

TECHNOLOGY ACQUISITION UPDATE

The Letter of Intent

The letter of intent is a useful tool that can facilitate a deal going together smoothly. What is a letter of intent? What are its primary uses? Should you use one? What are the key issues that should be covered? This article addresses these topics and includes some pointers on drafting an effective LOI.



The letter of intent summarizes the intentions of the parties and describes the general price, terms and conditions of the transaction. The letter of intent is generally drafted by the buyer and presented to the seller. If both parties agree to the terms, each party signs the letter and the transaction moves forward. The buyer then begins a detailed due diligence process and directs its attorneys to draft the definitive purchase agreement.

The letter of intent is the first step in the closing process. This letter demonstrates commitment on the part of the buyer. It shows that the buyer is serious and proceeding in good faith. It is a rare situation when the buyer will send a letter of intent without having serious intent to purchase the company. Firms are simply too busy to bother with an LOI unless they are serious.

The letter of intent is an excellent tool for moving a transaction forward

in a clear manner. In addition to demonstrating in the level of seriousness on the part of the buyer, the LOI is an effective way to solve issues early on so that they don't need to be negotiated later. It can prevent later misunderstandings. The letter clarifies the major issues before the buyer begins drafting the definitive documents, which is a time consuming and often an expensive task. Fewer deals fall apart once a letter of intent has been issued.

If there are any key issues or deal breaker issues, they should be negotiated before the letter of intent is drafted. If there are any additional buyers that the seller would like to discuss a sale with, these discussions should be held prior to accepting a letter of intent.

Most of the clauses in a letter of intent are not binding. However, there usually are a couple paragraphs that are binding and can have serious teeth. The letter should state specifically which paragraphs

are binding and which are not. Even though most paragraphs are not binding, buyers do not issue LOIs casually.

The LOI encourages the parties to negotiate in good faith and introduces an atmosphere of cooperation. The letter should be drafted quickly, simply and with minimal back and forth between lawyers.

For large acquisitions another reason to use a letter of intent is that the LOI serves to start the clock for complying with the Hart-Scott-Rodino Act. Parties must wait a specified time period before consummating these transactions and the LOI starts this time period.

The letter of intent usually covers five primary topics:

- Price and basic terms
- The no shop clause
- Employee matters
- Confidentiality
- Closing date
- Price

The price is almost always specified in dollar terms. Sometimes it might be specified in terms of a multiple of pretax profits or some other metric. If the buyer is a public company and using shares of its stock as the currency, the LOI should state whether the price is in terms of a specific number of shares or whether it is a dollar amount. It may be a good idea to set a minimum or maximum amount in case the share price fluctuates significantly in the market.

The deal structure should be specified. The structure is usually

phrased as a "purchase of assets" or "purchase of the outstanding shares" of the company. If there are any unique or significant deal issues, it is a good idea to include them in the LOI. Minor terms are not typically specified in a letter of intent.

The buyer can adjust the price later if it discovers issues in the due diligence process that warrant changing the price or terms. However, changing the price stated in the letter of intent without a good reason is not a good thing. A buyer who does this should be regarded with suspicion.

No-Shop Clause

One of the most important binding terms is the "no-shop" clause, sometimes called a "stand still" clause. The no-shop clause states that the seller will not communicate with any other companies regarding the sale of the business for a certain period of time. The language of the no-shop clause usually is stated something like: "the buyer will not solicit proposals or engage in discussions with other potential buyers."

The no-shop time period can vary widely. An acceptable time frame ranges from one month to two months. Six weeks is a very good time frame. If the buyer cannot perform its due diligence tasks within that period of time, the seller should be free to talk with other parties. Any time period longer than two months is overreaching on the buyer's part. There is no reason for a company to cease contact with other buyers for more than 60 days.

During this period the buyer will undertake its due diligence research to investigate the target company in depth. The buyer will expend significant resources during the due diligence process. The no-shop clause protects the buyer by giving it a window of time to perform the necessary due diligence.

Employee Matters

Another important and binding clause is the “no-hire” clause. This clause protects the seller because it prevents the buyer from hiring or attempting to hire any of the seller’s employees. Without this clause, there could be a real problem. The buyer will have just spent time meeting with and interviewing various employees of the seller and will have a clear idea of which employees they would like to hire. Without the no-hire clause, the buyer is free to contact and hire away any of the employees. A well-drafted letter of intent should always have a no-hire clause.

Confidentiality

For most transactions, a confidentiality agreement will have been signed long before the parties reach the letter of intent stage. If, for some reason, they have not signed a confidentiality agreement, the LOI should specify that they do so or include confidentiality language in the letter. If a confidentiality agreement was already in place, the parties may wish to tighten up the terms of this agreement. The paragraph on confidentiality is binding.

Closing Date

The letter of intent should specify a closing date. This date is not cast in concrete. It is usually an estimation of a likely time frame. The date can be changed later by the parties to accommodate their schedules.

The letter of intent may also contain numerous conditions to closing. These conditions include items such as disclosures, approvals, access to records, successful due diligence, legal issues and the signing of a definitive agreement. The letter usually specifies that the seller will conduct its business in its normal fashion and not change its compensation to employees. These paragraphs are nonbinding and are generally boilerplate.

The letter of intent should also include the date that the letter expires, which is usually about two to five days from the date of the letter.

When an LOI is not Appropriate

If the basic price and basic terms have not been agreed upon, it is too early to draft a letter of intent. It is important that the parties reach agreement on the basic price and terms before employing an LOI. The letter of intent simply summarizes this agreement in written form.

If the seller is not ready to commit to that specific buyer, it should not enter into a letter of intent with them. If other parties are still interested in acquiring the company,

it is best to explore these avenues before signing a letter of intent.

If the buyer is a public company, it may not wish to issue a letter of intent. The reason why is that issuing a letter of intent is a "material event." Publicly traded companies are required by SEC regulations to disclose any material event. Companies typically disclose an upcoming acquisition through a press release to notify the public. If a publicly traded company desires to keep the potential acquisition secret, it will not utilize a letter of intent.

A letter of intent sometimes can create problems. The drafter may inadvertently make all or a portion of the letter binding. It might commit one or both of the parties to something before they know all the facts. It may also tip one's hand in negotiations; the firm may want to hold some items back to use as negotiating points later.

Another reason for not using a letter of intent is that it may slow down the process. It is one more thing to negotiate. Sometimes attorneys can get a little overzealous and the LOI can take a significant amount of time to hammer out.

Tips for Good Drafting:

- Focus just on the major points; omit the details. Make sure that agreement is reached on the important issues. The letter should only be two to four pages long; otherwise, too much detail is going into it.

- Mention specifically which terms are meant to be binding and which are not.
- Draft the letter in the future tense.
- Specify that the transaction depends upon the execution of a definitive agreement.
- If a number of minor items have been agreed upon, you might as well include them in the LOI. As long as they do not open up discussions for new arguments, the more that can be agreed upon early on, the better.
- The no shop clause should be six weeks in length, not longer.

© Copyright 2019 Thomas V. Metz, Jr.



T. V. METZ & CO., LLC

Boutique Investment Banking

We specialize in selling technology and service companies from \$5 million to \$50 million in transaction size.

Seattle, Washington
206-779-7707
www.tvmetz.com