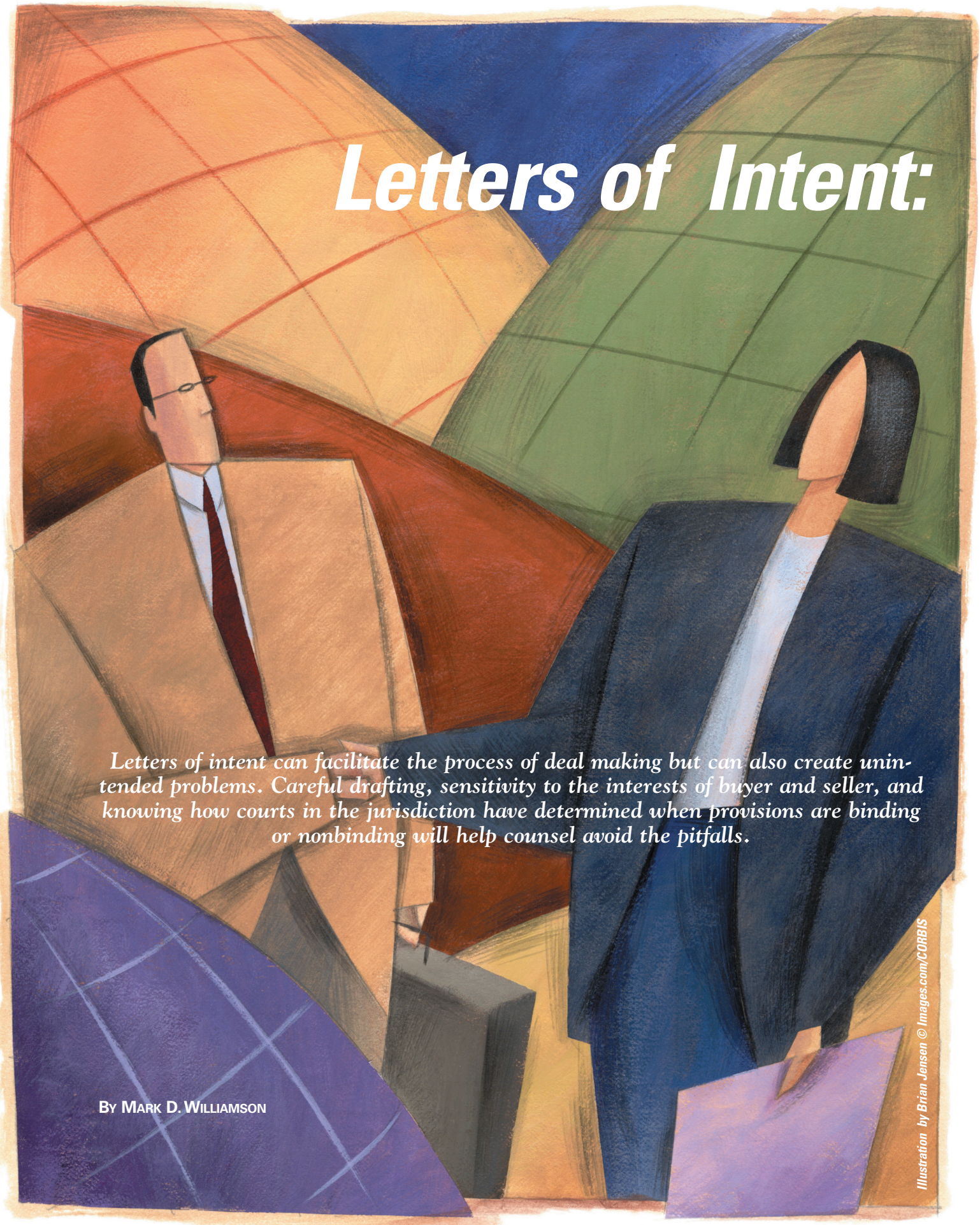
Letters of Intent:



Letters of intent can facilitate the process of deal making but can also create unintended problems. Careful drafting, sensitivity to the interests of buyer and seller, and knowing how courts in the jurisdiction have determined when provisions are binding or nonbinding will help counsel avoid the pitfalls.

By Mark D. Williamson

Illustration by Brian Jensen © Images.com/CORBIS

Their Use in Minnesota Business Transactions

In the early stages of many transactions, the parties often choose to memorialize the basic terms of their agreement by negotiating and entering into a letter of intent. In general, the letter of intent sets forth the purchase price and certain other key terms, all of which form the basis for further negotiations between the parties. The letter of intent is a preliminary document; it is intended to be superseded by a definitive agreement.

