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The Letter of Intent – A Primer for Business Owners

Posted by Eric King

At this stage you have likely held anywhere from one to three (or more) meetings with a prospective buyer. If you are running a structured sale process soliciting multiple buyers, then you have spoken with several suitors and narrowed the prospects to 1-4 prospective buyers for these more in-depth discussions. Ideally the prospective buyer(s) and you should both be at a go/no-go decision point on continuing the discussion. If the buyer elects to continue, then expect to receive a Letter of Intent (LOI) outlining the buyer's proposed deal structure and terms. Receipt of an LOI from a potential buyer is a clear signal that they are serious in their intentions; however it is not a "given" that they are fully committed yet. In fact, some buyers are known for not closing a high percentage of issued LOIs since their strategy is to lock-up as many potential deals as possible and close only the top 3-4 of the lot.

The Letter of Intent should include a summary description of all of the material deal terms that will later appear in the Purchase Agreement. There are differing schools of thought on how detailed an LOI should be, so your LOI may be anywhere from two to over ten pages long. Those advocating for a shorter LOI argue that using a short form speeds the negotiating process since the parties are focusing their efforts on the primary terms of price, consideration and timing. If there is no agreement on these then there is no need to have covered the other deal terms. Those advocating a long form prefer to have all issues addressed upfront and not have future surprises that can sink a transaction (e.g. reps and warranties, treatment of unvested options).

The following are the common terms you should expect to see in an LOI. Terms are generally non-binding (a non-binding LOI is typical) but a few will be binding beyond the term of the LOI. These surviving terms are noted below.

1. **Deal Structure**. Defines the transaction as a stock or asset purchase. Generally the seller prefers a stock transaction from a tax and future legal liability perspective. Asset transaction preferred by the buyer to protect against prior liabilities and provides a stepped-up tax

2. **Consideration**. Outlines the form(s) of payment to include cash, stock, seller notes, earn-outs, rollover equity and contingent pricing.

3. **Closing Date**. The projected date for completing the transaction. It is common for this date to extend past this date unless there have been no surprise in due diligence or the Purchase Agreement.

4. **Closing Conditions**. Lists the tasks, approvals and consents that must be obtained prior to or on the Closing Date to close the transaction.

5. **Exclusivity Period (Binding)**. It is common practice for a buyer to request an exclusive negotiating period. This is to ensure the seller is not shopping their deal to a higher bidder while appearing to negotiate in good faith. Expect to see requested periods of 30 to 120 days. Expect the period to be negotiable but the exclusivity term to be non-negotiable.

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6. **Break-up Fee (Binding)**. Relatively common to have a break-up fee of approximately 3% or a fixed amount in larger deals (>$500MM est.) but uncommon in the lower middle market.

7. **Management Compensation**. Describes who in senior management will be provided employment, equity plans and employment agreement. This term often vaguely worded to provide buyer with latitude since they may not be prepared to make commitments to senior management.

8. **Due Diligence**. Describes due diligence requirements of buyer from seller.

9. **Confidentiality (Binding)**. Although both parties have probably signed a confidentiality agreement, this ensures all discussions regarding the transaction are confidential.

10. **Approvals**. Lists any approvals needed by the buyer (e.g. board of directors) or seller (e.g. regulatory agencies, customers) to complete the transaction.

11. **Escrow**. Provides the summary terms of the buyer's expected escrow terms for holding back some percentage of the purchase price to cover future payments for past liabilities. Highly negotiable and often excluded from the LOI and presented for the first time in the Purchase Agreement.

12. **Representations and Warranties**. Will include indemnifications in the Purchase Agreement so best practice to include any terms that may be contentious or non-standard.

The following are less common terms but of no less importance to either party if applicable to the transaction.

1. **Employment Agreements**. This relates to Management Compensation above but may also include favored or long-time employees of the seller. Requiring the buyer to provide employees with employment agreements, maintain current compensation structure, etc. may fall outside their standard post-deal integration practices, and they may simply refuse or require the seller to compensate them.

2. **Retention Bonuses and One-Time Payments**. Similar to above, while seller's may want to "share the wealth" from selling their closely held company, buyers may not want the additional administrative or financial responsibility.

3. **Option Pools**. Treatment of unvested options, vested but underwater options, etc. are not standardized practices. Buyers may opt to honor current option plans by converting them into their plan or similar structure.

4. **Fees**. Generally the party who incurred the charges pays fees, but there are circumstances where ambiguity is possible. For example, if the buyer requires reviewed or audited financial statements from the seller and the deal does not close, then the seller may want the buyer to pay the audit fee.

While the LOI is not binding and the transaction terms, if completed, will be memorialized in the Purchase Agreement, it is a best practice to include all terms that are your deal-breakers in the LOI. Inserting terms into the Purchase Agreement that were not included in the signed LOI is not uncommon, but expect the other side to extract a cost for that change. For example, if you have employees who do not

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hold equity but you want them to receive a payment at closing or an extended employment contract, that should be in the signed LOI. Secondly, if you have issues that may impact valuation or a buyer's decision to close the transaction (e.g. unresolved equity disputes, regulatory/litigation), it is best that these issues are disclosed prior to signing the LOI. Expect all such issues to be exposed in due diligence and better to have them addressed in the LOI, or dismissed as non-issues by the buyer, than during due diligence when you have incurred legal costs and agreed to an exclusivity period.

The LOI is an important milestone towards a successful sale of your company. If you have not engaged an M&A attorney yet, then now is the right time to add him/her to your deal team. Likewise an opportune moment to consult with your tax accountant and wealth manager for their input on optimal deal structure relative to your personal needs and to engage a seasoned investment banking firm to ensure you are receiving the best deal.

When you are ready to sell your business, I highly recommend The Merger Expert to get the job done for you." *-- David A. Miller*

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