THE IMPORTANCE OF CONFIDENTIALITY AGREEMENTS AND LETTERS OF INTENT

By Gianfranco A. Pietrafesa*

The first step in the purchase of a business is often the drafting of a confidentiality agreement and a letter of intent. Just how important are they?

This article deals with the first two documents that are often prepared when a buyer seeks to purchase a business from a seller. They are the confidentiality agreement and the letter of intent. The importance of these documents will be discussed in this article.

CONFIDENTIALITY AGREEMENTS

A confidentiality agreement is frequently the first document prepared in the course of acquiring a business. It protects a seller from a prospective buyer's misuse of the seller's confidential information and prevents a prospective buyer from hiring away the seller's key managers and employees.

An acquisition of a business is very often a significant financial undertaking for a buyer. As a result, a buyer usually seeks to review certain information concerning a seller's business, such as financial, customer and technical information, before making an offer to buy a business. A seller, however, considers such information confidential and proprietary and is reluctant to disclose it to a prospective buyer, especially a business competitor. The reluctance is understandable when one considers that the acquisition, for one reason or another, may fall through and a prospective buyer may use the seller's information to its advantage and to the disadvantage of the seller.

Thus, a prospective buyer will not make a proposal to buy the seller's business without the information, and a seller will not disclose the information without certain assurances that the buyer will not use the information improperly. Enter the confidentiality agreement, which provides a mechanism for the release of the seller's confidential and proprietary information to a prospective buyer while minimizing the risk that the buyer will misuse the information.

This article will deal with the two major items that should be addressed in a confidentiality agreement: 1) defining the confidential information covered by the agreement and 2) providing the prospective buyer with access to the seller's management and employees.

Confidential Information

The agreement should begin with an acknowledgement by the buyer that the information to be provided to it by the seller is confidential and proprietary and a statement that the buyer will maintain the confidentiality of the information in accordance with the agreement. Next, the agreement should define the term "confidential information," which typically includes such sensitive information as historical financial data, financial projections, pricing and profit margins, as well as technical information such as manufacturing methods.

Typically, the definition is broad enough to include all information that the seller discloses to the buyer. A definition may be as simple as the following:

> The term "Confidential Information" means and includes any and all information concerning the Company that has been or may be provided to the Buyer by the Seller, the Company or the Company's Representatives or that is obtained from a review of Company documents or discussions with the Company's Representatives and also includes all notes, analyses, compilations, summaries and other materials prepared by the Buyer or its Representatives containing or based on any of the foregoing information.[1, 2]

The term "Representatives" should be defined to include "directors, officers, employees, agents, consultants, advisors and other representatives, including legal counsel, accountants and financial advisors."

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The agreement then identifies who may have access to the confidential information and the extent of such use, as follows:

> Buyer agrees that the Confidential Information will be kept confidential and will not be disclosed to any person except as permitted by the terms of this agreement. The Buyer may disclose the Confidential Information only to its Representatives who require the information for the purpose of evaluating whether to make a proposal to acquire the Company and who are advised of the confidential nature of the Confidential Information and the existence of this agreement. Buyer agrees that it will not use the Confidential Information for any other purpose or in any way detrimental to the Company.

The seller may fear that its business may be harmed if its competitors, suppliers and customers know that the company may be sold. If so, the seller should insist on a provision prohibiting the buyer from disclosing the fact that they are engaged in negotiations for the sale of the company.

A confidentiality agreement will contain certain exceptions to the buyer's obligation to maintain the confidentiality of confidential information, such as:

> The Buyer is not obligated to maintain the confidentiality of the Confidential Information if it demonstrates that the information (a) was known to the Buyer prior to the Seller's disclosure of the same or (b) was or becomes publicly available through no fault of the Buyer or (c) must be disclosed as required by law.

Finally, the confidentiality agreement must address the buyer's return or destruction of the confidential information in the event that the acquisition does not take place. For example:

> In the event the acquisition of the Company is not consummated, the Buyer (a) will return all Confidential Information to the Seller, including all copies and summaries of the same, and will destroy all notes, analyses, compilations, summaries and other materials containing or based on any of the foregoing information or (b) if agreed to by Seller, destroy all Confidential Information and certify in writing to Seller that all such information has been destroyed.

Access to Personnel

A prospective buyer's evaluation of a seller's confidential information alone may not provide it with sufficient information to determine whether to make an offer to purchase. Therefore, a buyer will very often request to discuss matters with the seller's management and employees. The seller, however, may not want its employees to know that it is discussing a sale of the company. The seller may want to limit the buyer's contacts with its employees. The seller will also want to prevent the buyer from hiring its employees in the event that sale does not take place. As a result, these issues should be addressed in the confidentiality agreement. A simple provision would provide:

> The Buyer will not communicate with any employee of the Seller concerning the Confidential Information without the prior written consent of the Seller. The Buyer will not, for a period of one year, solicit or recruit the employees of the Seller.