Nothing mandates a letter of intent, and parties can simply proceed to the drafting of a definitive agreement without ever signing a letter of intent. Nevertheless, buyers and sellers often prefer to formalize the principal terms of a proposed deal early in the process before engaging in lengthy and expensive negotiations of the definitive agreement.

Typically, a letter of intent contains both binding and nonbinding provisions. It is possible, however, to make the entire letter of intent binding, either explicitly or accidentally. Careful drafting is critical to avoiding unintended results.

Advantages

The primary benefit of a letter of intent is its potential to save time and money. It injects a degree of certainty into the early bargaining process. If the parties can agree on essential terms quickly, confirming those terms in a letter of intent encourages the parties to expend the resources necessary to close the deal, and the time and expense of due diligence and final negotiations become more palatable. Alternatively, attempting to draft and agree on a letter of intent may make it clear to both parties that they are simply too far apart to continue negotiations. In either case, both the prospective buyer and the prospective seller are better off for having assessed the terms of the proposed deal before negotiations reach a more advanced stage.

If the deal moves forward, a letter of intent serves as a useful road map for negotiating the definitive agreement. With the basic terms in place, the remaining negotiations are more likely to be focused and straightforward. Moreover, the parties typically develop a psychological or moral commitment to the terms of the transaction, particularly when the parties issue press releases or otherwise make the proposed transaction known to the public, employees, shareholders or customers. Further, the letter of intent may set forth the parties' expectations regarding when they will conduct due diligence and negotiations, so the process will benefit from the certainty of schedules and deadlines.

A letter of intent may also be advantageous to a buyer who needs to secure outside financing. Absent a written commitment to the deal, prospective lenders may not be willing to evaluate or commit to financing the transaction. In addition, the letter of intent evidences a commitment to the transaction that may help attrct third-party investment dollars.

Finally, a letter of intent may speed regulatory approvals. Many larger transactions require filings under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 ("HSR Act"), which cannot be made until after the buyer and seller have entered into an agreement with respect to the acquisition. A fully executed letter of intent can serve as the basis for making the filing under the HSR Act.

For these and other reasons, executing a letter of intent is common practice in many transactions.

Disadvantages

Despite the frequent use of letters of intent, there are significant disadvantages and potential pitfalls associated with the practice. While none of these should absolutely discourage the use of letters of intent, diligent practitioners will want to evaluate carefully both the upside and the downside before deciding that a letter of intent is indispensable to any particular deal.

The greatest disadvantage of a letter of intent is that, depending on the circumstances, a court may later find that provisions the parties intended to be nonbinding are actually binding. As a result, the parties could be stuck with a deal that has not been thoroughly negotiated and from which material terms are missing. The remaining unnegotiated terms must be worked out between unhappy parties, or be filled in at the court's discretion.

While a letter of intent may ultimately prove beneficial, the process of drafting and negotiating it has costs. Negotiating a letter of intent frontloads the expense in anticipation of a smoother path to an ultimate deal (or quicker insight that no deal is to be had). As a result, such letters tend to make more sense in larger and more complex transactions. Parties to smaller or more straightforward deals may prefer to proceed directly to a definitive agreement absent other compelling reasons for a letter of intent.

In addition, parties should be wary of the potential effects of negotiating too many details too early in the deal. Drafting a letter of intent may push the parties to consider fine points and difficult issues better left until after the broad outlines of the deal are established. The danger, of course, is that negotiations will bog down before they gain real momentum.

Moreover, parties who execute a letter of intent often negotiate ultimate terms in the definitive agreement that differ significantly from those in the letter of intent. This may not pose a problem in circumstances where the parties proceed with the understanding that the letter of intent represents tentatively agreed-upon terms. However, if discord arises, it is possible that the parties will point to competing written agreements.

Negotiating a Letter of Intent

In the merger or acquisition context, the control of information often defines the parties' respective bargaining positions. During the initial stages, the seller may remain circumspect, revealing only enough information about its business to maintain the buyer's interest without ceding its bargaining edge. The buyer, on the other hand, wants as much information about the seller as soon as possible. This bargaining friction is at its maximum before the parties have committed to a letter of intent, and in large part dictates what the negotiating parties will want to include in that preliminary agreement.

The Seller's Interests. Generally, the seller will be more motivated than the buyer to make the letter of intent as specific and explicit as possible. The seller's leverage is likely to be greatest before it signs a letter of intent, because the buyer has not yet had the opportunity to gather detailed information about the seller, and because the seller may solicit and entertain, or purport to entertain, multiple suitors. Thus, the seller is more likely to obtain favorable terms during this period and will want to go as far as possible toward formalizing and solidifying the material terms, such as deal structure, price, and form of consideration.

