

M&A Letters of Intent: Buyer and Seller Strategies for Drafting and Negotiating Preliminary Deal Terms

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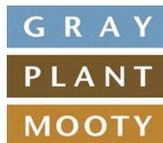
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Letters of Intent in M&A Transactions: Key Issues and Strategies

Mark D. Williamson



B. Scott Burton



December 1, 2015

Introduction

- Early in the M&A process, one (and maybe both) of the parties to the transaction will desire a more formal expression of the matters being discussed
- The seller will want some indication of the buyer's potential price, structure and material terms
- The buyer will want to know the seller's "range of acceptability" and try to "lock up the seller" before it devotes more time and resources
- Parties often use a letter of intent to memorialize these terms and other intentions, with more substantive and detailed negotiations to follow

Today's Program

- Overview of letters of intent
 - Advantages and disadvantages
 - Typical provisions
 - Buyer vs. seller concerns
- Critical legal issue: binding vs. nonbinding
- Duty to negotiate in good faith
- Drafting considerations

Attorney's Role

- Advising client on the need for and issues relating to the use of a letter of intent
- Attorney should draft or review and comment on letter of intent before it is signed
- Critical to review for key legal risks
- Business people often prepare an outline or term sheet to be converted into the letter of intent
- Sometimes terms that may be vigorously negotiated when lawyers are present may be conceded by the business people
- Strike balance between details and deal momentum

Overview of Letters of Intent

A Letter of Intent – What Is It?

- Generally a brief document indicating the parties' intentions or criteria for proceeding with the negotiation of a definitive agreement
- Contains the basic terms of the proposed deal
- Typically a nonbinding document (although often containing binding provisions)
- Also referred to as a “term sheet,” a “memorandum of understanding” and even the seemingly oxymoronic “preliminary agreement”
- Can take many forms:
 - Formal letter
 - Bullet point term sheet
 - Even PowerPoint illustration

Is a Letter of Intent Required?

- A letter of intent is not necessary and not always desirable.
- A number of factors may influence the need (or not) of utilizing a letter of intent:
 - Size and/or complexity of proposed transaction
 - Sophistication of the parties and their counsel
 - Available resources
 - Timing of transaction
 - The competitive nature of the process
 - Desire for exclusivity
 - Regulatory approvals
 - Buyer/seller motivation
 - Amount of perceived leverage

Advantages of Using Letters of Intent

Key Advantages:

- Isolates/memorializes key deal points or identifies deal breakers
- Provides a “deal map” and timeline
- Governs the parties’ relationship up to the signing of definitive documents
- Provides a vehicle for binding obligations (*e.g.*, exclusivity, expense allocation, confidentiality)
- Can be used with regulators (*e.g.*, HSR filing), financing sources, insurers and other constituencies
- Demonstrates the seriousness of the parties and creates “moral commitment”

Disadvantages of Using Letters of Intent

Key Disadvantages:

- Nonbinding nature of letters of intent does not always justify the expenditure of time and money
- Potentially triggers public disclosure obligation
- Certain provisions can lead to loss of leverage
 - e.g., for seller, exclusivity provision
 - e.g., for buyer, too much detail on deal terms
 - e.g., is an omitted item a concession or a deferred topic?
- May inadvertently create a binding agreement as to certain deal points along with potential liability and/or may create a duty to negotiate in good faith

Typical Provisions of Letter of Intent

- Form of Transaction
 - Stock Purchase
 - Asset Purchase
 - Merger or Reorganization
- Identify appropriate parties to transaction
- Price
 - Amount or transaction multiple
 - Form of consideration/timing of payments (cash, stock, earnout, promissory notes, etc.)
 - Source of funds
 - Treatment of debt, cash
 - Escrow or holdback
 - Purchase price adjustments
 - Special tax elections

Typical Provisions of Letter of Intent

- Other Material Terms
 - Extent of representations and warranties
 - Indemnification obligations
 - Representation and warranties insurance?
 - Non-compete obligations
 - Key employment issues
- Conditions to Transaction
 - Completion of buyer's due diligence
 - Receipt of necessary financing
 - Execution of definitive agreements
 - No material change in seller's business or results
 - Receipt of third party/governmental consents
- Milestones/Benchmarks

Typical Provisions of Letter of Intent

- Transition issues
- Other Obligations
 - Buyer’s right to investigate and have access to business
 - Exclusive Dealing/“No-Shop” Clause (with a possible fiduciary out if a public target)
 - Break-up Fee?
 - Confidentiality obligations (unless separate confidentiality agreement was signed)
 - Ordinary course conduct of business

