Perkins Coie

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TO: Center for Entrepreneurial Studies, Stanford Graduate School of Business

FROM: Perkins Coie LLP

RE: **Letter of Intent for Corporate Acquisitions**

This memorandum summarizes the material considerations relating to the use of a letter of intent ("***LOI***") in corporate merger and acquisition ("***M&A***") transactions involving the acquisition of a privately held corporation. LOI's are also often also referred to as "agreements in principle," "memoranda of understanding" or "term sheets."

While this memorandum is intended as a general primer of some of the key terms in M&A transactions, each transaction is unique and is typically highly-negotiated. Accordingly, the terms of specific M&A transactions can vary significantly based on a number of variables, including market and industry conditions, the profile of the buyer (e.g., private equity vs. strategic buyers), the tax status of the target entity, the nature of the consideration paid (e.g., cash vs. buyer stock), the availability and terms of debt financing, business-specific risk factors, the number of potential acquirers, regulatory hurdles and bargaining leverage of the parties.

If you have any questions regarding LOIs or the contents of this memorandum, please feel free to contact Mark Albert (650-838-4300; malbert@perkinscoie.com) or Jason Schneiderman (650-838-4300; jschneiderman@perkinscoie.com) at Perkins Coie LLP.

I. What Is an LOI?

An LOI is a document that memorializes the principal terms of a proposed transaction. An LOI is typically prepared once a prospective buyer and seller have completed the first phase of negotiations. The LOI generally, but not always, describes the purchase price, or a formula to be used to determine the purchase price, and certain other key economic and other terms that form the basis for further negotiations. Most of the provisions of an LOI are explicitly non-binding and are contemplated to be subject to further negotiation between the parties. The primary binding obligation in an LOI is a "no-shop" provision, which generally prevents a seller from negotiating with other parties while negotiations with a particular proposed buyer are ongoing during a specified period.

LOIs should not be confused with Non-Disclosure Agreements ("***NDAs***"), which typically govern the use of each party's confidential information prior to the consummation of a transaction. The terms of an NDA are frequently incorporated by reference in an LOI.

II. Why Do Parties Enter Into an LOI?

Some of the primary reasons why parties enter into an LOI instead of proceeding directly to drafting definitive acquisition agreements include: (1) to minimize the time and expense invested in a transaction prior to having an agreement-in-principle on the material terms; and (2) to agree on the basic “ground rules” for the next phase of the process, such as agreeing to a "no-shop" provision, defining the due diligence process, agreeing on the timing of the transaction, agreeing on certain confidentiality obligations of the parties (if no NDA was previously signed), and agreeing on responsibilities for paying each party's costs and expenses if the transaction is not consummated. The LOI will ultimately be superseded by a definitive written acquisition agreement upon the consummation of the proposed transaction.

III. Should Economic and Other Substantive Provisions of an LOI Be Binding?

Typically, the economic and other substantive provisions of an LOI are expressly non-binding. There are some circumstances, though, where a buyer and/or seller will prefer a fully-binding LOI, such as when the acquisition is so economically or strategically important that the parties are willing to enter into a binding agreement at an early stage in the process. The parties to a fully binding LOI should use caution prior to entering into such arrangement and should consult with counsel to understand the related risks, which could be significant. For example, an LOI that is expressly fully binding can sometimes be strictly enforced by one party even if many of the material terms of the transaction have not been fully negotiated.

IV. How Much Detail Should Be Included in an LOI?

In most cases, an LOI should include sufficient detail to set the parties' basic expectations as to the material terms of a proposed transaction and to outline the procedural steps necessary to close the proposed transaction. The more detailed the LOI, the more time and money will be required to negotiate the LOI prior to conducting due diligence and drafting definitive agreements.

The primary advantages of a comprehensive LOI are: (1) material issues can be identified and negotiated before substantial expenses are incurred in the diligence process and drafting of definitive agreements; (2) resolution of difficult issues at the LOI stage can make the negotiation of a definitive agreement considerably easier; and (3) resolving issues early in the process can minimize transaction costs.