Beyond this overarching desire for specificity in the letter of intent, the seller will want to secure the buyer's promise to keep in confidence certain information about the seller. Because any breach of confidentiality can be very damaging to the seller's interests, including its employee morale and its various business relationships, the seller will want the confidentiality provision within the letter of intent to be binding. If the confidentiality covenant is favorable to the seller, the buyer will be bound not to disclose any information about the seller that the seller chooses to designate as confidential. The provision should carve out any publicly known information and any uses of information that are necessary for obtaining consents or approvals necessary to close the deal.

Sellers may also want to consider obtaining a promise that the buyer will not compete with the seller nor solicit the seller's key employees, customers, or suppliers during negotiations and for a period of time following the conclusion of unsuccessful negotiations. Again, because the buyer will gain access to information regarding the seller's business relationships during the negotiations, the seller will want to prevent the buyer from using this information to affect adversely its business operations.

The Buyer's Interests. While the seller has a strong interest in preserving confidentiality, the buyer has an equally strong counter-interest in obtaining access to information from and about the seller. Even though the two interests substantially compete with one another, they are not mutually exclusive. The buyer will simply want to be sure that one of the provisions within the letter of intent grants it free access to the target company's otherwise proprietary information for the full term of the negotiations. The buyer will also want unlimited access to the seller's personnel, contracts, books and other data. Since the buyer will not gain this access until after the parties execute a letter of intent, the buyer will want to keep the key terms of the deal as general as possible, putting off the more problematic issues until it possesses greater knowledge.

Further, the buyer will want, at the earliest possible stage, to eliminate other suitors and elevate its own bargaining position. To that end, the buyer will want to include a "no-shop" commitment and other standstill provisions in the letter of intent. A no-shop provision establishes a period of exclusive dealing and typically has two components: a prohibition against soliciting or negotiating offers from any third party, and a mandate to notify the buyer if the seller receives any offers or inquiries. A break-up fee might also be considered, which would require the seller to pay the buyer an agreed-upon amount in the event the seller completes the business transaction with another buyer within a specified time period. Break-up fees are heavily negotiated, and most sellers will resist such a proposal.

The combination of a no-shop provision and the ability of the buyer to have full access to information regarding the seller leads most commentators and practitioners to conclude that letters of intent generally are more favorable to the buyer than to the seller.

The question of whether a letter of intent is binding is by far the thorniest—and the most litigated—issue associated with the topic of preliminary agreements.

Binding or Nonbinding?

The question of whether a letter of intent is binding is by far the thorniest—and the most litigated—issue associated with the topic of preliminary agreements. Professor Allan Farnsworth has flatly said that "[i]t would be difficult to find a less predictable area of contract law."[1]

The difficulty may not be immediately apparent. Corbin, in his treatise on contract law, declared it well-settled that no contract exists "where the parties consider the details of a proposed agreement, perhaps settling them one by one, with the understanding during this process that the agreement is to be embodied in a formal written document and that neither party is bound until they execute this document."[2]

The problem may arise, however, when trying to determine the parties' understanding during this process. That is, when negotiations go awry, the courts may be tasked with determining the intent of the parties after the fact—no easy job if the parties' words and actions contain any ambiguity. To complicate matters further, courts of various jurisdictions take different approaches in determining the intent of the parties. Minnesota courts, for example, take the strict-interpretation approach and construe any ambiguity in the language of the letter of intent against the party trying to bind the other party. Other courts look beyond the four corners of the letter of intent and consider other factors. Those courts may look at oral statements and other actions, and turn a let-

ter of intent that is nonbinding on its face into a binding agreement.

Lessons from the Case Law. Courts typically examine several factors in attempting to determine whether the parties intended to be bound:

a. the actual words of the document;
b. the context of the negotiations;
c. whether there has been partial performance of the obligations of either party;
d. whether any material issues remain to be negotiated, or whether the terms in the letter of intent are sufficiently definite to be enforceable; and
e. whether the subject matter of the discussions concerns complex business matters that customarily involve definitive written agreements.[3]

