Best Intentions: The Letter of Intent, Seller Beware

By: Ron Stacey, Managing Director

While perhaps not the longest or most expensive document among those found in the in the M&A process, the letter of intent ("LOI") may well be the most important, particularly to the seller. The LOI sets the tone for the transaction and serves as the roadmap for the due diligence and the Definitive Agreements.

The LOI is a necessary evil in the deal business. The seller cannot afford the time, money and distraction to give multiple parties the access necessary to conduct confirmatory due diligence. And, the buyer has little interest in investing time and money in confirmatory due diligence only to see the deal go to another party in the end; hence, the usefulness of the LOI. But, a detailed LOI is far more important to the seller than the buyer.

In this article we address buyer/seller negotiating advantage, exclusivity and confidentiality, bad faith buyers, full disclosure, the importance of thoroughness for the seller, and touch upon the business elements of the LOI.

Buyer and Seller Relative Negotiation Advantage

Prior to the execution of the LOI, the seller is negotiating among a number of different suitors (particularly in an effective auction), each with a unique perspective on the business. As soon as an offer is accepted and the LOI is executed, the exclusivity period commences, the seller's leverage is dramatically reduced; the business is off the market. The unsuccessful bidders disperse. The seller is now at risk of the deal failing and if that happens, starting over is a daunting task, much like pushing on a string. This shift in relative negotiation advantage is the single most important reason why the seller needs to get as much detail as possible in the LOI prior to execution, and conversely why the buyer wants exactly the opposite.

Terms that Bind: Exclusivity and Confidentiality

The LOI is non binding from a legal perspective, except for exclusivity and confidentiality. The non binding provision reduces the probability of someone suing for damages in the event the deal falls apart, and fall apart they do. While non binding provisions may lower legal liability, the parties must nonetheless negotiate in good faith. Moreover, once a position is taken in the LOI, it is very difficult to argue something different in the Definitive Agreements, non binding or not.

During the exclusivity or “no shop” period, the business is off the market and the advantage shifts to the buyer. A good investment banker representing the seller paces the timing and makes certain the due diligence progresses in earnest by regular communication with the buyer, and skillful leveraging of the seller’s primary post LOI bargaining advantage, exclusivity.
The old saying “time kills deals” is true. The longer the due diligence drags on, the less likely the deal is to close; fatigue sets in and the will to transact is diminished, if the company is performing above plan the seller wants a better price, below plan and the buyer wants to re-trade the LOI for a lower price. The typical 60 day exclusivity period is more than enough time to complete due diligence and enter into the Definitive Agreements. Anything longer encourages delays and possibly never ending negotiation of the Definitive Agreements; which is very costly to both sides. Setting a date certain for exclusivity to end makes for a more efficient process and better focused participants.

Confidentiality is initially set out in the Non Disclosure Agreement (“NDA”), or Confidentiality Agreement (“CA”). The NDA or CA is fully negotiated prior to delivery of the Offering Memorandum or Confidential Information Memorandum, prepared by the investment banker. However, confidentiality in the LOI may be expanded upon to include the price and terms of the offer, as well confidentiality that an offer has been made and accepted. This last point can be particularly tricky for public companies where a breach of confidentiality could influence a stock price; and in some cases land people in jail. Confidentiality is a serious matter for everyone involved in the deal process.

Bad Faith Buyer: A Special Problem

On occasion, the seller and the seller’s investment banker may suspect buyer bad faith in negotiating the terms of the LOI. Specifically, the buyer offers an attractive price and terms to get the deal off the market with the intent of taking advantage of the exclusivity period to make changes later. While distasteful on its face, the buyer nonetheless runs the risk of losing the deal if the seller refuses to capitulate. Frankly, it’s simply a bad buyer strategy, but it happens.

If the seller and the investment banker suspect bad faith, the best way to flush out the true intentions of the buyer is to get the buyer invested in the deal by segmenting the exclusivity period into milestones that require the buyer to incur meaningful cost to continue the due diligence. For example, many buyers employ outside accounting firms to conduct what is referred to a “quality of earnings” (“QOE”) audit on the seller, these can be quite expensive depending on the size and complexity of the business. A wise investment banker provides a three to four week window post LOI execution for the QOE audit to be completed. Immediately after the delivery of the QOE audit, the LOI should provide for delivery of the first draft of the Definitive Agreements.

