
DUE DILIGENCE: SHOULD YOU START WITH A LETTER OF INTENT OR A TERM SHEET?

Third of a series: Getting due diligence under way and appropriate

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I have recently been blogging on due diligence in connection with community bank acquisitions, and acquisitions in general, since that seems to be what is going on. This week I'm looking at two related issues: the timing of due diligence and the alternative forms of legal steps to get due diligence rolling. (Part one: "Due Diligence Stands Behind Sound M&A." Part two: "Due Diligence Keeps You From Buying A Pig In A Poke.")

How due diligence gets under way

Due diligence in an acquisition generally occurs one of two ways.

The first is by agreement of the parties under a confidentiality agreement before any pricing terms are discussed.

But more often, due diligence begins after the buyer has reviewed the publicly available financials of the selling bank and its bank holding company, and come up with a reasonable range of prices that would seem to make some sense.

The latter alternative, generally, is best for both parties, because the buyer does not want to spend a lot of time and money doing due diligence of the target if they cannot make the deal work for both sides based on publicly available information.

Likewise, the selling bank does not want its own personnel wasting their time, disrupting their staff (even if it is done offsite), and getting the word out (there are no secrets in community banking) that the bank may be looking for a buyer without having a meeting of the minds, at least on the price.

As a result, most of the time, in community bank acquisitions, the price and general material terms will be agreed upon before extensive due diligence occurs.

There are certainly exceptions to every rule. The most prominent exception in community bank acquisitions is that certain financial information may be requested by a community bank buyer and provided by the target offsite to a potential buyer. This step might be taken to allow the buyer to evaluate some of the issues in a little more in depth, particularly credit, that may significantly impact the purchase price without a full onsite due diligence prior to reaching a meeting of the minds.

In any event, due diligence is an ongoing process, whether it is completed before the parties have a meeting of the minds or after the parties have a meeting of the minds with respect to the material terms of the transaction.

Sketching out the terms of the deal

As relates to the material terms of the transaction, how do you document that? There are generally two alternatives.

1. The "old school" is to use what is known as a letter of intent, or in the parlance, "LOI." A letter of intent is normally a multi-paged, single-spaced definitive agreement in miniature.

The problem with a letter of intent is that you may spend weeks negotiating the language and the provisions of the letter of intent when, in reality, it is nothing more than a moral commitment by the parties that those are the terms they are going to incorporate in the binding definitive agreement.

Letters of intent are not binding generally except for the fact that each party will keep the transaction confidential and that each party will pay its own expenses.

2. The other alternative is the term sheet. (This is what my own firm uses.)

About 20 years ago or so, when we were doing many bank acquisitions and spending a great deal of our clients' time and money negotiating letters of intent, it occurred to me that that did not make a lot of sense, and switched to term sheets.

Term sheets are exactly what they sound like. They identify, generally in bullet point format, the material terms of the transaction. This includes the parties; the structure; the price; who will have employment contracts (if any); confidentiality; expenses; publicity; the treatment of the target's employees; and anything else that may be material.

The parties initial off on that as being the substance of the transaction. Then, on the basis of that term sheet, which is typically easy and quick to negotiate, the definitive agreement (the big 60-page agreement) is prepared.

Keep it simple, and back off if it isn't working

My advice is, don't make the process more cumbersome or expensive than you should. Also, be in a position where you can incrementally stop the process, cut off the cost, and move on to something else if it is not working for your bank as either the buyer or the seller.

About the Author

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