ROBERT G. HUTCHINS – LEGAL ESSAYS

Letters of Intent in Business Acquisitions - Problems, Risks, and a Mechanical Solution

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Preliminary Note

A recurring business phenomenon can be summarized as follows: Two firms reach a preliminary accord on the acquisition of one by the other. They feel compelled to memorialize that event in a joint writing. They sign a document identified variously as an "Agreement in Principle," a "Memorandum of Understanding" or a "Letter of Intent," the title used here.

The Letter summarizes the proposed financial and structural terms of the acquisition. It conditions closing upon a number of factors. These include the buyer's completion of a reasonably satisfactory investigation of the seller and its business, the seller's verification of the buyer's financial strength, the signing of a "Definitive Agreement" and the receipt by both parties of necessary approval from stockholders, lenders and regulators.

Somewhere in the text, perhaps more than once, the words "subject to" or "non-binding" appear. Despite those words, the seller is not to solicit or accept competing offers pending the negotiations, and it must provide the buyer with comprehensive access to the seller's place of business, internal records and employees in connection with the buyer's investigation. For its part, the buyer is to hold "proprietary information" it receives in "confidence" unless the information becomes "public."

The typical Letter makes only cursory reference to the remaining issues confronting the parties. It does not specify the precise assets to be owned by the acquired company or included in a direct sale. It does not address the impact of the acquisition upon affiliates of the parties. It may not identify the consequences of a failure to close, impose "breakup" fees or otherwise allocate the cost of any aborted negotiations between the participants. It invariably relegates to the "Definitive Agreement" the representations and warranties, detailed closing conditions and post-closing remedies of both seller and buyer.

The Letter, thus limited, leaves substantial uncertainty as to what the parties intended to accomplish by preparing it. It is clear only that a momentous transaction is imminent if matters proceed as planned. Nevertheless the Letter is signed, often in a climate of breathless anticipation.

The Problem - Letters of Intent are inherently ambiguous, and they have a dangerous tendency to produce unintended consequences.[1]

Sometimes the transaction closes seamlessly, the parties unaware of the minefield they have just traversed, miraculously without incident. All too often, however, something goes wrong. One or more of the terms specified in the Letter, or left to future agreement, proves divisive. The buyer's investigation reveals disturbing facts about the seller's business. Necessary opinions or regulatory approvals are not obtained or are delayed indefinitely. The buyer's financing commitments are suspended or withdrawn. The deal collapses.

On a best case basis, no claims arise. The parties have wasted a substantial amount of time and fees must be paid to counsel, accountants, investment bankers and others without benefit of more than an expensive education, but such are the risks of business.

In the worst case, the aftermath takes a sinister turn:

- One of the parties, feeling deprived of its bargain, claims the Letter of Intent was a binding contract after all, pointing to selected passages in the text and arguing that the other party breached a duty to pursue vigorously all avenues to closing and to act "in good faith."

- The buyer takes competitive advantage of information the seller disclosed to it in confidence. It appropriates the seller's technology or solicits customers of the seller. It induces the seller’s key employees to abandon the seller and accept positions with the buyer or one of the buyer’s subsidiaries. When confronted, the buyer claims that the words "subject to" or "non-binding," regardless of where they were located in the text, rendered

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[1] I have attached excerpts from a press release touting a proposed merger notorious enough to be remembered by those who follow the business press. The release was issued on January 4, 1984. It summarized an "agreement in principle" in which Getty Oil Company was to merge with Pennzoil Company and a newly formed entity to be owned by Pennzoil and by Gordon Getty as Trustee of the Sara Getty Trust. On the basis of the press release, Texaco, Inc. believed no binding contract had resulted. It launched a tender offer of its own to Getty stockholders that was accepted. Texaco closed its acquisition, and then was sued by Pennzoil for inducing the breach of what Pennzoil claimed was a binding contract between it and Gordon Getty. A Texas jury returned a verdict in favor of Pennzoil of close to $11 billion (including $3 billion in "punitive" damages). There followed various appeals by Texaco that succeeded only in reducing the punitive damages to $1 billion. Texaco then filed for bankruptcy protection. To emerge from bankruptcy, it settled the claim and satisfied the judgment by paying $3 billion - the maximum amount it could raise. I have italicized the language in the press release relied upon by Texaco as establishing the <u>absence</u> of a binding contract. I have highlighted the word "will," the repeated use of which persuaded both judge and jury that a contract was formed.

the entire Letter of Intent unenforceable, negating any stated duty to hold information in confidence or to refrain from exploiting it directly.

