and seller are, in many ways, different. However, the primary purpose of an LOI — making sure the buyer and seller are on the same page regarding key deal terms before they spend a lot of time and money — serves the buyer and seller equally well.

This article assumes that the parties have decided to enter into a letter of intent and discusses certain key provisions that may be included. The reasons a buyer or seller may be reluctant to enter into an LOI are beyond the scope of this article, but include: 1) exclusivity; 2) different leverage at the LOI stage; and 3) potential increased cost and length of negotiating the transaction.

Non-binding provisions

The non-binding provisions of a letter of intent will generally include: 1) introductory provisions naming the parties, outlining the transaction and explaining that the letter of intent is generally non-binding; 2) a further detailing of the assets to be acquired (or other nature of the transaction, such as stock acquisition or merger); 3) a description of the purchase price and any adjustments to the purchase price; 4) a description of the closing and the principal conditions that must be satisfied for the purchaser, and sometimes the seller, to be obligated to close the transaction; 5) a due diligence provision; and 6) other key deal provisions that may be negotiated between the parties.

Introductory language; statement of non-binding effect. The letter of intent should commence with a summary explanation of the parties to the transaction and a simple description of the transaction (the transaction is discussed in more detail below). After this usual preamble language, the LOI should include a provision that states the LOI "does not contain all of the essential terms" of the deal and that negotiations must be completed and a definitive agreement executed before the transaction is to be consummated.

An explicit statement should also be included that, except for a delineated list of binding provisions (discussed below), the terms of the LOI are non-binding. These provisions may be contained later in the boilerplate paragraphs at the end of the LOI, but for purposes of truly establishing the intent of the parties to the LOI, I prefer to place the provisions in the introductory section — before you get to the point of the agreement where the buyer and seller have stopped reading.

Listing of assets or other description of the transaction. For lawyers, the form of the transaction may be the first matter you discuss with your client, and it will certainly make its way into the LOI. Perhaps ironically, the form of the transaction is often missing when the buyer and seller have drafted a letter of intent without attorney involvement.

The LOI should, at a minimum, have one sentence describing the proposed form of the acquisition. For an asset acquisition, a list of assets to be acquired (introduced by "all assets, including, without limitation, the following" may be used), and a list of key assets that will not be acquired should also be included, A listing of liabilities to be and not to be assumed is also appropriate.

Purchase price and adjustments. It probably goes without saying that the purchase price should be included in the letter of intent. The more difficult question is how detailed the adjustments (e.g., net working capital,

accounts receivable true-up, earnouts) to the closing purchase price should be. Generally, the greater relative effect the adjustment can have on the purchase price, or the more convoluted the calculation of the purchase price, the more detailed the seller, and sometimes the buyer, will want the provision to be. Depending on the circumstances, ambiguity may serve the buyer well, giving the buyer room to negotiate as the deal nears execution.

Closing and conditions to closing. A description of when and where the anticipated signing and closing will occur should be included to set expectations. Further, both the buyer and seller will want to know what the buyer's conditions to closing the transaction will be. In some instances, the seller's conditions to closing may also be included. Obviously the buyer will want the broadest conditions possible, including, due diligence, financing and board approval. The fewer and more narrow the conditions, the better for the seller.

Due diligence. Another key provision in the LOI deals with how the parties will handle the due diligence process after execution of the LOI. For the buyer, a simple statement requiring the seller to provide access to its records and employees and to give all assistance reasonably requested by the buyer may be sufficient. The seller, on the other hand, may want to limit the access the buyer will have so that operations are not interrupted or otherwise adversely affected. To that end, a seller may limit a buyer's access to certain, or all, employees, and prohibit any interaction between the buyer and seller's customers, suppliers and regulators.

Other key terms. I will continue my monthly rant against blindly using forms by saying this: You can start with the form letter of intent — there is no reason to redraft the boilerplate each time — but discuss with your client and think through what other key terms are important to your client in the specific transaction. For a seller, this may include guaranties of employment for certain members of the seller group (or, in some cases, all employees), limitations on representations and warranties, and baskets and caps with respect to indemnification claims.

The buyer may be interested in key customer or regulatory approvals or escrow arrangements. I often include a provision about the next steps in drafting the definitive agreements to set expectations, such as: upon execution of the LOI the buyer's counsel will draft an initial purchase agreement for negotiation.

