

Letter Of Intent (aka Term Sheet)

Definition	Defines the respective preliminary understandings of the parties about to engage in contractual negotiations
Obligations	Not intended to be binding except with respect to certain limited provisions (e.g. exclusivity, confidentiality). To be 100% sure, the parties should define the terms under which it is and is not acceptable to withdraw from negotiations and, in the case of an unacceptable withdrawal, the amount of the liquidated damages
Pros	<ul style="list-style-type: none">• Set forth some binding agreements (e.g. exclusivity, confidentiality)• Ensure parties agree on principal terms before making substantial legal DD and SPA drafting expenses• Psychological effect of entering into agreement and therefore intention to close
Cons	<ul style="list-style-type: none">• If can close quickly, why bother?• Sometimes it's costly to negotiate, so better reduce it to one time (in SPA negotiations)
Time for execution	After the acquirer has completed its basic financial due diligence but before it embarks on its major legal due diligence
Drafting party	N / A

Acquisition agreement (aka SPA)

Overview

Purpose	<ol style="list-style-type: none">1. Sets forth the structure and terms of the transaction2. Discloses all the important legal and financial details of the target's operations, as well as the comments of each party prior to closing.3. Contains the conditions to each party's closing the transaction as well as the comments of each party prior to closing.4. Obligates both parties to do their best to complete the transaction5. Obligates the seller not to change the target in any significant way before the closing6. Governs what happens if, before or after the closing, the parties discover problems that were not properly disclosed
Obligations	Completely binding agreement
Negotiations objectives	<p>Sell-side:</p> <ul style="list-style-type: none">• Closing will occur as soon as possible (Conditions section in SPA)• No post-closing events will require a refund of any of the purchase price (Indemnity section in SPA) <p>Buy side:</p> <ul style="list-style-type: none">• Flexibility to abandon the transaction if any defects are discovered (Conditions section in SPA)• Full compensation for loss resulting from legal or financial problems that were not disclosed. Of course macro risks, etc. after closing are not compensated. (Indemnity section in SPA)
The risk of undisclosed flaws	<p>Two ways to deal with this risk:</p> <ol style="list-style-type: none">1. "As is" - the buyer assumes all the risk and discounts the price accordingly2. The seller indemnifies all or part of the risk <p>The second is general way, but the first might apply to create incentives for both parties to discover flaws beforehand. Also in some cases, seller may enjoy both high price and low risks (e.g. in auction)</p>
Drafting party	Buy-side for the following cons o/w:

	<ul style="list-style-type: none"> • Loss of control over pace of drafting • Seller's attorney drafts the changes and always protect the seller • Illusion of saved legal fees, while substantial redrafting will be necessary to make the agreement work anyway
Terms	<ul style="list-style-type: none"> • <i>Ordinary course of business</i> - normal practice of the specific business being acquired and the industry of which it is a part, including the normal character and size of routine transactions (may be specified further) • <i>Best of knowledge (Stronger version - after due inquiry)</i> - a limited liability of the seller to information which he knows of. Practice is not to permit by the buyer except for <ul style="list-style-type: none"> • Existence of threatened litigation by third parties of copyrights and patents • In case of MBO with no investment bank involved • <i>Material</i> - important to a normal, prudent investor in determining whether to make a given investment. The concept remains vague despite the court definitions in specific cases, and the accounting standards bodies definitions. To specify - use concrete sums for the definition (e.g. \$100 for this exhibit) • <i>Bring-down condition</i> - The buyer will not be required to close if <ul style="list-style-type: none"> • The seller has breached any of its covenants or • Any of the representations and warranties of seller and target were not true when made or are not true on the closing date, or as if made on the closing date • <i>Financing condition</i> - the buyer need not close if it is unable to finance the transaction • <i>Survival period</i> - the period of time when indemnity might be applied

Structure

1. Introductory material
2. The price and mechanics of the transfer
3. Representations and warranties of the buyer and seller
4. Covenants of the buyer and seller
5. Conditions to closing
6. Indemnification
7. Termination procedures and remedies
8. Legal miscellany

Introductory material

It is often useful in a legal document to describe the intentions of each of the parties (the legal significance of the introductory material is usually not great)

The price and mechanics of the transfer

1. Identifies the structure of the transaction as a stock disposition, an asset disposition, or a merger
2. Describes the mechanics to be utilized to transfer the property from seller to buyer
3. Optionally: the requirement for a deposit by the buyer, or other security for the buyer's obligations to close
4. Nature of the consideration to be received by the seller
5. The timing of payment
6. Provisions regarding satisfaction of net debt
7. In case of asset disposition (AL)
 - Assets are to be conveyed to the buyer
 - Liabilities of the seller will be assumed by the buyer
8. In case of merger (CABIN)
 - Composition of the board of directors
 - Articles of incorporation
 - Bylaws governing the surviving corporation
 - Identity of the surviving corporation
 - Names of the officers