The first of these factors—the actual language in the letter of intent—is the most important. Especially in Minnesota, the courts look primarily at the language of the letter of intent to determine the intent of the parties. Minnesota courts generally start with the premise that a letter of intent constitutes an agreement to agree and thus is not a binding contract.[4] If the parties clearly express that the letter of intent is legally binding, or explicitly identify which portions of the letter of intent are legally binding, such expressions control. If the parties do not manifest such an explicit expression on paper, Minnesota courts are unlikely to enforce such an agreement. Further, a letter of intent that merely represents a summary of the parties' negotiations and shows nothing more than an intention to negotiate in the future is unenforceable in Minnesota.[5] Such agreement does not constitute the parties' complete and final agreement.[6]

To create a binding contract, the parties should use keywords, such as "legally binding" and "enforceable," in the letter of intent. The parties may specify early on in the document that the entire agreement is "legally binding and enforceable," or indicate separately which parts of the agreement are binding. A mere label "letter of intent" alone will not be determinative.[7] The Minnesota Supreme Court declined to enforce a letter of intent containing the language, "the parties shall enter into a definitive purchase agreement … ."[8] Similarly, the Minnesota Court of Appeals held that the language, "the parties agree to proceed forward with a formal agreement" did not bind the parties.[9] Interpreting these Minnesota cases, the 8th Circuit also concluded that language that speaks of future actions and agreements indicates the parties' intent not to be bound.[10]

To create a binding contract, the parties should use keywords, such as "legally binding" and "enforceable," in the letter of intent.

Conversely, to assure that a letter of intent is not enforced, the lawyers drafting a nonbinding a letter of intent should clearly label the letter of intent as "nonbinding." Further, based on a Minnesota Court of Appeals decision, the drafter should include disclaimers, such as "[t]his letter of intent shall not be a binding legal agreement," and "neither party shall have any liability to the other until the execution of the definitive agreement."[11]

A word of caution is in order, however, when drafting a partially binding letter of intent. In one Minnesota case, the Court of Appeals invalidated the entire agreement, although the agreement contained a binding covenant. The provision stated that the parties "agreed to terminate negotiations with other prospective purchasers and work toward finalizing the definitive purchase agreement."[12] The court pointed out that, despite the good-faith covenant, there were two overwhelming facts that indicated otherwise. The letter was titled "nonbinding offer" and the letter also contained a broad statement to the effect that the entire document shall not be a binding legal agreement. Given the obvious title and the applicability of the broad language to the entire contract, the court decided to quash the covenant.[13] Subsequently, the 8th Circuit followed this precedent and concluded that where the parties have agreed that a letter of intent, in its entirety, is not binding, it will not enforce an individual provision of the letter of intent as a freestanding "contract" promise.[14]

Therefore, to create a partially binding letter of intent, a general statement declaring the agreement as nonbinding should be qualified with additional language, such as "except as specified." The ensuing provisions should then be separately noted and labeled as "legally binding and enforceable."[15] The combination of the two should alert the reader and the court that the letter of intent, though generally not binding, contains provisions that are binding.

Finally, for a letter of intent to be binding and enforceable in Minnesota, the parties must also include the essential terms in the agreement.[16] Without the essential terms, such an agreement does not provide a basis for determining the existence of breach or giving an appropriate remedy.[17] The mere inclusion of essential terms alone, however, will not bind the parties, unless the intent of the parties to be bound is also explicit in the agreement. In *Lindgren v. Clearwater Nat'l Corp.*, despite the inclusion of precise terms—such as sale terms, the property's

Mark Williamson is a principal at Gray Plant Mooty and cochair of the firm's Mergers & Acquisition practice team. He practices in the areas of general business, corporate and securities law and has extensive experience representing public and private companies in corporate transactions including mergers, acquisitions and divestitures, public and private offerings, tender offers, and corporate financings.

legal description, the purchase price, the terms of the mortgage and a closing date—the Minnesota Supreme Court nonetheless held that the agreement was unenforceable as a contract. The Court found that a letter of intent was not binding as a matter of law unless the parties clearly manifested intent to be bound.

One should bear in mind, however, that depending on the jurisdiction courts may nonetheless find agreement to negotiate in the future binding. In other jurisdictions, if the parties include a covenant to negotiate in good faith, they may be bound by it notwithstanding the nonbinding nature of the rest of the letter of intent.[18] Moreover, when the parties themselves have not been explicit as to whether or not its provisions are binding, the courts are split on the question of whether buyer and seller are bound by the letter of intent.[19]

Even language that apparently contemplates a definitive agreement to be reached in the future may not prevent a letter of intent from binding the parties.[20] If courts find that the parties, by their actions, demonstrated an intention to be bound, an ambiguously worded letter of intent may be held binding. This is true even when the letter of intent does not resolve all of the issues that require resolution for the transaction to be completed.[21]

Drafting Considerations

Because the actual language in the letter of intent is crucial, it is vital for the parties to seek legal counsel in drafting its provisions. Some parties may resist involving lawyers at all because they fear driving up the cost of the transaction or because they do not want to overcomplicate the process. Other parties prefer to work out the essential aspects of the deal and then invite their respective attorneys to review and comment on a draft of the letter of intent. In no case should the parties assume that simply captioning a written document with "agreement in principle" or "letter of intent" will reliably bind or prevent it from becoming binding. Many ships have broken on the shoals of such optimism.