Binding Provisions

As noted above, the LOI contains a number of key deal terms that are nonbinding. It is also important to include a number of binding deal terms; that is, terms that will bind the parties irrespective of whether the transaction is consummated. Binding provisions generally include: 1) brokers and payment of other expenses; 2) confidentiality; 3) governing law (and perhaps venue and jury trial waiver); and 4) termination of the letter of intent (including no shop clauses, termination fees and break-up fees). Other binding terms may be appropriate depending on the circumstances.

Brokers and expenses. Generally, though not always, the parties will bear their respective legal and other agent costs and the costs of any brokers involved in the transaction. Whatever the parties agree upon, it should be included in the LOI as some of these costs will be incurred regardless of whether the transaction is consummated.

Confidentiality. At the point when an LOI is executed, some preliminary due diligence, probably financial due diligence, has likely occurred. Hopefully your selling client has required the buyer to execute a nondisclosure agreement (NDA) prior to conducting such due diligence.

If an NDA already exists, and is sufficient to protect your client's interests, a statement indicating the NDA survives notwithstanding the execution of the LOI should be included. If no NDA, or an insufficient NDA, exists, a fairly strict confidentiality provision covering all information provided to, or otherwise reviewed by, the buyer and its agents is appropriate.

Governing law, jurisdiction — venue, waiver of jury trial. If something goes wrong with respect to the transaction prior to execution of the definitive agreements, the governing law of the LOI can be quite important. Some jurisdictions recognize bad faith claims with respect to LOIs and some do not. Likewise, a consent to jurisdiction or venue provision may be appropriate (if you can negotiate a home court advan-

tage). Unless your client is a sweet old lady selling her local business to a mega-mart, I would recommend a jury waiver provision.

Termination, no shop clauses and related fees. A buyer is usually going to require a "no shop clause" — a provision intended to tie the seller's hands for a period of time (customarily 30, 60, 90 or 120 days, depending on the deal) so that the buyer can perform its due diligence and negotiate a definitive agreement in good faith without worrying that the seller is seeking another suitor. For the seller, depending on the length of the no shop clause, the no shop period may be sufficient to drive other potential purchasers away. In that case, the buyer will have increased its leverage position and, if the deal does not close, will leave the seller with nothing but legal fees, a buyer that has sifted through seller's drawers, and a world of potential buyers wondering why the buyer backed away from the sale. Despite these drawbacks for the seller, the provision is common.

The no shop clause ties into the termination of the letter of intent. Generally a termination provision will provide that the LOI will terminate upon 1) notice from the buyer to the seller that he/she does not want to continue pursuing the deal or 2) the later of (a) the date the seller provides such a notice to the buyer or (b) the expiration of the no shop period. However, a seller with sufficient leverage may be able to have the LOI terminate upon the earlier of (2)(a) or (b) above, or avoid the no shop clause altogether.

As part of the termination, sometimes a party will be required to pay a fee or reimburse the other party for expenses. A seller with significant leverage (or who has been burned in the past) may be able to negotiate a termination fee. Under this type of provision, if the acquisition is not consummated (for any reason or based on buyer's actions, depending on the circumstances) the buyer must pay a termination fee to the seller. This provision can protect a seller when a no shop clause is present.

A buyer, on the other hand, may negotiate either a break-up fee or a provision requiring the seller to reimburse buyer for its expenses if the seller breaches the no shop clause or the transaction is otherwise not consummated because of the acts of the seller. The reasoning behind such provisions is that the buyer will potentially have expended considerable sums in conducting due diligence and drafting definitive agreements; however, the seller may also have expended considerable sums, and will certainly have expended time and energy and have undergone interruptions to its business.

Other terms. Other terms may be appropriate or inappropriate depending on the circumstances of the transaction. A provision prohibiting the announcement or other public disclosure of the transaction except as authorized by the parties, required by law or for Hart-Scott-Rodino purposes, is appropriate, if applicable. A buyer may attempt to include certain covenants of the seller — essentially requiring the seller to operate its business in the ordinary course during negotiation of the transaction.

General boilerplate such as counterparts, notices and entire agreement/merger provisions (but remember the NDA) are appropriate. An anti-assignment provision may be appropriate, though the buyer may want the ability to assign the LOI to an affiliate. I would argue that a severability provision would not be appropriate for an LOI.

Finally, the letter of intent is generally drafted as a "letter" from the buyer to the seller. The buyer does not want the offer to remain open indefinitely. As such, the final provision of the LOI should detail the timing and circumstances upon which the seller can sign, accept and deliver the LOI to the buyer.

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