The preceding addresses the key provisions of a confidentiality agreement. The confidentiality agreement may also include provisions found in other agreements, such as remedies for breach of the agreement, governing law, and jurisdiction and venue to resolve disputes under the agreement.

LETTERS OF INTENT

A letter of intent is usually the second document prepared in the course of acquiring a business. It is typically entered into between a buyer and a seller of a business after the first round of negotiations.

There are number of reasons why the parties may use a letter of intent. First, it allows the parties to summarize the key terms and conditions of the transaction, thereby reducing or even eliminating future misunderstandings during negotiations of the definitive transaction documents. A well prepared letter of intent can be used as a blueprint to prepare the transaction documents. A letter of intent also identifies problems (or deal-breakers) in the early stages of the negotiations, before incurring the costs of negotiating the transaction documents and performing due diligence on the seller. It is best to address any problems early on because if the parties cannot summarize the key terms and conditions in a

letter of intent, then they will undoubtedly have a problem when negotiating the transaction documents.

Next, if the period of time between the signing of the letter of intent and the closing of the transaction is significant, the letter of intent can govern the parties' relationship during this time period. The time period can be significant depending on, for example, the scope of the buyer's due diligence, the negotiation of the transaction documents, and the number of third party consents or approvals to be obtained by the parties.

A buyer can use a letter of intent to provide information to a lender to obtain financing for the acquisition. In addition, the parties may need to comply with certain regulatory requirements, such as the Hart-Scott-Rodino Antitrust Improvement Act. Again, a letter of intent can be used for this purpose. Under the Act, the parties cannot close on a transaction until the expiration of the required waiting period. If the parties submit a letter of intent to satisfy Hart-Scott-Rodino filing requirements, then they can perform due diligence and negotiate the transaction documents during the waiting period.

Notwithstanding the foregoing, *some* attorneys believe that the advantages of a letter of intent are outweighed by the *possible* disadvantages. One possible disadvantage is that a court may find that certain terms of the letter of intent, which the parties intended to be non-binding, are binding. The other possible disadvantage is that the parties will spend too much time negotiating the details of the letter of intent and that this time should be used to negotiate the transaction documents. However, the first concern can be addressed by clear language in the letter of intent. The second concern can often be dealt with by a candid discussion between the parties' counsel on the purposes of a letter of intent, noted above.

Contents of Letters of Intent

A letter of intent may be short, describing only the key terms and conditions of the transaction, or long, containing a comprehensive description of the transaction. This will obviously depend on the amount and complexity of the transaction.

Structure of Transaction. A letter of intent should include a description of the transaction. For example, whether it will be structured as a merger, a stock purchase or an asset purchase. It should also include a description of any specific assets or liabilities excluded from the transaction, regardless of how it is structured.

Price and Payment Terms. A letter of intent should set forth the purchase price (if known) or the method for determining the purchase price, and any adjustments to the same. It should address payment terms; that is, whether the purchase price will be paid in cash, notes, securities, or a combination of the same. It should describe any indemnification obligations of the seller and any amount of the purchase price to be held in escrow. It should also address any required employment agreements for the seller's employees and non-competition agreements for the selling shareholders.

Conditions. A letter of intent should describe any conditions that must occur before closing; for example, financing to be obtained by the buyer, satisfactory due diligence by the buyer, consents to be obtained from third parties (such as landlords), receipt of approvals from directors and shareholders, and any necessary approvals to be obtained from regulatory agencies.

Due Diligence. A letter of intent will outline the scope of and procedures for the buyer's due diligence of the seller's business. A simple provision setting forth the parties' respective due diligence rights and obligations is:

> The Seller will cooperate with the Buyer's due diligence investigation of the Company and will provide the Buyer and its Representatives with prompt and reasonable access to key employees and to books, records, contracts and other information pertaining to the Company (the "Due Diligence Information").[3]

Confidentiality and Non-Solicitation. A letter of intent should address the buyer's obligation to maintain the confidentiality of any confidential information provided to it by the seller as well as the buyer's prohibition of soliciting the seller's employees. If, however, the parties signed a confidentiality agreement containing these provisions, then

the provisions may be incorporated by reference into the letter of intent. Many attorneys, however, prefer to repeat these provisions in the letter of intent.

Other Provisions. A letter of intent may describe the types of representations and warranties that will be required in the transaction documents. The buyer should also insist on a provision obligating the seller to conduct its business in the ordinary course and to avoid any extraordinary transactions between the time the letter of intent is signed and the time of the closing of the transaction.

