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June 16, 2014


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Letter of Intent: Gateway to a Deal

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Your time is valuable. So is the business that you are thinking about selling or the business you intend to acquire. You may also be thinking that before running up professional advisor costs, your business folks should be able to put together a non-binding letter of intent ("LOI") and then turn it over to legal counsel and other advisors. As discussed below, a party entering into an LOI may not be as free to walk away from the deal without consequences as is commonly thought. LOIs that included a covenant to negotiate in good faith have resulted in some courts awarding reliance damages to a jilted party who shows that the other side ended negotiations in bad faith. Reliance damages permit the complaining party to recover out-of-pocket expenses and similar losses linked to its reliance on the other party's agreement to negotiate in good faith. We will return to this good faith issue after covering other important elements of LOIs.

In general, a well drafted LOI represents an opportunity to cover key issues, confirm that a "meeting of the minds" has occurred, and avoid misunderstandings before spending significant time and money drafting definitive agreements. The LOI normally includes a description of the assets or stock being acquired, the liabilities being assumed, the deal structure, and related financial terms such as earn-outs, escrows, baskets, caps, working capital requirements, adjustments, and purchase price allocations. Financing contingencies and other conditions to closing are also included, such as obtaining consents of key vendors, customers, and banks. If seller personnel are to continue employment with the buyer post-closing, this condition should be included as well. LOIs also allow the parties to set forth their expectations regarding the timing of pre-closing activities such as due diligence, the securing of financing, and commencement of definitive document preparation.

LOIs typically contain provisions expressly setting forth non-binding provisions as well as binding provisions. This latter category would include confidentiality and non-disclosure requirements, no-shop exclusivity covenants (pursuant to which the seller is prohibited from soliciting other suitors for a stated period), provisions for the payment of expenses by each party, earnest money deposit terms, and indemnification provisions applicable to a breach of the LOI's binding provisions. LOIs may also include covenants of non-solicitation of employees between the parties during the courtship period as well as for a stated time thereafter in the event that negotiations break off.

Clients sometimes reach out to their business counsel only after negotiating the LOI. The better approach for clients is to obtain input from their professional service team (legal counsel, accountants, and business brokers/investment bankers) prior to negotiating the LOI. Seller's potential for a higher sale price is enhanced by a market analysis of potential strategic and financial buyers as well as a pre-LOI effort to do internal housekeeping and "corporate cleanup." It is much easier to take care of these matters prior to the time a buyer engages in due diligence of the seller.

Not every deal is destined to be consummated, and the parties' efforts to move beyond discussions and put together the LOI can shed light on potential deal breakers. Much time and expense will be avoided if the two sides learn early on that they simply cannot agree on a key transaction term. If the deal progresses to the definitive document stage, a comprehensive LOI will act as a road map for the binding documents and hopefully prevent the parties from re-negotiating the deal. Usually buyers avoid any significant change to the purchase price set forth in the LOI unless due diligence turns up something materially adverse to the seller's operations.

Returning to the issue of LOIs and the potential for a court enforcing a duty of negotiating in good faith, it is clear that clients desiring to have the freedom to walk away from a negotiation for any reason during the LOI stage should look to counsel to assist them with clarifying in the LOI the parties' intent that neither party is to have a duty to negotiate in good faith and that no action taken by the client such as due diligence or partial performance shall create any binding obligation of one side to the other. Otherwise, the gate to an unwanted transaction may be opened just enough for costly litigation, potential reliance damages and, based on a 2013 Delaware Supreme Court case[1], even "benefit of the bargain" type damages. You may be signing up for more than you think.

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[1]SIGA Technologies, Inc. v. PharmAthene, Inc., 67 A.3d 330 (2013).