Letters of Intent: Use Caution in Drafting to Avoid the Unintended

by Jack P. Baron

Though not every transaction commences with a letter of intent (LOI), the use of letters of intent has become more frequent, particularly given the uncertain economic environment during the last several years. An LOI can be a useful preliminary step in the negotiation of commercial transactions, which often require substantial time, due diligence and expense prior to the parties proceeding to a formal agreement.

Use of a well-drafted LOI to confirm expectations regarding certain key aspects of the transaction, often will provide the parties the requisite level of comfort needed before investing the time, effort and expense of moving the transaction beyond the LOI stage. As an example, a potential purchaser of a business may be reluctant to incur the costs associated with the drafting and negotiation of a contract, as well as the obligations arising thereunder. An LOI containing a due diligence period, among other provisions, may provide the purchaser with sufficient information and confidence to proceed to the next stage of drafting and negotiating the contract.

Inasmuch as many clients and practitioners may be more familiar with drafting the definitive acquisition documents (such as an asset purchase agreement or stock purchase agreement), they may underestimate the importance of properly drafting the LOI, so that neither party is subject to unintended obligations, liabilities or consequences. In addition, practitioners may be under the misimpression that an LOI is not binding, when, in fact, the LOI may be binding, in whole or in part, either by design or as the result of inartful drafting.

To What Extent, if Any, is the LOI Binding?

Whether an LOI is binding on the parties depends on the intent of the parties. "If the parties intend to be bound by their preliminary agreement and view the later written contract as merely a memorialization of their agreement, they are bound by the preliminary agreement."[1] "On the other hand, if the parties intend that their preliminary agreement be subject to the terms of their later contract, they are not bound by the preliminary agreement."[2] The language of the preliminary agreement, the course of dealing between the parties before and after the preparation and execution of the preliminary agreement, and the facts surrounding its preparation are factors a court will consider in determining whether the parties intended to be bound by the preliminary agreement.[3]

On the one hand, parties to a transaction frequently are concerned that the LOI will constitute a binding contract, requiring them to proceed with and consummate the underlying transaction. On the other hand, the parties often want to be bound by specific provisions of the LOI, such as due diligence, confidentiality, exclusivity and various other provisions.

Avoiding Construction of the LOI as a Binding Contract

If it is the intent of the parties not to be bound by the LOI, the following points should be considered when drafting an LOI in order to avoid creating a binding contract:

1. The LOI should clearly, unambiguously and unequivocally state that the LOI is not intended to be a binding contract, is not an offer to proceed to contract, and should not be construed as a contract or offer to contract.
2. The LOI should also state that the parties do not intend to be bound by the terms of the LOI, unless and until the parties agree upon and execute a definitive agreement (such as an asset purchase agreement or stock purchase agreement, as the case may be).
3. Limiting the inclusion of material terms likely indicates that the parties intend not to be bound by the LOI, but rather by a formal, definitive agreement following the LOI. Examples of such material terms and details would be purchase price, representations

and warranties, terms of indemnification, closing date and the like. The LOI should specify the terms that have not been agreed upon, and that are subject to further negotiation. The LOI should further provide that the parties intend not to be bound unless and until all terms have been negotiated and agreed to in an executed definitive agreement.

4. Similarly, deferring inclusion of certain key aspects of a transaction from the LOI stage to the signing of the definitive agreement tends to indicate that the parties intend not to be bound by the LOI. Examples of such elements would include commencement of the due diligence period, undertaking of search and title work and tendering of the deposit. The deferral of due diligence may be unacceptable to the purchaser given that many purchasers want to commence due diligence once the LOI is signed.
5. Specify a deadline by which the definitive agreement must be reached. Further provide that if the parties fail to negotiate a definitive agreement within the specified time frame, negotiations shall cease and the parties shall have no further obligation to one another.

Commonly Binding Provisions in an LOI

Although it is usually the intent of the parties that the LOI be nonbinding, there are certain provisions that are commonly made binding in the LOI. Generally, the terms of the LOI that govern the conduct of the parties with respect to the LOI should be binding, even though the terms of the transaction itself are not. Examples are as follows:

No-shop/Exclusivity

A no-shop or exclusivity provision is a common term in an LOI. One party may want to prevent the other from marketing the transaction or seeking other transactions during the period commencing with the LOI and ending with the signing of the definitive agreement. The purchaser would like to prevent the seller from soliciting other offers, having contact with other prospective buyers or responding to unsolicited offers. The seller must consider fiduciary obligations it may have to its shareholders that require the board to consider third-party proposals in an effort to obtain the best possible deal. Often, the no-shop period will extend at least through the due diligence period, and often longer.

Solutions to the issues that exist in this area include breakup fees for the purchaser, go-shop provisions that allow the seller to seek alternative offers, and many other variations.

Due Diligence

The provision allowing the purchaser to conduct due diligence is typically binding, thus enabling the purchaser to move forward with this important step.

