M&A Newsletter Series

Part 2: Preliminary documents in M&A share deal transactions

The purpose of this Baker McKenzie M&A Newsletter Series is to give an insight to prospective sellers or purchasers into some key legal documents and/or provisions they will most likely be confronted with when entering into any sale or acquisition process concerning a Luxembourg commercial company.

Part 2: Preliminary documents in M&A share deal transactions

This second newsletter deals with so-called preliminary documents, which are extensively used in such type of transactions (without being required).

Preliminary documents, also known as preliminary agreements or precontracts, are usually entered into by the parties to a share deal at an early stage of any complex share deal transaction, i.e., before starting the drafting of any of the key transaction documents (such as the share purchase agreement, the investment and shareholders' agreements and/or the shareholders' agreement).

In practice, they are encountered under many different names such as letters of intent, memoranda of understanding, heads of agreement, heads of terms, term sheets, etc. For example, when drafted as a letter, a preliminary document will be qualified as a "letter of intent"; when drafted as a contract, it will be qualified as a "memorandum of understanding," "head of agreement" or "head of terms"; when drafted as a chart or bullet point list, it will be qualified as a "term sheet."

However, practitioners should not be fooled. Irrespective of their names, the documents referred to above differ more by their form than by their content and purpose.

All of these documents ultimately aim at:

- expressing a genuine interest of one or several parties to a contemplated transaction to close a final binding agreement with respect thereto;
- determining the key commercial terms of such contemplated transaction
- bringing out any misunderstandings and differences (if any) concerning the contemplated transaction at the earliest possible stage.

Preliminary documents usually claim to have a non-legally binding character and the parties thereto frequently perceive them as low-risk legal documents. However, from time to time, such an analysis may prove shortsighted for several reasons.

First, preliminary documents always contain at least some minimum legally binding provisions (such as provisions concerning confidentiality and/or exclusivity of the negotiation, standstill undertakings, non-solicitation undertakings, breakup fees, costs, applicable law, jurisdiction, etc.).

Second, under Luxembourg law, the mere indication in a preliminary document that the transaction outlined therein is "subject to contract" or "nonbinding" is not necessarily sufficient to deprive it of any legally binding effect, for example, any time its terms otherwise demonstrate a willingness of the parties thereto to conclude a contract. Indeed, for any party to an agreement governed by Luxembourg law, the binding force of an agreement depends on its content, irrespective of the manner in which it is qualified and that the courts, when interpreting an agreement, seek the real intention of the parties rather than sticking to its literal terms.

Third, when improperly drafted, a preliminary nonbinding document may end up, in certain circumstances, being requalified as an offer (offre), a pre-agreement (accord de principe) or even a contract. The risk of having a court requalify a preliminary document concerning the negotiation of a share purchase agreement as an offer should remain remote in a large majority of transactions, notably due to the increased complexity of share purchase agreements, including representations, warranties and indemnification mechanisms that have become an essential part thereof.

THE MERE INDICATION IN A PRELIMINARY DOCUMENT THAT THE TRANSACTION OUTLINED THEREIN IS "SUBJECT TO CONTRACT" OR "NONBINDING" IS NOT NECESSARILY SUFFICIENT TO DEPRIVE IT OF ANY LEGALLY BINDING EFFECT

However, such risk can increase in some specific circumstances, for example, where a prospective purchaser has exchanged a redlined version of a share purchase agreement with the seller in an auction process. Finally, such risk should certainly not be disregarded in the event of an asset deal, which may sometimes be much more straightforward than a share deal. The risk of a court requalifying a preliminary document as a pre-agreement appears more tangible and could lead to the payment of damages in case of a breach by a party of the terms thereof. However, proper drafting should prevent or circumscribe such risk, such as the risk of seeing a preliminary agreement requalified as a "full contract."

Fourth, entering into a detailed preliminary document (even when nonbinding) increases the risk of liability of the parties thereto in case of the unilateral termination of the negotiation covered thereunder (culpa in contrahendo), as it will obviously force the terminating party to anticipate and/or carefully justify its decision to abandon a negotiation that is well underway. If it is usually accepted that no party to a negotiation has any obligation to close it and may normally terminate a negotiation at any time without reason, such right of termination is not absolute. The unilateral termination of a negotiation may lead to misconduct when advanced negotiations are, for example, suddenly and/or ruthlessly terminated without reason. One will easily understand that when a party terminates a negotiation once a detailed preliminary document has been signed, the risk of a court considering that the party that breaks such negotiation is engaged in wrongdoing increases significantly.

PARTIES TO A PRELIMINARY DOCUMENT SOMETIMES UNDERESTIMATE THE PSYCHOLOGICAL WEIGHT OF A PRELIMINARY DOCUMENT IN A NEGOTIATION

Fifth, parties to a preliminary document sometimes underestimate the psychological weight of a preliminary document in a negotiation, which often makes it very difficult for a party to reconsider a position expressed therein or, at least, to reconsider it without making (significant) concessions for it.

