

Kick-starting deals

How letters of intent provide a road map for business transactions

INTERVIEWED BY JAYNE GEST

A letter of intent, memorandum of understanding or term sheet — all essentially the same — is intended to be a nonbinding expression of the parties' intended business transaction, creating a framework for putting a deal together.

It's useful for a merger, acquisition or other combination, stock purchase, joint venture, real estate sale or lease, purchase or licensing agreement, or business contract.

Business owners usually aren't in the business of doing deals, so it's better to address the salient, material business points upfront in a simple, understandable way, says Peter J. Smith, a member at Semanoff Ormsby Greenberg & Torchia, LLC.

"The last thing you want is to go through an entire negotiation, do your due diligence, get your financing and then find out there's an issue that becomes a deal killer," he says. "You've now spent tens of thousands of dollars in time and expense on a deal that doesn't, or won't, close."

Smart Business spoke with Smith about why using a letter of intent makes sense.

What is the purpose of a letter of intent?

It allows the parties to see if there is a basis for, and to document as a preliminary matter, the terms of a deal before expending time, energy and money. It's better to determine if you can reach an agreement on the basic framework before you and your organization spend significant time, plus out-of-pocket expenses for attorneys, accountants, inspections, application fees, appraisals, travel and more.

The letter of intent also lays the groundwork for the transaction, including areas businesspeople don't consider at first

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like non-competes, non-solicitations or indemnification. If it is sufficiently detailed and anticipates all major points, a letter of intent limits future negotiation, surprises and issues that could derail the deal, making the transaction more efficient and likely to close smoothly.

How detailed should a letter of intent be?

Unless there is a specific reason not to, a letter of intent should be as detailed as possible. The more you can include, the less there is to argue about later.

Sometimes business owners want a quick, one-page agreement that doesn't get too hung up on the details. However, parties tend to be more agreeable and reasonable at the letter of intent stage. Plus, in my experience, the more detailed the letter of intent, the more likely the transaction is to close. Letters of intent also help minimize the 'difficult lawyer' problem, when counsel wants to continually negotiate the deal or make so many changes that the deal doesn't come to fruition.

How can you negotiate important points if you have only done limited due diligence?

You can ask for the information upfront to resolve the issue, which is probably the best solution. If this is not practical, use a range or formula, or you can raise an issue, but leave the details for after due diligence.

What good is a letter of intent if it's not binding?

Though not legally binding, a letter of intent has a psychological impact. It memorializes the understanding of the parties, and most people don't want to be seen as breaking their commitments. Parties should sign a letter of intent, even if there are no binding provisions, solely for the emotional effect.

Nevertheless, a letter of intent often contains binding provisions such as confidentiality, no shop, non-solicitation of employees or customers, good faith negotiations or best efforts. It may provide a timeline for deposits, break-up fees or other provisions that become binding over time.

A letter of intent also can be provided to third parties to evidence the parties' commitment and terms of the deal, perhaps in support of financing applications, approvals, etc.

In addition, you may not want to read a 30-page agreement, line-by-line, that is full of legalese. That's why you pay a lawyer. With a letter of intent in place, counsel can say, 'Yes, the agreement says the same thing as the letter of intent, and here are the five additional things you need to know.' A detailed letter of intent helps you understand the deal better and results in a smoother, more cost-efficient transaction. ●