

Letters of Intent: Why Business People Love Them and Lawyers Hate Them

Letters of Intent (“LOI”) , also known as Memoranda of Understanding and Memoranda of Agreement, are a device used to signal parties’ agreement to the basic structure of serious negotiations to close a deal. An LOI typically comes into play after a round of initial discussions and after the signing of a Confidentiality Agreement and a second round of more serious discussions about the proposed transaction. A letter of intent legal form by the author is available for purchase at www.coollawyer.com.

Business Functions of a Letter of Intent

A Letter of Intent serves several business functions:

Commitment to Each Other and to the Deal: Signing a letter of intent, from a business perspective, indicates that each party has obtained senior management’s approval to work towards closing the proposed business transaction and that the parties have moved into a stage of serious negotiations.

Commitment to the Deal for Others to See: After signing a letter of intent, the parties usually issue a joint press release announcing the event. This is usually to provoke a positive reaction in the stock market to the news and some times to send a message to competitors in the marketplace.

Commitment to a Time Line: An LOI will set forth a time line for negotiations, including a deadline for closing the deal and what will occur if the parties fail to meet the deadline.

Partial Performance and Authorization of Expenditures: After signing a letter of intent, parties will often begin due diligence for the transaction and/or preparation of a formal estimate regarding the transaction. Research and preparation of such documents involves expenditure of significant funds for the time and materials of employees designated to perform these tasks. Senior management will usually authorize spending such funds based on signing the letter of intent, although rarely will the LOI specify that there is any way to recoup these funds if the deal does not close.

Confidentiality: If not already agreed to in a Confidentiality Agreement, each party will agree to keep the transaction and information exchanged in negotiations confidential in an LOI.

Legal Functions of a Letter of Intent

Letters of Intent, legally, are the worst of all worlds. In law, you either have a contract or you don’t. LOI’s are the legal equivalent of “almost pregnant”. Letters of Intent emphatically state that that they are not formal agreements and then often proceed to set forth agreed terms of the proposed transaction. Given this paradox, if the deal goes sour, one party can argue that those agreed-upon points were, in fact, agreed upon – or, in fact, a binding contract and, in some cases, furthermore, that the party relied on the LOI and has monetary damages based on such reliance.

This is the legal problem with a Letter of Intent – you can't legally state you agree to something and then state that you don't in the same document. If the LOI is held to be binding by a court, you have a contract with general essential terms but without the many terms you would normally want in final agreements – a liability limit, warranty waivers, detailed payment and stock terms, etc. If upheld in court, you have the worst possible contract to work with – one in which either the court or the parties will have to work out all the details when the parties are at odds with each other.

If, when drafting an LOI, the author tries to remedy this ahead of time, by putting as much detail as possible into the Letter of Intent, so if upheld by a court the important clauses will be there, then that author risks greatly increased the odds of a court upholding the document as binding contract because so many of the essential terms were included.

LOI's are to be used with great caution and, whenever possible, in conjunction with serious consultation with your attorney. Nevertheless, they are a reality of the business world.

A Letter of Intent Gone Bad

Not long ago, in very early 1984, Getty Oil and Pennzoil signed a "Memorandum of Agreement" for a complex investment and stock transaction whereby Pennzoil would purchase Getty Oil stock. The Memorandum set forth general terms of the investment that had been reached in conversations and that the Memorandum was subject to the approval of the Board of Getty Oil. The Memorandum was to expire if not approved at the January 2 meeting of the Board and was signed by persons who made up the majority shareholders of Getty Oil.

After some negotiations between Pennzoil and the Board of Getty Oil during that Board meeting which ran for several days, the Board approved the transaction. On January 4, 1984, both parties issued press releases with "agreement in principle" to the terms of the Memorandum.

On January 4, Getty Oil and Texaco began discussions for Texaco's purchase of Getty Oil, while at the same time the officers of Getty Oil and Pennzoil ratifies the agreed-upon terms of the Memorandum and the lawyers for each began preparation of final agreements.

On January 5, the Board of Getty Oil accepted a better stock offer from Texaco and voted to withdraw its negotiated counter-offer to Pennzoil which had been announced as agreed in principle with Pennzoil.

On January 6, Texaco issued a press release that Getty Oil and Texaco would merge. Pennzoil protested and Getty Oil filed suit for a declaratory judgment that it was not bound by any contract with Pennzoil. The final agreements for the merging of Texaco and Getty Oil were signed on January 6 – 8.

There, of course, is a long legal opinion about this case which focuses on the intent of the parties as determined by their acts and communications. The court scrutinized not only the Memorandum, but also the wording of the press releases and other documents.

In the end, Getty Oil was found to be in breach of the Memorandum of Agreement – the document the parties had viewed as a letter of intent. At what point in the story did it change from a letter of intent to a final agreement? Very hard to tell.

Pennzoil ended up with \$10.6 billion (later settled for \$3 billion) from Texaco for interfering in its deal with Getty Oil.

Conclusion

Moral of the story – watch out if you're using Letters of Intent – be cautious, don't let your press releases (and mouth) get ahead of the deal, and consult your attorney. A letter of intent legal form by the author is available for purchase at www.coollawyer.com.