The Best of Intentions: Letters of Intent in the Sale of a Business

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The sale of a business[1]often takes several months and generates huge amounts of paperwork. The process culminates in a purchase agreement typically exceeding fifty single-spaced pages full of dense wording. There is nothing wrong with this: a comprehensive agreement is one of the most important steps that can be taken to reduce the risk of much more costly disputes between the parties arising later.

The purchase agreement usually is preceded in the process by a "letter of intent" (referred to in this article as the "LOI"). While certain terms in the LOI are legally binding, the LOI is not intended to bind the parties to do the sale itself. The LOI instead expresses the parties' intent to pursue the sale.

The LOI may be brief, identifying the parties, the business to be sold, and the price but not addressing other terms. However, based on the author's experience, it usually is much better -- especially for the seller -- to negotiate as much of the key terms of the sale as possible in the LOI.

Bargaining Power. Even the briefest of LOIs typically includes the pricing. But there are many other terms besides pricing that are important. If a party agrees in the LOI to the pricing but leaves the other terms to be negotiated later, the party has given up the ability to use its agreement to a price as bargaining power in negotiating the other terms.

The seller is usually much more disadvantaged by this. With some exceptions, these other terms mainly are for the buyer's benefit. If the pricing is already agreed, the seller has less opportunity to gain anything meaningful in the negotiation of the other terms. If the pricing is not already agreed, the seller can require the buyer to pay more if the buyer wants these other terms to be more buyer favorable.

This adverse impact on the seller's bargaining power is compounded by a very common LOI term – a "no shop" or "exclusivity" provision. As discussed below, in this provision the seller agrees not to negotiate for the sale of the business with any third party for some specified period of time during which the parties expect to negotiate and execute a "definitive" binding purchase agreement.

The "no shop" is a matter of fairness to the buyer. Before expending all the time and money needed to pursue the transaction, including investigating the business and negotiating the purchase agreement, the buyer wants assurance that the seller is committed for some limited time period to pursue a deal exclusively with the buyer and not negotiate with someone else.

But by taking the business off the market for the agreed period, the seller has given up bargaining power in negotiating the other important terms of the sale -- the "threat" of the seller going with a different buyer if the buyer asks for too favorable terms. Combined with an agreement on the pricing, the "no shop" places the seller at a distinct bargaining disadvantage in negotiating the other terms of the sale.

The seller can avoid this by insisting that key terms of the sale besides the pricing be negotiated in the LOI – as part of the agreement on price and before the seller agrees to take the business of the market.

This preservation of the seller's bargaining power means less advantage for the buyer. For this reason, and because negotiation of the other terms takes more time during which another buyer potentially could arrive to "steal" the deal, a buyer may resist negotiation of the other terms in the LOI. A potential compromise is for the parties to agree on a preliminary short (e.g., a week or ten days) "no shop" period during which the parties negotiate the other key terms for inclusion in the LOI. This preserves more of the seller's bargaining power while providing the buyer assurance that the seller is negotiating exclusively with the buyer. If the negotiations are successful, the LOI can include another "no shop" period during which the purchase agreement is negotiated. This second "no shop" period can be relatively short because the parties have already negotiated the terms that are to be reflected in the purchase agreement, shortening the period needed to produce the purchase agreement.

Efficiency. From a time and cost-saving standpoint, both parties can greatly benefit from negotiating not only the price but also the other key terms in the LOI.

If only the price is agreed, what typically happens is counsel for the buyer proceeds to prepare a draft of the purchase agreement, which as noted earlier is often very long and densely worded. This draft will reflect the purchaser's wants for the other key terms. After review by the buyer, the draft is sent to the seller and its counsel. The seller's counsel analyzes the draft and summarizes for the seller what the buyer has proposed in the draft for the other terms. The parties then proceed to negotiate those terms, sometimes by exchanging drafts of the purchase agreement.

Compared to negotiating the key terms in the LOI, this process is very inefficient in both time and money spent. When the key terms are negotiated in the LOI, the terms are stated in simple, brief language that the buyer and seller can easily understand. When the key terms are instead negotiated through drafts of a purchase agreement, the key terms are buried in dense wording, making it difficult for the clients to understand, greatly complicating and slowing down the process.

Furthermore, if the key terms are negotiated in the LOI, it saves a great deal of time and expense in preparing the purchase agreement. The LOI serves as a road map for the purchase agreement. There is an understanding of what the purchase agreement should provide, greatly narrowing the scope for argument. Counsel for the parties can be left to handle the details of the drafting to make sure the drafting reflects what has been agreed. Time is not wasted in drafting and reviewing long provisions that end up not being part of the deal.