The primary disadvantages of a comprehensive LOI are: (1) the parties may not yet be equally committed to the transaction, and the more-committed party runs the risk that the transaction may be terminated during this stage if certain issues cannot be resolved at this stage of the process; and (2) if the buyer’s due diligence process has not been completed while the parties are negotiating the LOI, it may be difficult for the buyer to negotiate specific deal terms, such as the size of the escrow for indemnification claims, the escrow being the sole source of indemnification claims, the size of baskets and caps for indemnification purposes, etc. Since LOIs are typically non-binding, the buyer preserves the ability to renegotiate these terms; however, a detailed LOI can make renegotiating settled deal points more difficult.

V. Structure of an LOI

LOIs are typically divided into two parts: binding provisions and nonbinding provisions. Non-binding provisions primarily consist of the proposed economic terms of the transaction, the proposed structure of the transaction, the timing of the transaction, the type of consideration and purchase price, any adjustments to the purchase price, earnout consideration (if any), indemnification obligations after the consummation of the transaction, employment and/or consulting arrangements and the key conditions to closing. The binding provisions typically focus on the conduct of the target's business between the signing of the LOI and the consummation of the acquisition, access to the target's books, records and personnel to allow buyer to conduct its due diligence investigation of seller, “no-shop” provisions, break-up fees, nondisclosure obligations, procedures for making public announcements, payment of the parties’ expenses and termination provisions. The non-binding and binding portions of an LOI should be clearly delineated to assist a court in determining the intent of the parties, if it becomes necessary.

VI. Enforceability of an LOI

An LOI is an undertaking between two or more parties that they will enter into a specific contract at some time in the future. Agreements to agree on terms at a later date are well-recognized in many states. While many of the proposed terms set forth in an LOI may be expressly non-binding, the parties may nevertheless undertake certain legal obligations to one another by entering into such an LOI. For example, courts in many states, including California, have held that contracts to negotiate a future contract are enforceable contracts and impose duties of good faith and fair dealing on the parties. An obligation to negotiate in good faith and deal fairly should be presumed to be implied in all binding agreements, whether or not specific language to this effect is included.

VII. Key Provisions of an LOI

Specific sections and common issues of a LOI are as follows:

A. Typical Non-Binding Provisions:

1. Structure of Transaction

M&A transactions generally take one of three forms: an asset purchase, a stock purchase or a statutory merger. Each has certain advantages and disadvantages to the seller and the buyer. The desired structure of a given transaction will largely depend upon the corporate goals, tax benefits, profile of the target's stockholder base and liability exposure. Tax and accounting issues are critically important in structuring M&A transactions, and unaddressed tax and accounting issues at the LOI stage can quickly derail a transaction. Accordingly, tax and accounting advisors should be involved at any early stage in structuring the transaction.

2. Timing of the Transaction

The expected time between signing the LOI and closing the transaction will vary from transaction to transaction but will generally require at least 20 days and possibly as much as several months. Tasks that typically need to be accomplished during this period include conducting buyer's due diligence investigation of the target, finalizing any unresolved deal terms, including issues that emerge from buyer's due diligence investigation of the target, drafting and negotiating the definitive agreement and any ancillary agreements, obtaining the financing necessary to fund the purchase price of the acquisition, obtaining required stockholder approval, obtaining any required third-party consents and/or regulatory approvals, and the expiration of any government-mandated antitrust review periods, if applicable.

3. Form of Consideration and Purchase Price

The form of consideration payable by the buyer typically consists of either cash, stock of buyer or its parent (either common or preferred), debt instruments (so-called "seller notes"), earnouts, the assumption of specified liabilities or a combination of the foregoing. If all or a portion of the consideration is payable in stock, a number of other issues must be addressed by the parties, including, among others, tax considerations, liquidation preferences, voting rights, transfer restrictions, dilution issues, and compliance with federal and state securities laws (possibly including so-called "tender offer" rules). It is important to fully explore the tax and accounting issues relating to the form of consideration payable in the transaction to maximize the tax and accounting benefits to both buyer and seller.