- The buyer learns that the seller closed with another bidder at a substantially higher price that was obtained, at least in part, by shopping the buyer's proposal while only pretending to negotiate.

There are infinite variations. Now the ambiguities inherent in the Letter of Intent loom very large. Litigation ensues, the outcome is uncertain and the costs continue to mount. Only the lawyers are happy.

The Problem Compounded - Exposing a Letter of Intent to public scrutiny increases substantially and unnecessarily the risks that already attach to it.

Given their uncertain legal effect, and their extraordinary propensity to cause harm, it may be wondered why Letters of Intent are signed at all. The parties seem to be motivated by an irrational and apparently irresistible desire to document *something* quickly, as if to confirm the reality of the transaction before the negotiations lose momentum. In fact, the transaction is not yet real and the Letters confirm nothing. What is worse, particularly where the buyer or seller is a public company, the Letters are often accompanied by a press release announcing the proposed transaction to the world.

Parties negotiating a major business acquisition are joined in an intense, high-stakes competition with a small tolerance for error. Of all the strategies they could employ to gain advantage, the precipitous issuance of a press release making a public event of a Letter of Intent is probably the most hapless. The announcement creates expectations or fears (which may prove groundless) among the employees, competitors, suppliers, major customers, lenders, landlords and distributors of both buyer and seller.

Lenders examine the fine print of their loan documents with renewed interest. Employees (and their union representatives) agitate over the possibility of job losses. Sensing opportunity or threat, competitors take advantage of the preoccupation of the parties with the announced transaction to launch aggressive initiatives of their own. Morale suffers and production lags. Suppliers or major customers suspend or modify relationships in fear (or anticipation) of changed circumstances. The risks associated with a failed transaction rise exponentially. The pressures to close, even on unfavorable terms, rise in lock step.[2]

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[2] A press release will often mislead even if it is published exactly as written. The creation of a brief but accurate summary of a complex and still prospective acquisition is high art, mastered by few and fraught with risk for the rest. Moreover, newspapers often condense the release further before printing it. The result can be a public impression that bears little resemblance to the facts.

The Reality - Letters of Intent, with all of their associated risks, are neither necessary nor helpful. Press Releases are not generally required prior to closing.

Before signing a Letter of Intent, to say nothing of authorizing a press release, both buyer and seller should consider carefully the following factors:

- A Letter of Intent, by definition, postpones agreement on major components of a transaction to a later date. It therefore cannot take account of all the terms and conditions that must be satisfied before the transaction can close. It is not the functional equivalent of a "Definitive Agreement." It cannot guarantee a closing, or even enhance significantly the prospects of one. Its value as "cold comfort" is often calculable at zero.

- There is the greatest possible difference between having no obligation to close, and having no obligation at all. Most parties are terrified of a closing obligation at the Letter of Intent stage, but it is rarely the case that they mean to disclaim any mutual responsibility for pursuing the transaction. Yet the careless insertion of phrases like "subject to" or "non-binding" to protect against an inadvertent closing commitment can reduce a Letter of Intent to a nullity for all legal purposes, sweeping away even those provisions meant to be enforceable. If the negotiations then collapse, the absence of any control over the aftermath can be disastrous.

- The United States employs what is called an "objective" theory of contract formation. A Letter of Intent offered as evidence of a contract will be given the meaning that (in the opinion of a judge) a reasonable and objective person would give to it. The subjective, privately held notions of the parties themselves as to what is binding, what is not binding, which terms have been settled and which remain open are irrelevant in court. The adage "get it in writing" should be modified in this context to "get it in writing, but only if it can be stated clearly." It is infinitely better to forego a Letter of Intent than to sign one that is susceptible to more than one interpretation.

