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The Ins and Outs of Private Equity Letters of Intent

In 2008, private equity firms in the United States and abroad will continue to compete for new opportunities, with the highest volume of deals primarily in the $1 billion-and-under middle market. In this highly competitive market for new deals, the hardest-working fund manager will get the brass ring. So, how can the fund manager and the target company ("Seller" or "Target") expedite the deal process? The principals should agree on the "deal" terms prior to the lawyer's drafting of definitive agreements, and then craft a letter of intent ("LOI").

So, how can the fund manager and the target company expedite the deal process?

The purpose of an LOI is to establish a common understanding between the parties of the terms of an investment and how those terms should be reflected in the key legal documents that will memorialize the transaction. But is a LOI enforceable? That depends on whether, and what parts of it you want to be enforceable and how well you write it. It's important to specify in your LOI, whether you intend it (or some part of it) to be legally binding and enforceable. To reduce the risk of a court deciding to enforce a provision in the LOI that was not intended or desired to be legally binding, it's a good idea to disclaim contractual, binding effect as to all but a few specifically enumerated terms, including the disclaimer itself. The terms that an investor should consider giving binding effect to (regardless of whether the transaction closes) include: allocation of expenses; exclusivity period of negotiation; an investor's access to the Target's materials and information; governing law; and special remedies, such as injunctive relief.

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2007 was a Target's market and Targets required deal terms such as the ability to terminate a deal without penalty and waivers of financing conditions in LOI's. Many large Targets also required reverse termination fees if the deal was not consummated by a specified date. Funds then sought to limit their liability on reverse termination fees by trying to cap liability to either the reverse termination fee or a multiple thereof and also to require Targets to waive their right to specific performance (e.g., the right of the Target to compel the fund to close.) These issues were at the heart of the Sallie Mae, Home Depot and Acxiom cases last year. In the most infamous example, United Rentals sued investment firm Cerberus to force it to complete its $4 billion buyout of the

equipment-rental company. Cerberus claims it is not bound to complete the deal and “only” has to pay a $100 million breakup fee to walk away. These cases highlight the need for careful drafting.

Here are 20 important legal and business issues that you should consider in an LOI for a private equity investment.

1. Form of transaction (e.g., asset or stock transaction, merger).
2. Purchase price.
   a. Consider how purchase price will be paid, timing, interest rates, collateral, etc.
   b. Requires a valuation of the Seller
   c. Allocation of expenses
   d. Assumption of specified liabilities
3. Investor rights as a stockholder
   a. Voting rights, veto rights, super-majority provisions
   b. Dividend payments
      i. Cumulative vs. non-cumulative
      ii. Frequency of payment
   c. Liquidation rights
   d. Conversion rights
   e. Anti-dilution rights
      i. Consider weighted average or full-ratchet anti-dilution
   f. Redemption rights
      i. Consider triggering event and price
   g. Pre-emptive rights
4. Investor management rights
   a. Member on board/management committee
   b. Rights to appoint additional board member or manager
   c. Rights to be set forth in shareholders' agreement or limited liability company agreement
   d. Informational rights
   e. Right to vote on "material" transactions
5. Escrow provisions
   a. How much and how long will escrow be held?
   b. Who will pay costs of escrow agent?
6. Indemnification
   a. Will there be caps and/or baskets?
7. Term for survival of representations, warranties and agreements
8. Management compensation agreements
9. Brokers' and finders' fees payable
10. Registration rights
11. Treatment of outstanding options, warrants and convertible securities
12. Protective provisions such as holdback, escrow, guarantee and/or grant of security interest?
13. Restrictions on operations pending closing
14. Break-up fees
15. Binding vs. non-binding
    a. A binding LOI may result in a lawsuit for the failure to perform the contract, breach of a duty of negotiate in good faith, unjust enrichment, promissory estoppel, or tortuous interference with contract, among other possible claims.

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b. An obligation to negotiate in good faith can be dangerous as this obligation may create a cause of action and liability for breach of the obligation. Various provisions in the LOI can be made binding irrespective of whether the transaction is culminated.

16. Choice of law/venue
17. Conditions of closing
    a. Due diligence
    b. Approvals of third parties (Landlords, vendors, employees, debt holders)
    c. Also consider the need to comply with various laws, such as SEC Blue Sky laws, the need to file under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (which requires a filing with the U.S. Federal Trade Commission and U.S. Department of Justice), the Investment Company Act of 1940, the Investment Advisors Act of 1940 and the Small Business Investment Act.
    d. Consider whether there are any laws in the state of incorporation of the Target that may affect the investment transaction (e.g., anti-takeover provisions, stockholder voting requirements, statutory pre-emptive rights, etc.).
    e. In addition, the sale of stock or assets in a transaction involving United States licenses of satellites will require the pre-approval of the US Federal Communications Commission. The LOI should cover who will pay the FCC licensing fees.
    f. Financing
    g. Board and/or stockholder approval
    h. "Drop dead" dates (term of LOI)
    i. Minimum EBIDTA of Target
    j. No material adverse changes of Seller

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18. Other issues
    a. Publicity/Disclosure
        i. If a public-company, if transaction is "material" public announcement should be made upon execution of LOI. If not "material," public announcement may be deferred. SRO's such as the NYSE require that once negotiations have broadened in scope to include persons other than top management, and accordingly, the risk of leak or the misuse of insider information cannot be discounted, an announcement of existence of negotiations should be made. Sellers generally do not want public disclosure because their employees, customers, and suppliers could react negatively to an announcement. In addition, competitors could seek to take advantage of the pending transaction in many ways.
        ii. In addition, there can be a stigma if a deal is not consummated once it is made public.
19. No-shop provision (takes Seller out of play)

20. Break-up fee

This is only a general outline and you should consult with an attorney and your financial advisor before negotiating and finalizing any LOI.

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