4. Purchase Price Adjustments

In arriving at a proposed purchase price, a buyer generally makes certain assumptions regarding the target's business, financial condition and operating results, and may require a purchase price adjustment if those assumptions prove to be inaccurate. Many purchase price adjustments are reciprocal and can therefore work to the seller's benefit and increase the purchase price if the buyer's assumptions are ultimately lower than actual results. Common purchase price adjustments include net working capital, net worth, net income, operating revenues, EBITDA and net financial debt. Purchase price adjustments can also include a "window" – a range of closing values such that if the actual item subject to measurement falls within the range, no adjustment is made – or "caps," "collars" and "floors." Additionally, purchase price adjustments may involve known areas of potential liability, such as environmental clean-up issues or pending litigation.

5. Earnouts

In many instances where a buyer and seller are unable to agree on a definitive purchase price for the acquisition, an earnout can be used to bridge the gap between the seller's perceived value of the business and the amount the buyer is willing to pay. An earnout is a future payment obligation by a buyer to the seller contingent upon the achievement of specified milestones during a specified post-closing period (whether financial, product development, customer acquisition or other qualitative milestones). Earnouts can be one of the most intensely-negotiated aspects of M&A transactions. Tensions between a buyer and a seller that naturally emanate from the nature of the earnout can expose the parties to significant risk of a post-closing dispute regarding, among other things, whether the buyer operated the business appropriately in support of achieving the agreed-upon milestones and whether the applicable financial line items were properly calculated. Accordingly, great care should be taken in structuring and negotiating earnout provisions.

6. Vesting considerations and debt

If the target's outstanding securities include stock options (vested and/or unvested), restricted shares subject to vesting and/or warrants, the parties will need to specify how the aggregate purchase price will be allocated among these types of securities and how these securities will be treated post-acquisition. Additionally, the parties will need to determine whether any outstanding financial debt of the target will be paid off at closing, assumed by the buyer or refinanced.

7. Indemnification

Subject to certain limitations, the target and/or its stockholders will generally be required to indemnify the buyer for the target's operation of its business prior to closing to the extent that items are not disclosed to the buyer prior to the closing. An LOI often summarizes some of the key indemnification obligations and limitations, such as the survival period for indemnification claims, thresholds and baskets prior to any claim being made, security (such as an escrow) for indemnification claims and the seller's (and/or its stockholders') maximum exposure for indemnification claims.

8. Definitive Agreement

The final terms of the proposed transaction will be set forth in a definitive purchase agreement. The terms contained in the definitive agreement that are typically not addressed in the LOI include: (1) detailed representations, warranties and covenants to be made by the buyer, the target and, if appropriate, some or all of the stockholders of the target that will form the basis for claims of indemnification post-acquisition, (2) detailed conditions to closing of the acquisition; (3) termination rights of the parties; (4) post-closing obligations of the parties; (5) detailed provisions relating to indemnification obligations of the parties post-closing; and (6) various miscellaneous provisions, often referred to as "boilerplate" but which can be critically important.

9. Employment, Non-Competition and Other Agreements

The material employment terms of key employees of the target that are expected to remain employees of the buyer after the closing of the acquisition are typically discussed in the LOI. Additionally, it is quite common for these key employees to agree not to compete with the business of the target for a specified period of time following the closing of the acquisition.

The execution of an employment agreement and a non-competition agreement reflecting these terms are often conditions to closing of the acquisition. Depending on the transaction, the execution of other forms of agreements may be material conditions to the consummation of the transaction as well, such as supply agreements, distribution agreements, manufacturing agreements, real property leases, license agreements, service agreements, stockholder agreements, registration rights agreements, etc.

