

## MERGERS &amp; ACQUISITIONS

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Letters of Intent In **Global** Deals*Certain aspects of a typical cross-border transaction impact their use, and the selection of provisions.*

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**T**HE USE of a letter of intent is a common practice in both domestic and cross-border merger and acquisition transactions. Letters of intent (sometimes described as signed preliminary term sheets) that are signed by both the prospective purchaser and the prospective seller are most common in transactions in which the seller is a private company. They are less frequently used, but still not uncommon, where the seller is a publicly traded company. Often, particularly in the public seller context, unsigned term sheets may be used.

In drafting, reviewing and counseling clients on the appropriate use of letters of intent and term sheets, attorneys must focus not only on the legal and business issues surrounding the letters, but also consider the impact that various provisions may have on later litigation even when the letter of intent is superseded by a definitive agreement. Letters of intent in cross-border transactions present some additional issues not found in domestic transactions.

This article will attempt to identify certain aspects of typical international merger and acquisition (M&A) transactions that impact the selection of various provisions in letters of intent.

The pros and cons of letters of intent are well known to M&A practitioners. On the positive side, from both a buyer's and seller's perspective, they (i) provide some certainty as to mutual agreement on key financial and business terms (such as price), particularly in complex

transactions, and (ii) increase the likelihood of ultimately concluding the transaction, thereby justifying the expense and time of moving forward toward a closing.

In addition, buyers who successfully bargain for a binding "no-shop" provision effectively take the seller "out of play" while giving the buyer time to conduct its due diligence.

From a seller's perspective, a letter of intent negotiation may represent the "high-water mark" of a buyer's assessment of seller value prior to detailed due diligence, and therefore represents an opportunity to memorialize the buyer's then-current value assessment, even if in a non-binding provision, in a manner that will make it difficult for the buyer to later renegotiate the price.

Furthermore, if public disclosure of the letter of intent is required, it may cause other bidders to emerge. Also, the ability to access transactional financing may require a signed letter of intent.

The negatives of letters of intent are also well known. In the context of a public company target, they inevitably

cause seller's legal counsel to advise (and otherwise heedless clients to reluctantly agree) that public disclosure is required, even if reasoned application of *Basic v. Levinson*<sup>1</sup> by itself does not do so. Such disclosure may not be in either the buyer's or seller's interest.

For both private and public sellers, the consequences of public disclosure may adversely impact relationships with customers, suppliers and employees. Furthermore, even an undisclosed letter, when combined with a binding no-shop provision, may leave a seller disadvantaged in later negotiations, particularly if the purchaser's stated price is tied to specific financial or business performance that is then found to be lacking.

From the buyer's perspective, even a non-binding letter of intent increases the risk of litigation by a spurned seller if the buyer fails to close, or fails to negotiate in good faith.<sup>2</sup>

### Use in Cross-Border Deals

This practitioner has found the use of letters of intent to be even more prevalent in cross-border transactions than in domestic transactions, for three reasons.

First, international M&A transactions are by their nature more complex (and often involve more legal entities) than domestic transactions. Therefore a letter of intent has greater utility than usual in summarizing complex transactional structures and legal issues in a form easily understood by executives,

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directors and principal stakeholders.

Second, a letter of intent is often a preferred vehicle for conveying a transaction description to a foreign governmental agency or regulatory authority whose preliminary approval is needed in order for the parties to proceed forward with confidence in ultimate closure. Often such agencies will respond more rapidly to a signed document rather than an unsigned term sheet.

Lastly, and perhaps most influential, the increasingly worldwide nature of international M&A transactions has been accompanied by an enormous increase in the number of young non-U.S. companies involved in such transactions, particularly in technology, life sciences and telecommunications. This means that often the non-U.S. business executives in a cross-border transactions are unfamiliar with an acquisition transaction of any kind, let alone with a U.S. company, are often unaccustomed to the length and depth of a typical acquisition agreement, and may not be fluent in English.

A relatively short letter of intent, memorandum of understanding or unsigned term sheet may be a necessity in order to enable such executives to fully understand a transaction before being able to proceed to the typical 50- to 100-page (or more) acquisition agreement with extensive representations, warranties, covenants and indemnities.

The use of some form of "deal protection" in a letter of intent has become commonplace, usually in the form on a "no-shop" clause coupled with exclusivity for a limited period of time (usually 30-90 days), while the buyer conducts due diligence and both parties negotiate and document the definitive agreement.

Very rarely, seller may ask for a reciprocal provision from the buyer (in which the buyer agrees not to seek other targets in seller's industry area while

negotiating with seller). Inclusion of break-up or termination fees at the letter of intent stage is far less common.

### **Effect of Deal Protection**

The use of a short-term "no-shop" clause and exclusivity in a letter of intent would not on its face appear to raise the issues of enforceability and director fiduciary duties that have been extensively litigated in Delaware and other jurisdictions in the past 15 years, often in the context of hotly contested struggles for control.

There has been little or no litigation over such issues as they relate to "deal protection" provisions in letters of intent. Indeed, business executives and counsel who routinely expend substantial time on negotiating no-shop agreements in definitive agreements, carefully reviewing them with their board of directors, and requiring board approval of such provisions, routinely sign letters of intent including no-shop provisions without submitting them for board approval.

Nonetheless, counsel should consider the impact of including such provisions in a letter of intent in light of both (i) the fast-paced nature of merger transactions today, in which even a 90-day no-shop may cause substantial damage to a target's sale prospects, and (ii) recent case law development in Delaware.

