LAW OFFICES OF BURTON L. RAIMI, P.A.
8499 South Tamiami Trail • Suite 266 • Sarasota, Florida 34238 • (941) 927-1603 • (941) 927-1703 (fax)

MERGERS AND ACQUISITIONS

Preliminary Merger Agreements
Letters Of Intent

Introduction

Following the first round of successful merger negotiations, it is common for the buying company (the "Buyer") to present the selling company (the "Seller") with a "letter of intent". A letter of intent, which may also be called "expression of interest", "agreement in principle", "memorandum of understanding" or the like, is usually written in the form of a letter and runs a mere two or three pages. On the surface, a letter of intent may appear quite simple and harmless; however, if not carefully drafted, a letter of intent can spell disaster for one of the parties to the transaction. A poorly drafted letter of intent can place a party in a weak position when negotiating the terms of the formal, definitive merger agreement or, worse, that party may find itself simply stuck with a bad business deal, to the financial detriment of its shareholders.

Because of the potential problems with letters of intent, many attorneys and investment bankers vigorously advise prospective merger parties to forego a letter of intent and proceed directly to drafting the definitive merger agreement. Despite this advice, the use of a letter of intent in merger transactions continues to be the norm and, if properly drafted, a letter of intent can be quite useful in outlining the terms of a transaction for purposes of negotiating the definitive agreement.
The parties should be mindful that there is no "standard" letter of intent. It is imperative that the parties carefully review a proposed letter of intent and aggressively negotiate its contents to protect the interests of their respective shareholders.

Purposes

A letter of intent is designed to spell out, in a summary fashion, the key terms of a proposed merger. A letter of intent is a preliminary agreement which is expected to be superseded by a formal, comprehensive merger agreement, setting forth the detailed terms and conditions of the transaction. Typically a letter of intent will state the purchase price, or the formula to be used to determine the purchase price, and other key economic terms of the transaction and it will govern the activities of the parties pending execution of the definitive agreement. The Buyer will seek a "no shop" provision to prevent the Seller from negotiating with other potential buyers during this time and, under the terms of the letter of intent, the Buyer will want full access to the books and records, assets and personnel of the Seller to conduct a "due diligence" review. While portions of the letter of intent may be non-binding, its execution tends to impose a "moral" commitment upon the parties to complete the transaction.

Court Decisions

Not surprisingly, a number of lawsuits have resulted when, after the execution of a letter of intent, one party to the transaction decides not to proceed forward. Depending upon the circumstances of the transaction and the language of the letter of intent, a court may find that the letter of intent is a binding contract even though the letter of intent contains language to the effect that it is subject to the negotiation of a definitive agreement.[1]

In reviewing court decisions interpreting letters of intent, the key element is the intent of the parties. If the parties did not intend to be bound by the letter of intent, courts will give effect to that intent.[2] Similarly, if the parties did intend to be bound, the courts will give effect to that intent, even though it was anticipated that the letter of intent would be replaced by a later definitive agreement.[3] In the normal transaction, the parties expect some portions of the letter of intent to be binding, such as the "no-shop" clause and nondisclosure provisions.

To determine the intent of the parties, a court will scrutinize the facts surrounding the execution of the letter of intent, including: (1) the actual words of the letter of intent, (2) the context of negotiations, including oral communications and other actions (such as shaking hands or uncorking champagne), (3) whether or not issues remain open subject to negotiation, (4) the partial or full performance of obligations by one or both parties, and (5) whether the agreement at issue is the type of contract that is usually committed to writing. [4] The fact that certain issues remain unresolved will not necessarily deter a court from finding a binding agreement if the court finds that all the required elements of a contract are present.[5] The court will simply impose its determination of commercially reasonable terms for any unresolved issues.

When it is found that the parties intended to be bound by the terms of a preliminary agreement, courts have held that the parties are obligated to negotiate in good faith to reach a binding agreement.[6] Courts have found that a party has failed to act in good faith if a party (1) simply renounces the deal or refuses to negotiate at all, (2) accepts a higher offer, or (3) makes demands inconsistent with prior terms or takes unreasonable or inflexible positions.[7]

If a court finds a party liable under a letter of intent, a number of remedies are available to the wronged party. The most onerous is the imposition of "expectation damages" which are damages based upon the expected profits the wronged party would have received from the transaction.[8] An alternative measure of damages is "reliance damages" where the damages are based upon the wronged party's out of pocket expenses.

Basic Terms

The letter of intent should include all essential, deal-breaking terms and conditions unique to the transaction to avoid a later break-down in negotiations. Because of the court decisions discussed above, it may be advisable that the letter of intent not contain a provision that requires the parties to negotiate in good faith; rather, the parties rely on a termination fee or some other protection against bad faith dealing.

