Letters of Intent – The Good and the Bad

January 4, 2010

By Ralph Kroman

The legal documentation involved in the sale of a business or other major business transaction can be complex. A common practice is using a letter of intent (LOI) to set forth the main points of a proposed business deal but to not consider it a legally binding contract. The idea is to clear away potential "deal breakers" through a non-binding business document so that the parties can proceed to the nitty gritty of a formal agreement.

Unfortunately, an LOI sometimes called a "memorandum of understanding", "term sheet" or "heads of agreement" is not a precise term and can mean different things in different situations. The key issue is not the name of the document but whether it is in fact legally binding or merely a statement of business intention. Problems arise when a party thinks an LOI is not legally binding when it in fact is or vice versa.

Draft the LOI with clarity of purpose

The best way to avoid LOI disputes is to establish at the outset whether it should be a legally binding contract and draft it properly. For example, the following drafting techniques will help ensure that an LOI is not legally binding:

- avoid use of the word "agreement" and use terms of intention instead (e.g., instead of saying "it is agreed" say "it is intended")
- expressly state that the LOI is not legally binding and that binding commitments will only arise upon the signing of a formal agreement in writing

Walk the talk

Although the LOI may contain language that suggests it is not legally binding, it is also important that the parties act as if they do not have a legally binding agreement. The Ontario Court of Appeal recently considered a case where language in an LOI suggested it was not legally binding: "THIS LETTER OF INTENT MUST BE REDUCED INTO A BINDING AGREEMENT OF PURCHASE AND SALE BY THE PARTIES WITHIN THE NEXT 40 DAYS."

Although a draft share purchase agreement was prepared subsequently and was not signed, the court found that the parties acted as if they were bound by the LOI. For example, the seller announced his retirement upon the sale of his business on at least two separate occasions and introduced the buyer as the new owner. The court found that the language in the LOI taken as a whole should be interpreted to create a binding agreement.

This means that if a party does not wish to be bound by an LOI, the LOI must not only be drafted to reflect this, but the party should act as if a binding agreement does not exist. Announcements must be made with care and correspondence such as e-mails should not suggest that the LOI is legally binding.

A better approach the hybrid LOI

One approach to LOI drafting that has gained popularity is the creation of a hybrid document that contains both binding and non-binding provisions. The non-binding provisions typically include the transaction structure, price, and similar items related to the business deal.

The legally binding provisions usually include a confidentiality provision and a “no shop clause”. The main concern of the seller of a business is confidentiality, especially since the deal may not close and the buyer may be a competitor. It will usually be necessary to disclose confidential information so that the buyer’s negotiation of the formal agreement is meaningful. As a practical mater, all confidential information should be marked as such by the seller and clear records should be maintained of the information that is disclosed.

The main thing a purchaser usually wants is a “no shop clause” so that it can spend time and money on due diligence with the comfort that the seller will not be “shopping the deal” to potential buyers during the exclusivity period.

A question of balance

A seller will usually have more leverage than the buyer before the LOI is signed. Typically, the buyer has less information at the LOI stage than it does later on, and the buyer must approach things with caution. After the LOI is signed, the buyer usually gains advantage as more of the seller’s confidential information is disclosed.

In light of these dynamics, a buyer of a business usually wants to keep the LOI short and vague so that it can take advantage of momentum that will build in its favour after the LOI is signed. Of course, the seller often wants to negotiate all important issues upfront to offset the momentum that will likely develop in the buyer’s favour.

Striking a balance during these early stages is key. Both parties need to be upfront enough during LOI negotiations to create that “warm and fuzzy” atmosphere of good faith. If a seller feels that the buyer is not being frank enough, or the buyer thinks that the seller is using the buyer’s lack of information to its advantage, it may be wiser to abandon LOI negotiations rather than move forward through what could be an acrimonious transaction.

For more information or inquiries:

Ralph Kroman

Toronto
416.947.5026

Email:
rkroman@weirfoulds.com

Ralph Kroman brings broad experience and high-level expertise to his business law practice with an emphasis upon contract negotiations, intellectual property, information technology and commercial transactions.

WeirFoulds LLP

www.weirfoulds.com

Toronto Office
4100 – 66 Wellington Street West
PO Box 35, TD Bank Tower
Toronto, ON M5K 1B7

Tel: 416.365.1110
Fax: 416.365.1876

Oakville Office
1320 Cornwall Rd., Suite 201
Oakville, ON L6J 7W5

Tel: 416.365.1110
Fax: 905.829.2035