10. Closing Conditions

The LOI typically discusses the primary conditions that must be accomplished prior to consummating the contemplated transaction. Such conditions may include: (1) completion of the buyer's due diligence review of the seller's business; (2) the negotiation of the definitive agreements; (3) the execution of any material ancillary agreements; (4) the assignment of material contracts; (5) the resolution of specific concerns of the buyer with respect to the seller's business, such as the resolution of litigation or specifically identified liabilities; (6) the payment or assignment of bank debt; and (7) the buyer's ability to raise the financing necessary to fund the purchase price.

B. Typical Binding Provisions:

1. Access to Seller and Due Diligence

An LOI typically provides that the buyer will have access to the seller's facilities, books, records and personnel to allow the buyer to conduct its due diligence investigation of the seller.

2. No-Shop Period and Exclusive Dealing

Since both the buyer and the seller will invest significant time, effort and resources to consummate the transaction once an LOI is signed, an LOI often restricts a seller from soliciting, considering or negotiating other offers to acquire it for a period of time after the date of the LOI (typically 45-90 days). These provisions are commonly referred to as “no-shop” provisions and are one of the primary reasons why a buyer desires to enter into an LOI.

3. Break-Up Fee

Break-up fees are typically paid by a seller to a buyer if the seller terminates the LOI after receipt of a competing offer to acquire the company. Break-up fees are not common in private transactions, but sometimes a buyer will negotiate the reimbursement of its out-of-pocket costs and expenses if the seller attempts to terminate the LOI.

4. Covenants Prior to Closing

A buyer generally expects that a target will operate its business consistent with past practice after the signing of an LOI to preserve the status of seller's business until the transaction is consummated. The LOI will typically include general covenants in this regard and can sometimes include detailed covenants specifying what the target can and cannot do without the buyer's consent, such as entering into any material agreements or transactions prior to the consummation of the acquisition or making distributions to its stockholders.

5. Confidentiality and Non-Solicitation

LOIs typically include confidentiality provisions if such provisions are not incorporated by reference by the inclusion of an NDA entered into by the parties prior to entering into the LOI. Additionally, LOIs sometimes include a non-solicitation provision which restricts one party from soliciting employees of the other party.

6. Legal Fees

In many cases, each party will bear the cost of its own legal fees, but in some cases, the buyer will agree to pay all or a portion of the legal and related fees and expenses of the target if the transaction is completed.

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Perkins Coie Private Equity and Search Funds | Overview

With more than 700 attorneys in 15 offices across the United States and China, Perkins Coie represents companies in a wide range of industries and stages of growth. With nearly 80 Bay Area attorneys, the firm harnesses a strong local presence with experience in a number of practice areas, including corporate, venture capital, private equity, search funds, intellectual property, licensing and litigation to name a few.

The Perkins Coie Private Equity group has a leading practice in the representation of private equity funds and search funds. Our attorneys are experienced in all types of transactions, from industry consolidations to leveraged buyouts of private and public companies. Our practice emphasizes middle-market transactions, typically involving companies with enterprise values from $10 million to $1 billion. In addition, Perkins Coie has a substantial practice dedicated to structuring and forming private equity funds, search funds, hedge funds, venture capital funds and real estate funds, and advising fund sponsors in connection with formations.

Perkins Coie has also developed a strong Search Fund practice with extensive legal experience in search fund formations, acquisitions and divestiture transactions, related debt financing transactions, counsel regarding tax and accounting structuring issues, and counseling on day-to-day operational issues. Perkins Coie currently represents more than a dozen active search funds and has consummated a number of search fund acquisitions in the past year.

Partner, Mark Albert and Associate, Jason Schneiderman remain at the forefront of the firm's Search Fund practice with a deep understanding of all aspects of search fund transactions. Mark has more than 20 years of experience representing search funds, private equity funds and venture capital start-ups. Mark began his career in Chicago as a private equity attorney and has been a partner in the Silicon Valley office of Perkins Coie for more than 10 years. Jason focuses his practice in the area of business law with a particular emphasis on search funds, venture capital, mergers and acquisitions, and general corporate matters. He has worked with a number of promising Silicon Valley start-ups and established companies in a variety of industries.