Letters of intent for buying/selling a business

Corporate Update

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Letters of intent (“LOIs”), like term sheets, are essential documents in corporate transactions as they outline the key parameters of a transaction so the parties can be on the same page before spending the time and money to negotiate final legal agreements. Whereas term sheets tend to be used for raising capital, LOIs are the preferred form for asset or share purchases, although both such documents have essentially the same legal status as a guidance document with limited binding provisions.

The do’s of LOIs

1. Focus on valuation and payment

The most important aspects of any business transaction is what is being transacted, how much is it worth and how is it being paid for. Parties are typically clear on the ‘what’ is being sold (i.e. the whole business or certain assets/operations) but LOIs must specify how this will be valued and purchased. Even when the parties have a clear price in mind upfront they should still specify if the purchase price may be subject to any adjustments on the closing of the transaction (i.e. if there is a material change in the business of the vendor, etc.). Where the exact purchase price is not specified, the parties must state in the term sheet the method and timing of the valuation of whatever is being transacted. Finally, the method of payment of the purchase price is also key; will all funds be disbursed on closing or over a longer period with some upfront and/or held back? Will there be any purchase price adjustments over time either for tax purposes or the future profitability of the business (referred to as an earn-out provision)?

2. Clearly state the key conditions to closing

Apart from what is being transacted and how it is being paid for, LOIs should also set out any conditions required to be met prior to the execution of final agreements. These conditions commonly include satisfactory due diligence by the purchaser or obtaining financing, but can often include certain productions by the company/vendor, such as audited financial statements, financial projects, business plans, etc. The purchaser may have their own undertakings prior to closing, such as agreeing not to terminate certain employees and/or assume the vendor's obligations under lease or customer/supplier agreements. If either party wishes an opinion of legal counsel, often as to whether the other party may enter the transaction with requisite authority, this should also be stated in the LOI.

3. Keep things confidential

In most instances, a purchaser will conduct more detailed due diligence on the business vendor after the LOI is finalized and, as such, the LOI should include a confidentiality provision to ensure sensitive business information is not made public. Depending on the nature of the business being purchased, the parties may wish to enter into a more fulsome confidentiality/non-disclosure agreement (discussed elsewhere in this series) but, in any event, the LOI should still reference that any due diligence or negotiations will be kept strictly confidential between the parties and their business advisors.

4. Set a deadline

While much of the purpose of an LOI is to frame negotiations for a final, binding agreement, these negotiations will often benefit from a deadline to close the transaction. This will help keep both the due diligence and legal negotiations moving swiftly. Deadlines may also be important for tax planning purposes if the transaction has to close in a certain fiscal year or quarter. When setting closing deadlines it is good practice to allow the parties to mutually amend this date, especially if forces beyond their control cause any undue delays.

The don'ts of LOIs

1. Don't get lost in the details

A LOI, like a term sheet, is a negotiating framework, not a detailed map of the transaction. As such, parties should focus on the key business terms and not all the covenants, reps and warranties, dispute resolution and other legal requirements of a final document. Parties should also not be afraid to move the more detail-oriented or complex matters of the transaction, even including some of the business terms, to the actual negotiations where there can be more time to get things right.

2. Don't lock up for longer than necessary

Purchasers will often seek the assurances of exclusivity when negotiating with a vendor and, as such, the parties will often include a binding lock-up or standstill provision in an LOI that prevents the vendor from negotiating with other parties. While often necessary, vendors must ensure that they do not lock-up for longer than necessary to complete the transaction; we generally recommend between 60-90 days. Lock-up periods that go much longer than that will hurt potential market opportunities for the vendor if the transaction doesn't close with the purchaser signing the LOI. Like the closing deadline, the lock-up can and should be extended by mutual agreement of the parties.

3. Don't forget to have both parties sign it!

LOIs are letters in form and addressed by one party to the other (though both parties will usually negotiate its contents). The party sending the LOI will sign it - as is the case for any letter - but don't forget to have a 'sign-back' from the recipient to ensure both parties sign the LOI. This is especially true when the LOI contains confidentiality or exclusivity provisions, which will not be enforceable without mutual signatures.

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