Good intentions

How to use a letter of intent in an M&A transaction **Interviewed by Clare Cottrill**

A letter of intent is used by a buyer and a seller to memorialize their intent to negotiate toward a sales transaction, and includes a general description of some of the fundamental terms of the deal. Naturally, any document that illustrates intent in an M&A transaction can have far-reaching implications for both parties.

"Even though letters of intent usually do not create binding obligations, they heavily influence future negotiations between the parties. And, if not drafted carefully, they may create unintended legal obligations," says Todd Kegler, a director at Kegler, Brown, Hill & Ritter and the chair of the firm's M&A area. "Business people frequently negotiate letters of intent without involving legal counsel; however, most would benefit from engaging counsel as early as possible and, at a minimum, prior to signing any letter of intent."

Smart Business learned more from Kegler about how to approach a letter of intent from both a buyer's and seller's standpoints.

Todd Kegler
Director and the chair of the M&A area
Kegler, Brown, Hill & Ritter

How should a business negotiate and craft a letter of intent?

The primary function of a letter of intent is to provide each party with some assurance that they're in general agreement regarding the basic terms of a transaction prior to either party spending significant resources on comprehensive due diligence and preparing and negotiating definitive agreements.

A seller's bargaining power is usually greatest prior to signing a letter of intent that contains any type of exclusivity provision. Accordingly, a seller generally should attempt to negotiate a letter of intent that is detailed and explicit with respect to the material terms of the transaction.

By contrast, a buyer's bargaining power usually increases after signing a letter of intent that includes an exclusivity provision. Consequently, a buyer will often prefer to negotiate a non-specific letter of intent, using general language and deferring the most difficult negotiation issues until a later date. Of course, there are exceptions, such as when a transaction will require a unique or material covenant from the seller, in which case a buyer may prefer to address that issue early to be sure that the seller will agree before proceeding further.

What are the risks of using letters of intent?

There are several risks in using letters of intent. One is that letters of intent can create unintended, binding legal obligations, particularly if the parties do not involve legal counsel. Most often, some provisions are specifically intended to be binding, such as exclusivity provisions, while others are intended to be non-binding. This requires careful drafting, and the parties need to ensure that all non-binding provisions remain non-binding following the termination of the letter of intent, particularly if negotiations continue following a termination of the letter of intent. Second, a buyer risks getting bogged down in detailed letter of intent discussions too early in the process, before any momentum and trust has developed between the parties, which may result in a premature breakdown in negotiations.

What terms should be included in a letter of intent?

A seller should:

- Insist that the letter of intent specifically addresses the form of the transaction; sellers generally prefer to sell stock rather than assets.
- Negotiate the purchase price and any details regarding any pre- or post-closing purchase price adjustment, such as a working capital adjustment.
- Insist that the buyer disclose any closing conditions to avoid later surprises, such as a financing or due diligence contingency.
- Be specific with respect to what sort of indemnification provisions would be contained in the definitive agreement, including indemnification limitations such as indemnification caps, baskets, or other limitations on post-closing liability.
- Negotiate a right to terminate the letter of intent and exclusivity in the event that the buyer attempts to renegotiate any of the material terms, such as purchase price.
- Include confidentiality and non-solicitation provisions to protect the seller's business, customers and employees.

A buyer should:

- Try to describe the form of the transaction more generally to preserve flexibility as to whether to structure the sale as a stock sale versus an asset sale.
- Describe closing conditions, indemnification provisions and so forth in a very general way, with language such as: 'The definitive agreement would include such provisions as is usual and customary for transactions of this type.'
- Always try to include an express exclusivity provision prohibiting the seller from entertaining offers from any other prospective buyers for some period of time — usually 60 to 90 days. <<

TODD KEGLER is a director at Kegler, Brown, Hill & Ritter and the chair of the law firm's M&A area. Reach him at (614) 462-5409 or tkegler@keglerbrown.com.

Insights Legal Affairs is brought to you by Kegler, Brown, Hill & Ritter