The affirmative response clause in another effective tool incorporated into the LOI for the seller's benefit if buyer bad faith is suspected. Simply put, the affirmative response clause is a requirement imposed by the seller that the buyer, periodically during the due diligence process, provide a written affirmative response asserting that the buyer perceives no material change in the deal terms negotiated in the LOI. Failure to deliver such a statement automatically terminates the exclusivity or no shop provision of the LOI.

Full Disclosure: An Opportunity

Any weaknesses in the business can be framed as opportunities and fully disclosed to the buyers prior to execution of the LOI; the due diligence army is going to find everything anyway so take the initiative and get it out on the table first. Usually these items can be handled in the Offering Memorandum prepared by the investment banker. By being proactive, the seller can frame the issue in the most favorable terms, and not be on the defensive. The seller need also ensure that all the information provided to the buyer is accurate, complete, timely and comprehensive; after all that is the information on which the buyer is making the offer subject to confirmation during the due diligence process. Disclose everything.

Material undisclosed weaknesses or other issues or misstatements discovered by the buyer during confirmatory due diligence is going to alter the course of the deal. For starters the buyer is going to ask; "What else didn't they tell us?" The buyer will almost certainly attempt to use the new information to reopen the negotiation on the price and terms, as expected.

Best Advice: Get It All in Writing

The seller and the seller's investment banker must be certain that the price and all of the business terms are thoroughly negotiated and are clearly and unambiguously stated in the LOI. The LOI is the culmination of a negotiation and not the beginning of a new negotiation. Be careful not to allow a buyer to foist over a "loosey- goosey" LOI and then proceed to "kick the tires." For example, the buyer expresses and interest (not an LOI), in acquiring the business in a certain price range, depending on the outcome of the due diligence. Assuredly, once the due diligence commences (the seller's leverage is diminished), the offer comes in at the lower end of that price range; great for buyers, not so good for sellers.

In short, all of the critical business issues must be locked in concrete before the LOI is executed. The seller's transaction attorney should review all of the legal issues. Some of the more important issues include the definition of the parties (who exactly are the seller and buyer), type of transaction (stock or asset), exact selling price (not a formula or method to arrive at a selling price depending on due diligence), form of payment (cash, notes, stock, earn-out), amount and terms of the escrow, working capital or other balance sheet targets, confidentiality, exclusivity, timing of milestones during exclusivity, non compete agreements, and employment agreements.

To the extent possible, the seller should push for an agreement on the representations and warranties of the parties including dollar amounts for "caps" (the maximum liability) and baskets (the threshold for a claim); as well as survivability periods, and identification of the indemnifying parties. Most buyers will resist getting into the representation and warranties negotiation prior to due diligence no matter how thorough the Offering Memorandum, mostly because the amount of the "money back guarantee" part of the deal is buyer leverage reserved for "surprises" during due diligence.

Summary

In summary, the LOI must be carefully negotiated by the seller and the seller's investment banker to ensure all of the business terms are fully covered prior to execution, because once the deal is awarded to a specific buyer, the negotiation advantage shifts to the buyer. Hence, the more detail in the LOI, the better, from the seller's perspective. The LOI must not be an invitation for further negotiations of the price and terms. Exclusivity and confidentiality may be the only "binding" terms, but the moral imperative to negotiate in good faith sets the tone for entire deal and what goes in the LOI usually ends up in the Definitive Agreement. The seller's investment banker must manage the exclusivity period to keep the buyer honest and on track. In the spirit of full disclosure, any weaknesses or shortcomings that could derail the deal during due diligence must be made known to the buyer upfront; and framed as opportunities. Lastly, take the LOI as far as possible, including representations and warranties; it's not going to serve as the Definitive Agreement, but it will certainly be the foundation upon which the Definitive Agreement is built. Sellers beware, build a strong foundation!