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APRIL 2018

U P D A T E

News of Developments in the Financial Sector and Related Areas

* *IN THIS ISSUE* *

Letters of Intent

Letters of intent, which are sometimes known as memorandums of understanding or letters of understanding, are generally utilized by parties to a business transaction to set forth the major terms of their understanding prior to the execution of a definitive agreement. Letters of intent may be either binding or non-binding, and it is important that the parties to a letter of intent state their understanding.

A typical provision in letters of intent is a statement that it is not a binding agreement. However, the parties may want to specifically provide that although the letter of intent is not binding on the parties until the execution of the definitive agreement, that certain portions of the letter of intent are binding and enforceable such as (i) the parties will deal exclusively with one another and will not utilize the letter of intent to shop the proposed transaction to third parties, (ii) a confidentiality provision requiring the parties to maintain in strict confidence all confidential information relating to the terms of the proposed transaction and the disclosed information by one party to another, (iii) access to information to determine if the proposed transaction should proceed, commonly referred to as "Due Diligence", and (iv) each party will be responsible for their own legal fees and expenses.

The main purpose of a letter of intent is to summarize the material terms of the proposed transaction and to prevent unnecessary expense in the preparation of the definitive agreement. In those cases where the parties cannot agree upon the terms of a letter of intent, there is no need to proceed with the effort and expense of preparing a definitive agreement.

A non-binding letter of intent may include material terms such as, the purchase price, the assets involved in the transaction, closing conditions, date for closing, and other terms which may also be in the definitive agreement. Besides setting forth the key elements, a letter of intent provides a sense of assurance that each side is committed to moving forward with the proposed transaction. The letter of intent needs to be signed by the parties to the proposed transaction.

In connection with the execution of a letter of intent by the parties, courts have recognized the obligation of each party to act in good faith in attempting to negotiate a definitive agreement. Some years ago after signing a letter of intent to merge with Pennzoil, the Getty Oil board of directors backed out of the deal and merged with Texaco because Texaco had made a better offer. When litigation arose over the obligations of the parties to the letter of intent, the jury in the case awarded Pennzoil over $10 billion in compensatory and punitive damages with the case being ultimately settled by the parties for approximately $3 billion. As a result, each party needs to deal in good faith when entering into a letter of intent. Our firm is available to answer questions involving letters of intent.

Due Diligence

In the financial sector, due diligence is a term that has been used and defined in many ways, but the best meaning of it is the level of judgment, care, prudence, determination, and activity that a person would reasonably be expected to do under particular circumstances. Due diligence involves exercising the degree of care in investigating a matter by verifying facts in order to eliminate unknown risks.

The origin of the term due diligence came about following the passage of the Federal Securities Act of 1933 which afforded a defense to persons selling securities when accursed of inadequate disclosure of material information to investors. As a result, persons selling securities to the general public, such as broker/dealers, instituted a standard practice of conducting due diligence investigations into the company having a stock offering in order to protect themselves from nondisclosure of material information. Although the term was originally limited to public offerings of stock, it has now become associated with all types of investigations.

The purpose of exercising due diligence is to cut down the risk to a manageably small level. A considerable measure of judgment is involved, not only in deciding what to do, but in determining the level of investigation into a particular matter.

Due diligence investigations frequently arise in a number of different contexts. These include (i) acquiring a company, (ii) loaning monies to a company, and (iii) marketing a new product. For instance, in the acquisition of a company, a careful analysis of the target company would involve an analysis of financial statements, environmental reports on real estate, existing contracts, pending litigation and regulatory proceedings and a review of contingent liabilities not reflected on the financial statements.

In loaning money to a company, due diligence would involve reviewing the business plan of the company, analysis of financial statements, possible environmental issues if real estate is involved, and making sure that the lender is the first lienholder on any collateral for the loan.

Due diligence in marketing a new product may involve such things as whether the product would infringe upon the rights of other similar products and whether a patent or trade mark is available for the new product.

In connection with the issuance of stock by a company, due diligence is a requirement on the part of the company as the issuer to insure that the offering does not misstate or omit material information to a prospective purchaser of its securities. To some degree, due diligence is involved in the day-to-day activities of everyone as they relate to a purchase of a car or home such as obtaining an appraisal, inspections and making sure that everything works.

In more complicated transactions, the due diligence will take place between the time of the signing of an agreement outlining the terms of the transaction, sometimes referred to as a letter of intent, and the execution of a definitive agreement which sets forth, among other things, the representations and warranties of the parties to the transaction. Due diligence reduces the risks by ensuring the creditability and accuracy of information.

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