- Buyers, most of whom deem themselves sophisticated, generally initiate the Letter of Intent. They see an opportunity to lock in place a potentially attractive acquisition without significant risk. They use the Letter as a strategic weapon, assuming it is not "binding" upon them at least as to its financial terms. Such buyers believe that, with the signing of the Letter, all of the negotiating leverage has shifted to them. After all, the price stated is a maximum price. The terms are the most favorable that the buyer will offer. The elated seller is psychologically committed and will be vulnerable to later demands for concessions. The buyer knows its investigation will almost inevitably produce opportunities to force a reduced price and more lenient terms on the pretext of adverse information discovered about the seller's business. In the meantime, the seller is off the market and deprived of meaningful alternatives. The buyer has obtained the functional equivalent of an option without paying for it.

- On the other hand, in its zeal to lock up a transaction a buyer (particularly a buyer that is publicly held, or is otherwise a high profile company)

may make concessions and dangle prices in a Letter of Intent from which, as a practical matter, it may not back away later without suffering an embarrassing loss of credibility. Legally, the buyer's assumption that the Letter was not binding may prove erroneous. A court may rule that the seller relied with justification upon the buyer's assurances, that all prerequisites to enforceable obligations were satisfied and that no material misrepresentations were made by the seller to induce the transaction. The buyer then finds itself closing on onerous terms. On balance, the common perception that Letters of Intent always work to the advantage of buyers is false.

- There is nothing improper or reckless about an exchange of letters, of memoranda or of informal notes clearly identified as products of an evolving and continuing analysis. Such documents can crystallize thoughts, frame negotiations and define objectives without becoming binding contracts. It is not an indispensable requisite for a proper deal, or even a requirement of good form, that some immediate writing be formalized by a date, a title and the signatures of all participants, their successors, heirs and assigns merely to hold a possible transaction in place until it can be researched and documented. As a general rule, the longer execution of a formal document is delayed the better.

- There are reasonable protections that the parties usually seek before entering negotiations on which they intend to rely whether or not a closing occurs. These, however, can be documented <u>separately</u> in contracts that are intentionally binding, but limited in effect. Protective contracts can govern the scope of a buyer's investigation and the manner in which the investigation must be conducted to minimize disruption of the seller's business. These contracts can also set forth specifically the buyer's duty to maintain confidentiality by defining what is confidential, against whom the confidence is to be preserved and for how long. They can define the circumstances, if any, under which the seller can solicit competing proposals (or respond to them) while negotiations are pending. They can set forth elementary representations that establish a foundation for the negotiations. These usually include representations that the seller owns the assets necessary for the conduct of its business, that the seller's stockholders own their shares free of competing claims and that the buyer has, or by the closing will have acquired, the financial capacity to pay the price tentatively offered. Finally, because these contracts do not address the merits of the transaction, they can disclaim effectively any intimation that by signing them the parties are committing themselves to a closing.

- Press releases should be avoided at least until the Definitive Agreement is signed, preferably until closing. When one of the parties is publicly held, a press release will often accompany regulatory filings made to satisfy disclosure obligations imposed by the securities laws. In general, however, a public company is under no obligation to disclose <u>pending</u> negotiations unless (a) the target transaction, if consummated, would be material to it, <u>and</u> (b) it is more probable than not that closing will occur. It may be inappropriate to conclude that a closing is probable merely because the parties have identified target financial terms and a workable structure in a Letter of Intent. If disclosure <u>must</u> be made, any companion press release should be consistent with the filings, and with reports given to market makers, analysts and others in the financial community. Care should be taken to avoid language that arguably suggests binding obligations where none are intended.

Drafting Alternatives

Conceptually, Letters of Intent can be drafted to achieve at least four distinct results:

- They can be binding contracts obligating the parties to conclude the acquisition if stated and objective conditions are satisfied. Under these circumstances, the parties are deprived of any opportunity to withdraw while the requisites for satisfying the conditions are being pursued. The definitive agreement is a mere formality that memorializes, but does not create, the underlying obligations.

