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Letter of Intent – a 'Must' for Sellers

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Why is a Letter of Intent (LOI) an important part of every business sale?

It is important because a seller's negotiating leverage tends to lessen as the process of selling a business moves from the confidentiality agreement to the LOI to the negotiation of the definitive acquisition agreement. Why does the seller's bargaining strength tend to deteriorate? There are several reasons. A qualified buyer will normally seek a "standstill" agreement before it will commence significant due diligence. During the standstill period, the seller will be prohibited from talking to other potential buyers. As the parties engage in discussions and negotiation and as due diligence commences, employees, customers and competitors may become aware of the impending transaction, as well as the psychological and financial momentum that completing the deal tends to build.

The proposed buyer often demands significant new terms and requirements resulting from its due diligence. These new terms and requirements can include such things as downward price adjustments or adjustment formulas, new risk allocations unfavorable to the seller and other economic demands that were not "on the table" when the discussions first began.

Although the seller may want to restart the process with a new potential buyer, the significant time and money already committed to this ongoing process, the loss of momentum and the possible confusion or uncertainty among employees and customers may all combine to induce the seller to continue with a deal that is not nearly as attractive as originally envisioned.

What can a seller do to minimize the risk that it will get involved in a deal that could deteriorate in this fashion? One good solution may be found in the strategic use by the seller of a LOI.

Following are 11 items that every seller should consider during the creation of this important document:

1. **Be specific.** Define or state the purchase price, state the structure (stock versus asset acquisition), and address limitations on warranties (including time and money limitations for indemnities.)

2. **Employment agreements, covenant not to compete.** Does the owner wish to retire or wish to keep working? What are the buyer's expectations?

3. **Protection against losing key employees.** If the deal falls through, will the buyer now be in a position to hire away your key employees to service his current business or his new acquisition target?

4. **Define purchase price adjustments.** Get a clear understanding of the buyer's "pricing model" upfront.

5. **Define/limit the buyer's conditions precedent**. Does the buyer have specific "absolutes" that must be satisfied during the due diligence period? Find out now.

6. **Limitation on indemnities**. As mentioned earlier, is the seller willing to go into retirement realizing that potential liabilities will be hanging over his head for a number of years? What about environmental risks? If these are "deal breakers," why not find out now?

7. **Tighten up confidentiality agreement**. Often the confidentiality agreement is a "standard" form. Now is the chance to have it reviewed and revised if necessary.

8. **Establish a firm timetable**. What are the expectations of the parties for completion of due diligence, completion of the definitive acquisition agreement and closing?

9. **Request a good faith deposit**. Although not always appropriate, this may be a good method to test the level of interest and sincerity of the buyer.

10. **Set a "drop dead" date**. Be specific about the period for completing due diligence for finalizing and actually signing the acquisition agreement, and for closing of the deal.

11. **Assign drafting responsibilities**. Normally the buyer prepares the first draft of the acquisition agreement. In the rare circumstances where it makes more sense for the seller to do so, the LOI should so state.

The process of preparing a company for sale involves a number of important steps. Among them should be the development of a carefully thought out LOI strategy.

The buyer often desires no LOI or one that has little more in it than a "standstill" provision. But for the seller, the LOI may be its last best chance to negotiate the deal while having superior bargaining leverage.