Most frequently, the author of a preliminary document will be a prospective purchaser (especially in an auction process). However, thereafter, the content thereof will usually begin to be negotiated with the seller, shifting from a unilateral instrument to a bilateral instrument, which will often end up being signed by both parties (irrespective of its form).

Preliminary documents should not necessarily be used in all transactions. Drafting a preliminary document should only be considered when a contemplated transaction is of a certain complexity and when the preliminary document is likely to be negotiated in a reasonable amount of time. Indeed, preliminary documents are meant to speed up the transaction processes, not to slow them down. Consequently, where the negotiation of a preliminary document proves likely to require unreasonably lengthy discussions or leads to an unreasonably long document, the parties might be advised to start negotiating and drafting the actual transaction documents (unless there is a legitimate concern about the genuine interest of a party to close a deal). Alternatively, the parties may limit themselves to negotiating preliminary documents that exclude "deal breaker issues." As in many things in life, balance will be of the essence.

Consequently, when drafting a nonbinding preliminary document, its author should always take care to clearly define its legal scope (portée juridique) and to refrain from using any wording implying, directly or indirectly, that any final agreement would have already been reached, in whole or in part, in connection with the contemplated transaction. Start by making clear that the purpose of the preliminary agreement is not to set forth any "agreements" between the parties thereto, but only some "understandings" written solely to try to expedite the negotiation and drafting process of the contemplated transaction. In addition, start by clearly identifying and separating its nonbinding provisions on the one hand and its binding provisions on the other hand, as both types of provisions will usually ultimately coexist in the same document.

The content of a preliminary document will vary from one contemplated transaction to another. Sometimes it will be lean and, for example, limited to a short description of the key commercial terms of the contemplated transaction. Sometimes it will be much more sophisticated, depending on the interests at stake. The content of a preliminary document will often depend on the fact that one party is trying to "secure" the completion of a contemplated transaction by "dragging" the other party into it, or to keep its option of whether to proceed with the contemplated transaction open as widely as possible.

The typical content of a preliminary document will include a series of nonbinding provisions on the one hand and binding provisions of the other hand, which would frequently be rather standard.

In addition to identifying the parties to the contemplated transaction (seller(s), purchaser(s), guarantor(s), target(s), etc.), the customary nonbinding provisions in preliminary documents will usually include the following commercial terms:

- a description of the contemplated transaction and its contemplated structure;
- a description of the purchase price structure (price adjustment, locked box, earnout, clawback, escrow mechanism, etc.);
- the key conditions precedent (or subsequent, as applicable) for the closing of the contemplated transaction (e.g., due diligence, governmental and/or regulatory consents, business carried out in the ordinary course, absence of material adverse change, notification to employees' representatives, financing, absence of the dismissal of key employees, etc.);
- an indicative timetable for performing the due diligence of the purchaser, securing financing by the prospective purchaser, preparing the first draft of the transaction documents, signing and closing;
- a list of the principal transaction documents to be prepared, together with identifying the party that will be responsible for preparing the relevant first draft; and
- other key terms of the transaction documents, which will vary according to their nature.

Customary binding provisions in preliminary documents will usually include the following:

- a confidentiality provision, unless the confidentiality of the negotiations is already ensured through a separate confidentiality agreement;
- an exclusivity provision aimed at preventing the seller(s) during an agreed period from negotiating with other parties and, from time to time, further reporting any proposal that may affect, prejudice or jeopardize the consummation of the contemplated transaction;
- a non-solicitation provision aimed at protecting the target's (key) employees, contractors, clients and suppliers, especially when the prospective purchaser is active in a competing business;
- a data room access provision aimed at guaranteeing to the purchaser and its advisers reasonable or full access to the information necessary to perform its due diligence concerning the target and its business during a minimum period (usually matching the exclusivity period);
- governing law and jurisdiction provisions applying to the preliminary document itself, but also to the transaction documents to be drafted later.

Less frequently, but in an increasing number of private M&A deals in recent years, the preliminary document may also include: (a) binding (reverse) break fees provisions applying in case of a breach of all or part of the binding provisions thereof; or (b) standstill provisions, when the target is a listed company. Finally, the parties will also make sure that the "binding effect" provision they insert in their preliminary document is itself binding.

WHEN PROPERLY CONCEIVED, DRAFTED AND USED, THEY MAY BE USED AS POWERFUL INSTRUMENTS FOR INFLUENCING THE RHYTHM AND OUTCOME OF COMPLEX NEGOTIATIONS

Preliminary documents are sometimes, for the various reasons outlined above, underestimated strategic documents in many transactions. However, when properly conceived, drafted and used, they may be used as powerful instruments for influencing the rhythm and outcome of complex negotiations, despite their generally sacred nonbinding character. A seller may use, for example, nonbinding preliminary documents as an interesting tactical instrument in a negotiation, as they are usually entered into before the contemplated purchaser starts its due diligence. A prospective purchase, conversely, may use them to quickly uncover any potential deal breakers at the early stage of a negotiation. Thereafter, they will often enable both parties to a contemplated transaction to save time in the drafting of the transactional documents and serve as an efficient basis for instructing their advisers.

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