- They can be binding contracts limited in scope to basic protections that are necessary for the parties to engage comfortably in the negotiating process. Such contracts may provide for a number of "exits." For example, the buyer may be free to withdraw if interest rates rise above a negotiated threshold. The seller may be free to respond to unsolicited third-party proposals if it provides the buyer with notice and an opportunity to match the third-party offer, but not otherwise. In any case, the protections themselves remain intact.

- They can reflect an exchange of commercial assurances, backed by commercial sanctions, without any pretext that they are binding contracts. As a matter of business ethics, the parties are expected to use reasonable efforts to pursue the transaction. Sanctions for abandonment or neglect, however, would be limited to the curtailment or termination of other business relationships. They would be imposed, if at all, outside of a courtroom. Lawyers would be involved only if the curtailment or termination were challenged, e.g. as constituting the breach of another contract between the parties.

- They can be devoid of any sanctions at all, even implied ones. Under these circumstances they serve merely to convey information.

A Mechanical Solution - Avoid the execution of a preliminary document containing both binding and non-binding provisions.

The practical reality is that Letters of Intent are drafted hastily, before a comprehensive analysis of their subject matter has been completed. They are often drafted without consultation with the lawyers who later may be asked to defend or challenge them. Given the chance, I advise clients not to use them. If they <u>must</u> be used (e.g., to appease an opposing party with a strong bargaining position), I offer the following guidelines for minimizing risk:

- Always state clearly and prominently the proposition that none of the financial or structural terms set forth in the Letter is binding unless and until a Definitive Agreement is executed. There are no exceptions. Use the Letter of Intent solely to articulate the rationale for the negotiations.

- Never insert non-binding terms in any preliminary document that also contains provisions meant to be enforceable. While there is no legal prohibition against a comprehensive single document that both defines objectives and imposes mandates, the parties rarely possess enough information or have enough time at the Letter of Intent stage to draft one safely.

- Because preliminary discussions result merely in shared objectives, binding protective contracts should cover only the rules under which the parties will conduct the ensuing negotiations. Those rules can be identified relatively quickly. The transaction itself, and any obligation to close it, should be left to the Definitive Agreement.

- Press releases should not be issued prior to closing in the absence of a legal duty to disclose the negotiations to public investors and regulatory authorities. When issued, they should conform to the relevant text of any regulatory filings.

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PRESS RELEASE

Getty Oil Company, The J. Paul Getty Museum and Gordon Getty, as Trustee of the Sarah C. Getty Trust, announced today that they have *agreed in principle* with Pennzoil Company to a merger of Getty Oil and a newly formed entity owned by Pennzoil and the Trustee.

In connection with the transaction, the shareholders of Getty Oil . . . **will** receive $110 per share cash plus the right to receive a deferred cash consideration in a formula amount. The deferred consideration **will** be equal to a pro rata share of the . . . proceeds, in excess of $1 billion . . . of ERC Corporation . . . and (the excess) **will** be paid upon the disposition. In any event each shareholder **will** receive at least $5 per share within five years.

Prior to the merger, Pennzoil **will** contribute approximately $2.6 billion in cash and the Trustee and Pennzoil **will** contribute the Getty Oil shares owned by them to the new entity. Upon execution of a definitive merger agreement, the . . . tender offer by a Pennzoil subsidiary for shares of Getty Oil stock **will** be withdrawn.

The *agreement in principle* also provides that Getty Oil **will** grant to Pennzoil an option to purchase eight million treasury shares for $110 per share.

The transaction is *subject to* execution of a definitive merger agreement, approval by the stockholders of Getty Oil and completion of various governmental filing and waiting period requirements.

Following consummation of the merger, the Trust **will** own 4/7ths of the . . . stock of Getty Oil and Pennzoil **will** own 3/7ths. The Trust and Pennzoil have also *agreed in principle* that following consummation of the merger they **will** endeavor in good faith to agree upon a plan for restructuring Getty Oil [within a year] and that if they are unable to reach such an agreement then they **will** cause a division of assets of the company.