Typical Provisions of Letter of Intent

- Contractual “boilerplate”
 - Choice of law
 - Venue selection
 - Merger clause
 - Responsibility for expenses
 - Termination provisions/survival provisions
 - Signature

Letters of Intent: Buyer's Perspective

- Exclusivity – eliminate other bidders
 - No-shop provisions
 - Notice and copies of other approaches
- Expense reimbursement/break-up fee?
- Access to Information
 - Books and records
 - Real estate
 - Customers
 - Employees
- Operating covenants

Letters of Intent: Seller's Perspective

- Seller's leverage may be highest at this point in a transaction
- Preservation of confidentiality (if not previously addressed)
- No-hire/non-solicitation of employees
- Limited access to information/personnel
- Reverse diligence of buyer
- Other specific terms/transaction details
 - Particularly price and indemnification

Critical Legal Issue: Binding vs. Nonbinding

Legal Principles

- The primary legal issue regarding letters of intent concerns whether the letter is binding or nonbinding
- Letter of intent should be clear on whether or not parties intend document to be binding
- Parties' intent is generally upheld if properly stated
- Often the parties want certain provisions to be binding and others to be nonbinding
- Of course the question only becomes germane when something goes wrong

Legal Principles

- The “real” intention of the parties is a primary factor
- It is not an “all or nothing” proposition – some parts can be held to be binding, yet other parts not
- Is there a duty to negotiate in good faith?
- Is there a claim for promissory estoppel?
- Is there a claim for fraud?
- Surrounding conduct – before and after the letter’s execution – can be crucial
- Make sure your letter reflects reality and your conduct remains consistent

Binding vs. Nonbinding

- Courts will look at language of letter of intent to determine if parties intended to be bound
- If there is a manifest intention that formal agreement is not to be complete until reduced to formal writing, there is no binding contract
- Courts frequently look to the conduct of the parties to determine if there was an intention to be bound

Factors Courts Apply

Teachers Insurance and Annuity Association of America v. Tribune Company

- Court held that a preliminary agreement setting forth economic terms of a proposed loan was binding upon acceptance of the other party, despite the fact there were open terms
- The Court performed a detailed analysis of the rationale for its holding – a set of factors that are still most relevant today for determining intent:
 - The express wording contained in the document
 - The context of the negotiations between the parties
 - The existence/extent of open terms
 - The conduct of any partial performance
 - Whether the customary form for such transactions necessitates a final writing

The Pennzoil Case

Texaco, Inc. v. Pennzoil Co.

- Parties (Pennzoil and certain Getty shareholders) entered into a “memorandum of agreement”
- MOA established a stock price (\$110/share)
- Subject to Getty Board acquiescence
- Board rejected price in MOA and authorized counteroffer
- Pennzoil accepted counteroffer
- Parties issued separate press releases
 - Announced an “agreement in principle”
 - Stated that transaction is “subject to execution of definitive merger event”
- Texaco makes higher offer (\$125/share)
- Getty Board withdraws from negotiation with Pennzoil and enters into agreement with Texaco
- Pennzoil sues

The Pennzoil Case

- Court found:
 - There was a clear intent to be bound as indicated in the press release
 - Focused on the use of “will” in press release
 - Reference to future agreement was not as a condition but rather an indication of timing
 - While there were open terms (*i.e.*, the definitive agreement), the Court felt that these terms were largely perfunctory and not material to the agreement of the parties
 - Pennzoil eventually wins \$10.7B!

Duty to Negotiate in Good Faith

Duty to Negotiate in Good Faith

- Alternative claim that typically is separate from breach of contract
- Some courts have found a separate duty
- Duty does not ensure a deal will be done; rather, it implies some sort of directional negotiations to at least try (*i.e.*, no abandonment)
- What is the proper measure of damages – reliance damages only?

Express Duty of Good Faith

SIGA Technologies, Inc. v. PharmAthene, Inc.

- Delaware Supreme Court held that an obligation to negotiate in good faith according to a term sheet that stated it was nonbinding can be enforceable
- Court concluded that SIGA was acting in bad faith when it proposed terms that were substantially different from those contained in the term sheet (despite an express provision that the term sheet was nonbinding)
- An express provision requiring the parties to “negotiate in good faith” was contained in binding agreements between the parties that were separate from the term sheet
- Court also indicated that expectation damages could be awarded if the court determined that the parties would have reached an agreement but for the defendant’s breach

Express Duty of Good Faith

Ev3, Inc. v. Lesh

- Delaware Supreme Court held that to show a breach of an express contractual obligation of good faith, the other party must show an act of “subjective bad faith” as defined in the context of the parties’ bargain
- Integration clause in a merger agreement that expressly excluded a prior letter of intent (which contained binding and nonbinding provisions) did not change the character of the obligations

Drafting Considerations

Letters of Intent: Drafting Considerations

- If no binding intent is contemplated, use words that clearly indicate nonbinding intent: “would,” “possible,” “proposed”
- Use binding words only if you mean them: “shall/will,” “must,” “covenant,” “agree”
- Be consistent – use only binding words in the binding parts and nonbinding words in the other parts
- Specify and limit any potential remedy for breach

Letters of Intent: Drafting Considerations, cont.

