Confidentiality Agreements, Term Sheets and Letters of Intent and Due Diligence: The Tricky Wickets, Honey Badgers and Cobras of the M&A World

by

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I. Introduction

At the beginning of an acquisition transaction, there are several steps in the process that could serve as a trap for the unwary. Confidentiality agreements typically represent the first step in conversations with the other side. Once a confidentiality agreement is signed, the parties often turn to the negotiation of a term sheet or letter of intent, which outlines the terms and conditions of the arrangement. After the term sheet or letter of intent is signed, the due diligence process usually kicks into high gear.

Although these initial steps may appear simple at first blush, each step could create missteps that impact the final transaction terms and its value. This article briefly highlights some of the problem areas and risks that can arise in all three areas. We begin with the first step in the acquisition song and dance: the confidentiality agreement.

II. Confidentiality Agreements

Early in the discussion between seller and buyer, one party will usually suggest that the parties enter into a confidentiality agreement to keep the conversations between the parties a secret. Typically, the selling party has the greatest concern about the disclosure of its business processes, financial statements and intellectual property. One side may throw out its "form" confidentiality agreement and often the parties will sign the "form" without much consideration. Confidentiality agreements are tricky wickets - they often contain terms that can derail the relationship or the subject transaction if the parties are not careful. Nonetheless, putting a confidentiality agreement in place is an absolute requirement to protect communications and disclosures from simply becoming public records or ending up in the hands of a competitor.

One key issue in confidentiality agreements is the length of the obligation of confidentiality. From a seller's perspective, there should be no end to the duration that the buyer has to maintain the confidentiality of seller information. A financial buyer, such as a private equity firm, will have little interest in such a long term confidentiality obligation. A strategic buyer may be hesitant to enter into a long term confidentiality agreement. This is typically the first tension in the buyer-seller relationship. Many sellers concede to a 2-3 year confidentiality term.

Another tricky issue regarding confidentiality agreements is the definition of "confidential information." In other words, what information is subject to the obligation of confidentiality? Three types of definitions are common: everything, trade secrets and only written information.

An “everything” definition categorizes literally everything that is exchanged between the parties as within the definition of “confidential information.” The idea with this provision is that everything that is exchanged between the parties is to be held as confidential. This is the most protective provision from a seller's perspective because the seller will not have to be concerned about whether a certain piece of information is outside the bounds of the confidentiality obligation. A buyer may not be as comfortable with this definition because it may not want to have such broad coverage.

The second type of definition is one that mirrors the state law definition of trade secrets - essentially that only those pieces of information that are confidential <u>and proprietary</u> to the disclosing party are within the definition of confidential information. This definition is more restrictive and may not provide the seller with sufficient protection. There may be pieces of information that are not necessarily trade secrets and do not meet this definition, but still are sensitive and would harm the seller if disclosed.

The third definition is one that provides that only written information exchanged between the parties is subject to the definition of confidential information. This definition can be problematic for several reasons. While written information may be defined to cover all electronic information disclosed between the parties, this definition may still not be broad enough to cover all of the parties’ disclosures. For example, oral discussion regarding the seller's plans would not be subject to a secrecy obligation.

The definition of confidential information often also contains exceptions for information in the following categories: (a) information in the public domain, (b) information that is independently developed by the receiving party, (c) information that is required to be disclosed pursuant to a court order, and (d) information received by the receiving party from a third party other than the disclosing party. Each of the these exceptions represents potential risk for the disclosing party and each side will want to make sure that they have carefully assessed the possible exceptions that could apply to this arrangement.

One additional point regarding confidentiality agreements: confidentiality agreements should not contain any provision regarding the transfer of intellectual property. Every once in a while a draft confidentiality agreement comes across my desk that contains an attempt by the other side to include a provision that states that any intellectual property that is developed by that party using the other side's intellectual property becomes the non-disclosing party's intellectual property. This type of provision should be rejected. The parties to a confidentiality agreement should defer any kind of intellectual property license or other arrangement until the definitive agreements are drafted. The only possible exception to this rule would be the inclusion of an agreement that each party’s intellectual property remains that party's intellectual property despite the disclosures made under the confidentiality agreement and that no derivative works are permitted.

Before the parties move forward with further discussions, the parties should pay careful attention to the terms and conditions of the confidentiality agreement. Once the confidentiality agreement is in place, the parties can then turn to the drafting and negotiation of the term sheet or letter of intent.

III. Term Sheets and Letters of Intent

Terms sheets and letters of intent are just preliminary writings between the parties that are intended to describe the proposed transaction and set the stage for due diligence and the negotiation of the terms and conditions in the definitive agreements. The phrase "term sheet" is typically used for more of a bullet point format, while the phrase "letter of intent" or "LOI" is typically used for more of a letter format. The point of either document is the same - to describe the terms and conditions of a future arrangement.

Term sheets and LOIs are like a honey badger (one of the fiercest creatures on the planet, which refuses to let go of its prey despite extreme pain. See http://www.youtube.com/watch?v=wPKlryXwmXk). Like honey badgers, a misstep in this stage and the grip of the error will not release throughout the course of the deal.

An initial question to be asked is whether the term sheet or LOI is intended to be binding or non-binding. A binding term sheet or LOI can be held to be a contract and can then be enforced through a lawsuit or other proceeding for breach of contract. A non-binding term sheet or LOI provides for the terms that will be negotiated, but is not intended to create contractual obligations between the parties, except for certain terms and conditions that are specifically described as binding terms. The binding terms in a non-binding term sheet are typically a confidentiality obligation (or confirmation of the terms of a separate confidentiality agreement) and a no-shop provision (preventing the seller from shopping the terms of the arrangement to other third parties).

A binding term sheet or LOI at this early stage can be a costly mistake. With such limited information having been exchanged, it is often impossible to know the risks of the business and of the buyer. A non-binding term sheet is more typical and a less risky proposition than creating binding obligations among the parties.

Once a term sheet is negotiated between the parties, the parties can turn their attention to due diligence.

IV. Due Diligence

Due diligence often begins with the buyer sending a lengthy due diligence checklist to the seller. The seller immediately feels overwhelmed (as if it faces a cobra) and begins the diligence process in a negative position. For both buyers and sellers, the process can be managed.

For both parties, it will be important to have a discussion with the other party about the priorities in diligence. This simple step can save the parties thousands of dollars and frustration. Having a sense early on as to the buyer's emphasis points in diligence will help the seller prioritize the diligence process.

Sellers need to remember that although one key purpose of diligence for the buyer is to assets and liabilities, it is also a method to try to find issues that could create an argument to reduce the purchase price. For that reason, sellers will want to have their house in order prior to beginning the diligence process.

V. Conclusion

The initial steps of the acquisition process can impact the entire course of the transaction. Confidentiality agreements are tricky wickets - there are a number of terms that could impact the relationship of the parties, not the least of which is the definition of confidential information. Term sheets and LOIs are the potential honey badgers of the mergers and acquisition world. Any misstep in that phase of the transaction will hang on through the remainder of the deal. Finally, the due diligence process can be a difficult and frustrating period. However, if carefully managed, the process can be positive for both buyer and seller. Although these initial phases can easily be glossed over, careful management of these steps will avoid any missteps early in the life of a transaction.