Preliminary agreements - substance over form

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8 May 2013

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Anyone who has worked on the early stages of a commercial deal is likely to have come across a 'preliminary agreement' in one of its many guises. Lawyers use a myriad of names for preliminary agreements, and while the name of the document itself is usually of no real consequence, there are issues common to all preliminary agreements that are worthy of some consideration.

This article briefly identifies the various forms that preliminary agreements may take, addresses some of the key questions to be considered at the outset, and some of the pros and cons of investing time in drafting and signing a preliminary agreement.

Different shapes and sizes

Preliminary agreements come in a number of shapes and sizes. The name of the document is not really the defining point, and many advisers have their own preferred framework reflecting experiences over the years. The most common preliminary agreements are the Letter of Intent (LOI), the Letter of Understanding, the Memorandum of Understanding (MOU), the Heads of Agreement (HoA) and the Indicative Offer.

As with most legal drafting, when it comes to preparing these agreements, the focus should be on 'substance' rather than form. It is easy to fill a draft agreement with weasel words and make it look good and sound useful. However the trick is to pin down the purpose of the document, and to use clear and concise drafting. Cramming a preliminary agreement with too much content can have unintended consequences, or otherwise detract from the role that the agreement can play in a negotiation, and it is generally preferable to consciously adopt a 'less is more' approach.

Pros and cons of preliminary agreements

As with many things in the legal world, there are arguments for and against investing the time in preparing and signing a preliminary agreement. The pros include:

- The upfront agreement of one or more key commercial terms within a preliminary agreement can sometimes make the difference in terms of a deal getting underway – it can be the trigger that motivates an otherwise cautious party to commit to due diligence investigations, or to a timetable for negotiating and finalising a deal.
- A simple preliminary agreement can get things moving, and can pave the way for a smooth negotiation by setting out an agreed timetable, and identifying key approvals and steps for the parties – bringing these matters to the foreground and avoiding later surprises for either party.
- For a complex deal, the road map up front can assist, and it can also serve to demonstrate early commitment of the parties to enable other discussions to be progressed in parallel, including with funders, with regulatory bodies, internal approvals, and arrangements with other third parties.
- Where the agreement locks down exclusivity, it can provide some certainty to a bidding party in what might otherwise be a very competitive landscape. Where the agreement locks down pricing or a price range, it may also provide a tactical advantage to a seller where a buyer has not otherwise completed due diligence.

On the other side of the coin, there are disadvantages:

- Some lawyers take the view that a preliminary agreement is a waste of time and money. There is always the risk of the parties getting sucked into a process for the sake of process, with valuable negotiating time taken up by focusing on something that might end up being largely non binding.
- The risk of the drafting morphing into a document that is too detailed is ever present – parties need to take care to avoid 'no man's land', with a Heads of Agreement that is too detailed to be finalised and signed, but not detailed enough to take the place of the main transaction document.
- A preliminary agreement may also provide less room for manoeuvre in subsequent negotiations. There is also a risk of early non-binding expressions becoming morally binding on a party. For example, where a bidder has not completed

due diligence but is asked to agree to positions even on a 'non binding' basis, it can be difficult to move from those positions in a negotiation, and the party seeking to move away from non binding clauses can sometimes find themselves on the back foot in a future negotiation. If in doubt, it is usually better not to record anything if approaching the topic without adequate supporting information.

- When agreeing to binding provisions in a preliminary agreement, there is also the risk that you may miss something important. As with any legal document, the best advice is often not to sign anything without appropriate advice – whether that be legal, accounting or technical.

A starting point, rather than the detailed legal drafting

Preliminary agreements should be thought of as a starting point, but not an end point. They should not be used to conclude every last detail of a commercial transaction. A well constructed preliminary agreement should address key commercial and risk allocation issues in a clear manner, but should not take on the detail of the negotiation and drafting that will inevitably follow.

While these agreements can provide a useful road map to define the destination and plan the route for the deal, the goal should always be to put a stake in the ground on key points only. Often the key points to be nailed down may be a price, or a price range, or sometimes other important issues regarding risk allocation, exclusivity, intellectual property, or process.

Before embarking on drafting a preliminary agreement, here are some simple questions to ask at the outset:

- Why do the parties want the preliminary agreement? What purpose will it play?
- What are the most important points that the parties are each wanting to record at this early stage, and why are those points important to each party?
- Do the parties intend any of the preliminary agreement to be legally binding, and if so, which parts?
- Are the parties of the same view regarding the status of the agreement, and what remedy may be required if a party breaches a key provision?

For drafting tips, please see part two of this series of articles.

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