THE IMPORTANCE OF PRELIMINARY DOCUMENTS ON A MERGER OR ACQUISITION OPERATION

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Each one of us probably have already participated on the beginning of a negotiation in which it is necessary to put on paper the basic conditions for the structure of a corporate or commercial transaction. Usually it requires the definition of liabilities for the parties, in addition to other conditions.

Prior to the contract drafting, in which will be reflected such circumstances, it is common to elaborate preliminary documents that will summarize the transaction that will occur or the business that will be executed. Such preliminary documents are very important to enable the negotiation process to be developed with clearness, rapidity and objectivity.

Among many preliminary documents, three types are used more frequently: the letter of intent, also called LOI, the memorandum of understanding, also called MOU and the term sheet. What these documents have in common is the establishment of the basis for an agreement. However, they have important differences which determine the situations in which they must be applied.

The letter of intent is typically used when there is an intention of a transaction but the interested company does not acknowledge the actual situation of the company to be acquired or invested. Therefore, after the execution of the letter of intent usually it follows the conduction of a due diligence or accounting and legal audit.

The memorandum of understanding is similar to the letter of intent in the sense that they clearly determine the conditions for two companies to come into an agreement. However, the memorandum of understanding is usually applied when the purpose of the transaction is the institution of a new company or the execution of a joint venture, and such situation is different in some aspects from a purchase and sale transaction itself.

The term sheet details the legal and financial terms of the investment and quantifies, in numbers and other indexes, the transaction value. This document, when executed by the parties, is considered as the basis for the elaboration of all legal documents that support the investment. The structure of a term sheet tends to be more complex and this document is usually executed after an audit or a due diligence.

The preliminary documents may be non-binding or binding. The ‘non-binding’ documents represent the preliminary terms of a negotiation and do not commit the parties involved. The ‘binding’ documents create obligations to the parties and already reflect the preliminary structure of a future Contract. Its terms

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shall be reflected in the final documents to be executed for the investment or transaction formalization.

This is a very important step on a process of merger and acquisition considering that according to the current Civil Code these documents assume the legal nature of preliminary contracts that may bind the parties and constitute, as a consequence, the right to the execution of a final contract. [1]

The preliminary contract is so important that, once it is registered before the competent public office and due to the request of the concerning party and in order to meet the will of the breaching party, the judge may grant it the nature of a final agreement[2]. For that reason it is essential that the preliminary contract reflects as much as possible the conditions of the final contract to be executed at the end of a corporate transaction.

The preliminary documents may be elaborated by the interested company, by its controllers or directors, by the "leading investor" of a group of investors and usually it is addressed to the investor and controllers of the target-company.

Among many advantages of this documents it is possible to mention the following: i) statement of the main terms and conditions of the transaction, ii) induction of the parties as from the beginning to express in writing their intentions regarding the investment, reducing the chances of negative surprises, iii) help to detect possible impediments for the execution of the transaction ("deal breakers"), iv) acceleration of the investment process, v) facilitation of the drafting of final contracts, among several other advantages.

The most common contents of preliminary documents, besides the qualification of the parties involved, are: a) a summary of the proposed investment; b) offer conditions (due diligence, tax and accounting analyses), c) allocation of invested resources, d) schedule of the investment; e) rights of the investor and the parties, f) definition of percentage to vote specific matters (veto), g) non competition among the founding members, directors and key executives, h) right of leave and others, i) conditions for closing, j) confidentiality and exclusivity for a determined period; k) other provisions depending on the nature of the business.

Another important issue with respect to the preliminary documents is related to the adjustment of their terms. That occurs because each jurisdiction has its particularities and therefore it is essential the management of the documents, considering the investor's and invested company's jurisdiction with the resulted company. The typical terms that are normally present on the preliminary documents are: tag along, drag along; redemption; anti dilution; preference on settlement, put option, cal option and others.

It is important to mention that the parties usually adopt the arbitration to solve any dispute and even in cases of transactions in Brazil the parties normally apply the rules of Common Law rather than applying the Civil Code. The preference is justified by familiarity that foreign investors have with such system, allowing more flexibility in closing the corporate transaction.

[1] CC, art. 463. Upon execution of the preliminary contract, in compliance with the provisions of the previous article and if there is not any clause of regret, any party has the right to require the execution of the final contract establishing the term to the other party for its effectiveness.
[2] CC, art. 464.

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