Confidentiality

The imposition of confidentiality provisions, commencing with the LOI, is a critical term of the LOI. The due diligence process, and the attendant disclosure of confidential information typically commences soon after the LOI, and may continue during and after negotiation of the definitive agreement. It is imperative that concerns about confidentiality be addressed in the LOI. Though the LOI is pre-transactional in nature, it is important for the parties to know that each party is obligated to keep confidential the information it acquires while due diligence is underway and the definitive document is being negotiated. The incorporation of confidentiality provisions in the LOI is discussed below in greater detail.

Payment of Expenses

Typically, each party is responsible for its own expenses incurred throughout the transaction, including fees to attorneys, accountants and financial advisors.

Non-Binding Provision

To underscore its generally non-binding nature, the LOI should provide that the LOI is non-binding, except for the provisions that are specifically described as binding.

The LOI should clearly state in detail that these provisions survive the termination or expiration of the LOI, and are enforceable against the other party from and after the signing of the LOI.

Confidentiality Provisions

In transactions for the purchase and sale of a business, there typically is an exchange of confidential information from the earliest stage of the transaction. It is important that prior to the disclosure of any confidential information, the parties agree to terms and provisions

protecting the confidential nature of this information. As a result, confidentiality provisions are often: 1) contained in the LOI, 2) set forth as an exhibit to the LOI, or 3) executed as a standalone document, signed at or before the time of the LOI. Though a full discussion regarding the drafting of confidentiality agreements is beyond the scope of this article, a brief summary is pertinent.

Binding the Parties

An initial issue is who is to be bound by the confidentiality provisions. Often, an LOI will permit a purchaser to conduct due diligence about the seller. As a result, unilateral confidentiality provisions binding just the purchaser are commonly the case. There may be instances, however, where as negotiations progress, the seller conducts due diligence and seeks confidential information from the purchaser. Examples would include transactions where the creditworthiness of the purchaser is a factor, or the consideration includes securities of the purchaser. Under those circumstances, the parties should amend the LOI to include confidentiality provisions protective of the purchaser or adopt new confidentiality provisions. The better practice is to use bilateral confidentiality provisions from the inception in order to facilitate the two-way free flow of information between the parties.

Defining Confidential Information

The confidentiality provisions should contain a clear definition of what constitutes confidential information. In many transactions, it is good practice to provide that any and all exchanged information is confidential, rather than requiring the parties to affirmatively identify confidential information as it is exchanged.

New Jersey Uniform Trade Secrets Act

The draftsperson should consider using definitional and protective language from the recently adopted New Jersey Trade Secrets Act.[4]

Limiting the Use and Disclosure of Confidential Information

The confidentiality provisions should provide that the recipient shall use the confidential information only as part of the contemplated transaction. Disclosure by the recipient should be limited to approved advisors and representatives, such as counsel, accountants and financial advisors.

It is not unusual for a seller to have concerns about its employees having knowledge of the existence of the proposed transaction. This may create a tension between the seller's desire to keep its employees from having knowledge of the transaction and the purchaser wanting to communicate with various employees, particularly key personnel, during the due diligence period. Well-drafted confidentiality provisions will address the issue of if, when and to what extent the purchaser may communicate with the seller's employees during the due diligence period, as well as prior to closing.

Duration

A provision should be included specifying the period of confidentiality. From the disclosing party's perspective, having a permanent confidentiality period is most beneficial. Though a permanent confidentiality period is not unusual, purchasers may be reluctant to be bound by any permanent obligations, and will seek to negotiate a term of years.

Exceptions

The confidentiality provisions should provide for exceptions to the general requirement for confidentiality. Examples would include information already known by the recipient or known to the general public through no fault of the recipient. In addition, a recipient should be allowed to reveal confidential information when legally required to do so, provided the recipient gives notice to the owner of the confidential information and an opportunity to seek a protective order.

Enforceability

A provision should be included specifying that the confidentiality provisions are enforceable by injunctive relief, without the requirement of posting a bond.

The client should be advised that there is no absolute guaranty that the confidentiality provisions will operate to prevent the disclosure of confidential information. The client may wish to consider requiring that certain types of information are to be deferred until the definitive agreement has been signed by the parties.

Conclusion

A letter of intent can be a valuable tool in the early stages of a transaction. However, given some of the uncertainties that can arise regarding the intent of the parties, counsel would be well served to advise the client

of both the risks and benefits of the letter of intent. As with any document, great care should be taken when drafting the letter of intent to avoid unintended consequences. ■

Jack P. Baron is of counsel to Lum, Drasco & Positan in Roseland, practicing in the firm's business group. A substantial portion of his practice consists of commercial transactions and their tax consequences, as well as tax, estate and succession planning for business owners.

Endnotes

1. *Morales v. Santiago*, 217 N.J. Super. 496 at 501-02, 526 A.2d 266 (App. Div. 1987).
2. *Id.* at 502, 526 A.2d 266.
3. *Morales*, *supra*, 217 N.J. Super. 502-503, 526 A.2d 266.
4. N.J.S.A. 56:15-1 *et seq.*