- Use explicit disclaimers of nonbinding provisions
- Disclaimers should include the following:
 - Document is nonbinding in every respect and is for discussion purposes only.
 - There is no agreement relating to the subject matter, whether written or oral, and there is no agreement to agree.
 - The parties will not be bound in any respect unless and until a written definitive agreement is signed and executed.
 - No past or future action, course of conduct or failure to act relating to a possible transaction, or relating to the negotiation of the terms of any possible transaction or definitive agreement, will give rise to or serve as the basis for any obligation on the part of any party.
- Disclaimer should expressly carve out binding provisions

Letters of Intent: Other Considerations

- The “real” intention of the parties is a primary factor
- It is not an “all or nothing” proposition – some parts can be held to be binding, yet other parts not
- Surrounding conduct – before and after the letter’s execution – can be crucial
 - verbal/non-verbal communication (e-mails can be loaded weapons)
 - partial performance
 - press release language
 - “care and feeding” – Turner v. McDavid
- Bottom line – realities govern
 - Make sure letter reflects reality and conduct remains consistent

What If It Goes Wrong?

- Possible Measure of Recoverable Damages
 - Expectation Damages – intended to place the non-breaching party in the same position as it would have been in had the breaching party performed
 - Reliance Damages – intended to compensate non-breaching party for expenses incurred in reliance on breaching party's promise
- To Be Recoverable Damages Must Be
 - Capable of calculation within a degree of reasonable certainty
 - Reasonably foreseeable as a result of a breach at the time the parties enter into an agreement
- What Courts Have Done
 - Courts have generally held that expectation damages, *i.e.*, lost profits or consequential damages, are not available for the breach of binding provision, such as an exclusivity or non-solicitation provision, contained in a nonbinding preliminary agreement, such as a letter of intent or term sheet

Recommended Resources: Articles & Books

- [Model Stock Purchase Agreement, 2nd Ed., ABA Publishing \(2010\)](#) (specifically Ancillary Document B)
- [Special Study for Corporate Counsel on Using Letters of Intent in Business Transactions \(2014 Edition\)](#), Thomson-West (2014)
- Spreen, Kristopher, "Ten Practice Tips for Negotiating the Letter of Intent," Deal Law 13 (May-June 2008)
- The M&A Process – [A Practical Guide for the Business Lawyer](#), ABA Publishing (2005)
- Williamson, Mark D., "Letters of Intent: Their Use in Minnesota Business Transactions," Minnesota Bench and Bar (November 2007)

Recommended Resources: Cases

- [Teachers Insurance and Annuity Association of America v. Tribune Co.](#), 670 F.Supp. 491 (S.D.N.Y. 1987)
- [Texaco, Inc. v. Pennzoil Co.](#), 729 S.W.2d 768 (Tex. App. Houston 1st Dist. 1987)
- [Goodstein Constr. Corp. v. City of New York](#), 604 N.E.2d 1356, 1361 (N.Y. 1992)
- [Venture Associates Corp. v. Zenith Data Systems Corp.](#), 96 F.3d 275 (7th Cir. 1996)
- [Vestar Dev. II, LLC v. Gen. Dynamics Corp.](#), 249 F.3d 958 (9th Cir. 2001)
- [Logan v. D.W. Sivers Co.](#), 169 P.3d 1255 (Or. 2007)
- [Global Asset Capital v. Rubicon US Reit, Inc.](#), C.A. No. 5071-VCL (Del. Ch. Nov. 16, 2009)
- [Turner Broadcasting System v. McDavid, et al.](#), 303 Ga. App. 593, 693 S.E.2d 873 (2010)
- [White Const. Co., Inc. v. Martin Marietta Materials, Inc.](#), 2009 WL 961135 (M.D. Fla. 2009)
- [SIGA Technologies, Inc. v. PharmAthene, Inc.](#), 67 A.3d 330, 2013 Del. LEXIS 265 (Del. Sup. Ct. 2013)
- [Ev3, Inc. v. Lesh](#) (2014 WL 491 4905 (Del. Sept. 30, 2014))

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