Representations and warranties

Purpose	<p>As of the date of the signing the Seller makes detailed statements about</p> <ul style="list-style-type: none">• Legal and financial condition of the target• The property to be conveyed and that the transaction will not have adverse effects upon the property to be conveyed• The ability of the seller to consummate the transaction <p>The buyer makes similar representations and warranties about its legal and financial ability to consummate the transaction (and some other)</p> <p><i>Representations must include those required by lenders (anticipated by the buyer)</i></p>
Contents	<p>Representations and warranties (text), exhibits and schedules (appendix to text, listed in separate disclosure statement if company is public)</p>
Materiality	<p>Materiality in this section usually used only for conditions to closing (i.e. permission to walk away from the deal). In indemnity section there are other notions of materiality</p>
Volume and scope	<p>The buyer is interested in the broadest scope, the seller is in the narrowest. The seller motivation for narrow scope:</p> <ul style="list-style-type: none">• Time and cost for preparation• Risk of buyer backing out the agreement• Risk of indemnification <p>Minimum scope: financial statements, litigation, undisclosed liabilities, and taxes</p>

Covenants

Purpose	Defines the obligations of the parties with respect to their conduct during the period between the signing and the closing
Description	<ul style="list-style-type: none">• In the representations and warranties, the seller assures the current snapshot as of the date of signing SPA; in the Covenants section, the seller agrees not to do anything to change that picture in any material way, except as necessary in the normal operations of the business.• Typically, changes other than those that are specifically permitted under the agreement can be made only with the consent of the buyer. However, it is often necessary to limit the restrictions by requiring the buyer not to “withhold consent unreasonably”

Conditions to closing

Purpose	<ul style="list-style-type: none">• If a condition to the buyer’s obligation to close is not satisfied, the buyer will have the right to terminate the agreement without being liable for damages to the seller• If one of the seller’s conditions is not satisfied, the seller will not be obligated to close
Negotiations	<ul style="list-style-type: none">• Bring down condition – almost always included in SPA• Financing condition – (either in SPA, or holds automatically if acquirer is a shell company). Seller says<ul style="list-style-type: none">• If the buyer is confident of financing, should take the risk or• Require financing commitments before the deal or• Require loan agreement from buyer in a certain period or• At least seller must know financing structure and basic parameters• Seller should state no financing out condition in the letter of intent, the buyer should defer it to the last moment• Material adverse change – if industry is in downturn who's bearing the risk? Logically the buyer, cause he also benefits from upside. Traditionally seller
Buyer aware of breach	An proceeded to close => no claim for damages from the buyer

Indemnity

Purpose	<ol style="list-style-type: none">1. Set forth the circumstances under which either party can claim damages in the event the other party to the agreement has breached a representation or warranty or failed to abide by its covenants.2. Supplements the parties' general legal rights by providing specificity regarding the kinds of recovery to which the parties may be entitled, as general legal rights and the corresponding amount of claims are vague
Properties	<ol style="list-style-type: none">1. Survival period – generally in effect for 2 years (the buyer should request 2 years or at least until the buyer receives audited financials for the full fiscal year)2. For willful breaches by the seller survival period must not be of the essence3. Basket – the buyer claims $(S_t - K)^+$, where K – is the amount of basket, usually 1-2% of the deal price4. Also indemnity subject to minimal amount for claim5. Should be accompanied with either escrow or setoff rights (right to pay only part of the sum)6. Litigation arose after closing due to activities before closing in indemnified (might be insured as well)

Sample answers in negotiations

Seller says he can't get knowledge about certain representation or warranty	<p>We certainly understand your concern, but we have even less of a basis for intimate knowledge of the target's operations. The real issue is, Who should absorb the risk in the event that there are undisclosed material defects in the business? We have different views, of course, of who should bear the risk, but let's really talk about what matters, not about what each of us knows about the company right now. The agreement between us ought to be structured to provide incentives for both of us to do the best job possible to unearth problems and to increase our knowledge of the company now, before we close, rather than wait for problems to surface afterward. Then, if something does surface later, either after we sign or after we close, we need to decide where the risk should reside.</p>
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Seller speeds up to include less representation	Look, if we want to sign in this milieu, we can't possibly prepare exhibits based on these representations and warranties. We'll have to recirculate questionnaires to all the officers of each member of the target's corporate group (often scattered around the world) and review once again all the pertinent documents (and, of course, there are hundreds of documents) to make sure we don't violate these tighter representations and warranties.
Buyer shifts macro risks to seller	<ul style="list-style-type: none"> • Deals just aren't done this way • Hey, you still control the operation of the business • My price doesn't take into account this type of risk
Buyer shifts macro risks to seller	<ul style="list-style-type: none"> • The public company survival period ends at closing