In *Omnicare v. NCS Healthcare, Inc.*,<sup>3</sup> the Delaware Supreme Court enjoined a pending merger because the deal protection measures at issue — a "force the vote" provision requiring submission of the merger agreement to a shareholder vote even if the directors later withdrew their recommendation (which they later did), coupled with an agreement by the holders of a majority of the voting power to vote for the merger — irrevocably "locked up" the merger, and because they did not

contain a fiduciary out, were coercive and preclusive and, therefore, invalid under the *Unocal*<sup>4</sup> test.

It is not yet clear whether *Omnicare* will be limited to its unique facts, or whether it presages heightened scrutiny of deal protection provisions, and whether that scrutiny will extend to binding no-shop provisions in letters of intent. In current-day transactional practice and markets, a seller may suffer more damage in terms of lost opportunity from a 60- to 90-day no-shop provision in a letter of intent than from the later 180-day (or more) period from signing to closing during which a no-shop provision in a definitive agreement is operative. At a minimum, counsel to the seller should consider requiring his client's officers to seek board approval before accepting a no-shop provision.

Many cross-border transactions commence with letters of intent that propose longer no-shop periods than the equivalent domestic transactions. These periods are designed to accommodate the longer time periods that such transactions often require for both (i) adequate due diligence by a buyer, who may need to retain local counsel, auditors and consultants, and contend with travel and translation requirements, and (ii) preliminary regulatory review before the parties proceed further.

However, the longer time periods may exacerbate the possible enforceability and fiduciary duty issues raised by such clauses. In addition, the longer the no-shop period, the greater potential for actual harm to the seller if buyer terminates the negotiations, and thus the greater the probability of a seller claim.

In light of these issues, both seller's and buyer's counsel should consider whether all the parties' interests may be better served by an unsigned term sheet, rather than by a signed letter of intent,

and forego deal protection provisions.

Sophisticated buyers and their counsel in domestic transactions often view the letter of intent stage as an opportunity to quickly “wrap up” various transaction issues at an early stage, particularly when the seller is relatively inexperienced in M&A transactions.

Although often true in domestic transactions, where some sellers (even today!) often do not involve their counsel in the discussions until a letter of intent is all but signed, thus resulting in negotiations that are over before they are begun, this is not necessarily true in the case of a non-U.S. buyer.

### Beware Over-Reaching

Differences between U.S. and foreign legal systems or regulation may allow a U.S. attorney representing a non-U.S. seller who is invited late to the transaction an opportunity to revisit terms of the letter of intent as the transaction progresses if the negotiated terms are at variance with local law or practice. Furthermore, foreign parties are less likely to adhere to the letter of intent terms in subsequent negotiations if they do not (or can credibly argue that they did not) fully understand the import of those terms because of language difficulties or linguistic or cultural confusion.

Significant tension and an atmosphere of mistrust can then ensue. Therefore, a buyer's counsel in this context needs to be careful not to over-reach at the letter of intent stage, because the result may be a seller walk-away at the definitive agreement negotiations, rather than a consummated transaction at favorable terms.

Experienced acquisition attorneys in U.S. transactions drafting letters of intent or even unsigned term sheets on behalf of a purchaser should (and usually do) ponder, if only briefly, whether to include even a non-binding

covenant to “negotiate in good faith” in the document.

Given the substantial amount of litigation surrounding letters of intent (usually by jilted sellers), such a clause, which may give rise to a potential claim of damages for breach, needs to be carefully considered before being included or accepted. In that regard, counsel should carefully consider the circumstances surrounding the negotiation and execution of the letter of intent, and what a court, with hindsight, may infer from it.

An attorney might be excused for believing that a “memorandum of understanding” referred to as an agreement in principle, that was expressly subject to board approval, that was not fully executed, and that was described to the press as subject to execution of a definitive merger agreement, was not binding. The court in *Texaco Inc. v. Pennzoil Co.*<sup>5</sup> thought otherwise, resulting in a \$10.53 billion award against Texaco (still one of the largest judgments ever handed down in a business dispute).

The situation may be even more opaque in cross-border transactions. Because of cultural and linguistic styles and a business party's natural desire to conform to local custom, many international transaction letters of intent are rife with references to “mutual understanding of the parties,” “using their commercial best efforts,” “with a view to achieving common goals,” “in a spirit of mutual cooperation,” and similar phrases. Their use in a letter of intent or unsigned term sheet should be carefully monitored and restricted to avoid providing support for a later litigation claim.

### Choice of Law, Forum Impact

In light of the issues described above, counsel in a cross-border transaction

should give as much attention to choice of law and forum clauses (or their absence) in a letter of intent as they do in a definitive agreement. The appropriate choice of law may render moot some of the issues described above. Similarly, a choice of forum clause may change the risk-reward calculation when evaluating whether to include or not include provisions that may create potential litigation hazards.

In light of the complexities of evaluating and reaching an agreement on a choice of forum at the early stages of a business negotiation, selecting arbitration as the choice of forum in a letter of intent should be considered. If that is the selected approach, counsel should consider which of the various arbitration organizations to utilize, and whether to specify any special procedures or rules of evidence for such arbitration.

Much as letters of intent for most attorneys and their clients are the initial outline of the ultimate business deal and its definitive terms, they also present legal issues and potential litigation risks which are often a mirror of those encountered in negotiating and documenting a definitive agreement

1. 485 U.S. 224 (1988).

2. See, for example, *Entercom Communications Corp. v. Royce International Broadcasting Corp.*, et. al., 203 Cal. App. Unpub. Lexis 4481 (Cal. 2003); *Huber and Sons, Inc.*, et al. v. *Service Corporation International*, 2002 U.S. Dist. Lexis 10999 (USDC Minn. 2002); and *Kysor Industrial Corporation v. Margaux, Inc.*, 674 A.2d 889 (Del. 1996).

3. 818 A.2d 914 (Del. 2003).

4. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

5. 729 S.W.2d 768 (Tex. 1987), cert. dismissed, 485 U.S. 994 (1988).

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