A Seller should seek to avoid or limit inclusion of a "no-shop" clause. Often, however, this is not possible as inclusion of a "no-shop" clause in the letter of intent is the Buyer's top priority. To off-set a "no-shop" clause, the Seller should insist on a "fiduciary out" clause. A "fiduciary out" clause permits a Seller to terminate the proposed merger in favor of a better deal with another buyer. Once a Seller's board of directors has determined to sell the company, it is under a duty of care and a duty of loyalty to obtain the best deal for its shareholders.[9] A "fiduciary out" clause permits the Seller's board of directors flexibility to consider competing offers that are made within a certain period of time after the letter of intent is signed.

To avoid unnecessary controversies or even court challenges in the event the parties having a falling out, a letter of intent can be divided into two parts, one part containing the non-binding provisions and the other part containing the binding provisions.

The non-binding part of the letter of intent should include all substantive business terms, such as (1) a description of the proposed transaction, (2) the purchase price or purchase formula, (3) any agreement regarding employment of key personnel, (4) non-compete agreements, and (5) indemnification provisions. Also, it is not unusual for a letter of intent to allocate potential liability arising under the environmental laws or from material litigation.

The binding part of the letter of intent should govern the rights, obligations and behavior of the parties during the negotiation of the definitive agreement. While not intended to be a dispositive list of possible binding provisions, the binding part of the letter of intent might include: (1) a "no shop" or other stand still agreement prohibiting the Seller from shopping its company during this period, (2) a right of access for the Buyer to the Seller's books, records, assets and personnel to conduct a due diligence review (and, if the transaction is a stock exchange, a reciprocal right for the Seller to have access to the Buyer's books and records), (3) a prohibition against the Buyer disrupting the Seller's business during its due diligence review, (4) a right for the Buyer to walk away from the transaction if its investigation reveals problems, even if those problems can be corrected, (5) a requirement that all information disclosed by the Seller to the Buyer in connection with the Buyer's due diligence review be kept confidential and used only in connection with its evaluation of the Seller, (6) a requirement that, if the deal does not close, all of the Seller's documents provided to the Buyer will be returned or destroyed, (7) a provision specifying how the expenses of transaction are to be paid, (8) limitations on the rights of each party to disclose or publicize the transaction without the consent of the other party, (8) understandings on how the Seller is to conduct its business prior to closing, (9) condition that closing is subject to governmental and shareholder approval, and (10) deal termination provisions which may include termination fees.

If the letter of intent is divided into binding and non-binding parts, the letter should emphasize that the parties do not intend to create a binding contract except with respect to those provisions that have been identified as binding.

Conclusion

Prior to executing a letter of intent, the parties to a prospective merger should understand the legal import of each provision in the letter of intent and they should appreciate the legal risks involved in entering into a letter of intent.

[1] *International Telemeter Corp. v. Teleprompter Corp.*, 592 F.2d 49 (2d Cir. 1979); *Melo- Sonics Corp. v. Cropp*, 342 F.2d 856 (3d Cir. 1965); *Arnold Palmer Golf Co. v. Fuqua Industries, Inc.*, 541 F.2d 584 (6th Cir. 1976).
[2] *Feldman v. Allegheny Int'l, Inc.*, 850 F.2d 1217 (7th Cir. 1988); *Empro Mfg. Co., Inc. v. Ball-Co. Mfg., Inc.*, 870 F.2d 423 (7th Cir. 1989).
[3] *American Cyanamid Co. v. Elizabeth Arden Sales Corp.*, 331 F.Supp. 597 (S.D. N.Y. 1971); *Itek Corporation v. Chicago Aerial Industries, Inc.*, 248 A.2d 625 (Del. 1968); *Computer Systems of America, Inc. v. IBM Corp.*, 795 F.2d 1086 (1st Cir. 1986).
[4] *Teachers Insurance and Annuity Association v. Tribune Company*, 670 F.Supp. 491 (S.D. N.Y. 1987); *Arcadian Phosphates, Inc. v. Arcadian Corp.*, 884 F.2d 69 (2nd Cir. 1989).
[5] *American Cyanamid Co. v. Elizabeth Arden Sales Corp.,supra*; *Itek Corporation v. Chicago Aerial Industries, Inc., supra*.
[6] *Teachers Insurance and Annuity Association v. Tribune Company*, *supra*.
[7] *Fickes v. Sun Expert, Inc*, 762 F.Supp. 998 (D.Mass. 1991) and *Bruce v. Marchesan Implementos E. Maquinos Agriculas, Tatu,* S.A., Civil No. 87-774-A S.D. Iowa 1990) (1990 U.S. Dist. Lexis 18527).
[8] *Texaco v. Pennzoil Co.*, 729 S.W.2d 768 (Tex. Ct. App. 1987), *cert. denied*, 485 U.S. 994 (1988).
[9] *NBT Bancorp Inc. v. Fleet/Norstar Financial Group Inc.*, NY CtApp, No. 43, March 26, 1996.
(July 1996)