Exclusivity. A buyer may desire a provision requiring the seller to deal exclusively with the buyer (a "no-shop" provision). It may also include a provision entitling the seller to a fee in the event that the buyer decides not to proceed with the transaction (a "break-up fee" provision). For example:

> For a period of 120 days from the signing of this Letter of Intent, the Seller will not, directly or indirectly, solicit or entertain offers from any other Person relating to the acquisition of the Company, whether by purchase, merger, consolidation or otherwise.
>
> If for any reason the acquisition of the Company is not consummated, the Buyer will pay to the Seller a break-up fee which will equal the sum of one percent (1%) of the purchase price, plus the Seller's expenses in connection with the negotiation of the acquisition.

Miscellaneous Provisions. A letter of intent will also include the customary but necessary provisions, such as governing law, jurisdiction, termination of the letter of intent and each party bearing its own expenses.

Binding vs. Non-Binding Provisions

Whether a letter of intent is intended to be binding or non-binding, or whether certain provisions are intended to be binding and others non-binding, is perhaps the most litigated issue involving letters of intent. Most often, the parties do intend certain provisions to be binding while other provisions non-binding.

For example, the parties do intend that the provisions requiring the buyer to maintain the confidentiality of the seller's confidential information and prohibiting the buyer from soliciting the seller's employees will be binding even if they do not enter into transaction documents. Likewise, the parties do intend that provisions requiring the seller to deal exclusively with the buyer and entitling the seller to a fee in the event that the buyer decides not to proceed with the transaction will be binding. Also, provisions dealing with such issues as governing law, jurisdiction and termination of the letter of intent will be binding.

However, those provisions outlining the key terms and conditions of the transaction (the "deal points"), such as purchase price and payment terms, are often not intended to be binding until they are in the transaction documents. That is, the parties do not intend to have a binding agreement until they sign the definitive transactions documents. Obviously, these are the provisions that time and again lead to litigation.

To minimize, and ideally to prevent, such disputes, letters of intent are frequently divided into two distinct sections, one containing the binding provisions and the other the non-binding provisions. Alternatively, or additionally (a "belt and suspenders" approach), a well-crafted letter of intent will include a provision specifically identifying the provisions intended to be binding and non-binding. For example:

> Except for Paragraphs 3, 4, 5 and 7 of this letter of intent, this letter of intent is not binding upon either the Buyer or the Seller, and is subject to the negotiation and execution of the Transaction Documents between the Buyer and the Seller. Paragraphs 3, 4, 5 and 7 are binding upon the Buyer and Seller whether or not the parties enter into the Transaction Documents and will survive the termination of this letter of intent.

In addition, letters of intent that are not intended to be binding regularly include a provision that the parties will use their best efforts to enter into the transaction documents. This type of provision is used as further evidence that the letter of intent was not intended to be a binding agreement. An example of such a provision is as follows:

> The parties will negotiate in good faith and use their best efforts to execute the Transaction Documents as expeditiously as possible and close the transaction

as soon as is reasonably practicable.

A letter of intent should clearly distinguish between the provisions the parties intend to be binding and non-binding. Careful drafting of the letter of intent will minimize, and perhaps even prevent, disputes about whether the parties intended provisions to be binding or non-binding. By doing so, the parties will be afforded the benefits of a letter of intent.

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[*] ***Gianfranco A. Pietrafesa*** *is a partner of Cooper, Rose & English, LLP in Summit, New Jersey. His practice consists of corporate and commercial matters, including business acquisitions, as well as corporate, commercial, employment and land use litigation. Mr. Pietrafesa has written extensively on both corporate and litigation matters and is admitted to practice in New Jersey and New York. He is a member of the board of directors of the Corporate and Business Law Section of the New Jersey State Bar Association. He can be reached at gpietrafesa@crelaw.com.*

[1] The examples in this article are intended for illustrative purposes only and are abridged versions of the provisions found in the source materials provided in the endnotes. The drafter of a confidentiality agreement and letter of intent may very well desire more comprehensive provisions depending on the particular transaction.

[2] See Leigh Walton, "Confidentiality Agreement," Representing the Growing Business: Tax, Corporate, Securities and Accounting Issues (ALI-ABA 2001).

[3] See Leigh Walton, "Letter of Intent," Representing the Growing Business: Tax, Corporate, Securities and Accounting Issues (ALI-ABA 2001); Maryann A. Waryjas, "Letters of Intent in the Acquisition or Sale of the Privately Held Company," Acquiring or Selling the Privately Held Company (PLI 1998).