Beyond making certain that attorneys are a part of the negotiation of letters of intent, parties who want nonbinding letters of intent should know that certain strategies will help to ensure that courts will not reach a contrary conclusion:

a. include an express and unequivocal statement that the letter of intent is not intended to be an enforceable agreement;
b. clearly label all provisions that *are* intended to be binding (*e.g.* a confidentiality agreement or no-shop provision), and set them apart from nonbinding provisions;
c. if appropriate to the circumstances of the deal, refrain from specificity about essential terms;
d. refer to conditions to be satisfied in the future; and
e. use the subjunctive tense (*i.e.*, *would*, not *will*).

Overall, the language of the letter of intent should be definite and precise.

Given the numerous benefits associated with negotiating and entering into a letter of intent and the fact that most parties prefer to have the basic business terms memorialized early in the negotiations, it is unlikely that the practice of using letters of intent will change. Consequently, it is imperative that the parties and their legal counsel draft all provisions carefully and purposefully in order to avoid unintended consequences. ▲

Notes

[1] E. Allan Farnsworth, "Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations," 87 *Colum. L. Rev.* 217, 259–60 (1987).
[2] 1-2 Arthur L. Corbin et al., *Corbin on Contracts* §2.9 (2007 ed.).
[3] To be enforceable, a letter of intent must contain the essential terms of the transaction—price, structure, and the assets or properties involved. *See Restatement (Second) of Contracts* §27, cmt. c (1981); *Winston v. Mediafare Ent. Corp.*, 777 F.2d 78 (2d Cir. 1985).
[4] *Hansen v. Phillips Beverage Co.*, 487 N.W.2d 925, 927 (Minn. App. 1992).
[5] *Id.*
[6] *Mohrenweiser v. Blomer*, 573 N.W.2d 704, 706 (Minn. App. 1998).
[7] *Metro Office Parks Co. v. Control Data Corp.*, 295 Minn. 348, 355 (Minn. 1973).
[8] *Lindgren v. Clearwater Nat'l Corp.*, 517 N.W.2d 574 (Minn. 1994).
[9] *Mohrenweiser*, 573 N.W.2d at 707.
[10] *Richie Co. v. Lyndon Ins. Group, Inc.*, 316 F.3d 758, 762 (8th Cir. 2003).
[11] *See Hansen*, 487 N.W.2d at 926.
[12] *Id.* at 927.
[13] *Id.*
[14] *Richie*, 316 F.3d at 761.
[15] *See Huber and Sons, Inc. v. Service Corp. Int.*, 2003 U.S. Dist. LEXIS 4094, at *6 (D. Minn. 03/13/03).
[16] *J & W Enterprises v. TM Marketing, Inc.*, 1997 Minn. App. LEXIS 678, at *3 (Minn. App. 06/24/97).
[17] *Richie*, 316 F.3d at 761.
[18] *See Fickes v. SunExport, Inc.*, 762 F.Supp. 998 (D. Mass. 1991); *see also A/S Apothekernes Laboratorium v. I.M.C. Chemical Group, Inc.*, 678 F.Supp. 193 (N.D. Ill. 1988); *Feldman v. Allegheny Int'l, Inc.*, 850 F.2d 1217 (7th Cir. 1988).
[19] For a discussion of this split in courts nationwide, *see Farnsworth*, *supra* note 11, at 288–90 and accompanying notes.
[20] The leading case is *Texaco, Inc. v. Pennzoil Co.*, 729 S.W.2d 768 (Tex. App. 1987). *See also Field v. Golden Triangle Broadcasting, Inc.*, 305 A.2d 689, 693 (Pa. 1973), *cert. denied*, 414 U.S. 1158 (1974); *Restatement (Second) of Contracts* §27 (1981).
[21] The court may supply terms that are left unresolved according to what is commercially reasonable, or it may require the parties to negotiate those matters in good faith. *See Itek Corp. v. Chicago Aerial Indus., Inc.*, 248 A.2d 625 (Del. 1968).