Finally, negotiating the key terms in the LOI will accelerate uncovering any impasse between the parties over terms – again saving both parties time and expense. If the parties are not going to be able to reach agreement on a key term so that the deal does not happen, the sooner this occurs, the better.

"It usually is much better -- especially for the seller -- to negotiate as much of the key terms of the sale as possible in the letter of intent."

Terms of the Sale. LOIs almost always cover the basics of identifying the parties and the business being sold, the purchase price, and the manner of payment of the price (e.g., whether the buyer is paying all cash at closing or the seller is financing part of the price by taking a promissory note from the buyer). Beyond these essential basics there are many additional important terms to be addressed, and for the reasons noted above the parties – and especially the seller – should consider negotiating them in the LOI. A few of the more important of these terms are:

Form of Transaction and Tax Treatment. Buyers often prefer to buy assets instead of the seller's ownership interest in the entity owning the business. Buying assets provides less risk to the buyer of taking on seller liabilities that the buyer does not want to assume. From an income tax perspective, depending upon the type of entity owning the business, buying assets allows the buyer to allocate the purchase price to assets that the buyer can depreciate over time, whereas buying the seller's ownership interest may defer the tax benefit of the purchase price to the buyer until the buyer sells the business.

The seller, on the other hand, often prefers to sell the ownership interest in the entity owning the business. Depending upon the type of entity, this may allow the seller to avoid two levels of tax on the sale[2] and/or allow the seller to pay tax at the much lower rate applying to long term capital gains. The tax difference to the seller of asset sale versus ownership interest sale could exceed 30%.[3]

Because the seller and buyer can have such opposing interests on the form of transaction and the resulting tax treatment, this is a fundamental term that should be agreed in the LOI. The gap between the parties often can be bridged by an adjustment to the price in which the party who obtains the desired structure shares some of its tax benefit with the other party through a change in the price – an example of why it is better to not agree on the price until the other key terms are agreed to as noted above.

Post-Closing Purchase Price Adjustment. Another critical term is whether there will be an adjustment to the purchase price following the closing based, for example, on the amount of working capital in the business at the time of closing. If there is to be an adjustment, what is the formula for the adjustment, how will the parties resolve any dispute over the adjustment calculation, and will any part of the purchase price be withheld following closing pending determination of the adjustment?

Post-Closing Indemnification. The buyer typically will require the seller to represent and warrant to the buyer certain facts about the business being sold. This is usually coupled with an obligation on the seller to indemnify the buyer if these representations are not true, and to indemnify the buyer if a party with a claim against the seller asserts this claim against the buyer except for a liability that the seller agrees to assume.

These indemnification provisions typically include provisions regarding how long after closing the buyer can assert a claim against the seller, a threshold in the amount of claims below which the buyer cannot assert a claim, one or more caps on the amount of claims the buyer can assert, and whether any part of the purchase price will be withheld as security for paying the buyer's claims. These indemnification provisions often are the subject of extensive negotiation. Fortunately, the provisions have become standardized enough such that the parties can negotiate them in concept in the LOI and leave the detailed drafting for the purchase agreement.

In addressing the post-closing indemnification, the parties should consider whether to obtain insurance for the seller's representations and warranties, and if so how the cost of this insurance is borne. Insurance is becoming much more common because of the benefit provided both parties: the buyer gets assurance that there will be a source of funds to satisfy the buyer's claims, and the seller is relieved from the obligation to pay any claims above a threshold amount.

Restrictive Covenants. The agreement, if any, of the seller not to compete with the buyer following the sale, including the particular types of covenants (e.g., non-solicitation of customers, non-solicitation of employees, general non-compete, etc.), the scope of the covenants (activities restricted, geographic areas, and time periods), and what portion (if any) of the purchase price is to be allocated to the covenants.[4]

Employment of Seller. The key terms of any employment of the seller by the buyer following the closing.

Conditions to Closing. The key conditions to be met and their timing (especially in terms of whether to be met before or after signing the purchase agreement), such as (i) completion of buyer's investigation of the business, (ii) buyer's obtaining of any loan financing, (iii) approvals or consents of third parties (e.g., lenders, lessors, customers, suppliers, and regulatory authorities), (iv) buyer's employment of key executives of the business, and (v) the absence of a material adverse change in the business.

Binding Terms. While the parties in the LOI do not legally commit to the sale of the business, there are other terms in the LOI that the parties do make legally binding. These terms govern the parties' relationship leading up to the time (if any) that a purchase agreement is signed by the parties. If a purchase agreement is signed, the purchase agreement governs the parties' relationship thereafter.[5] If a purchase agreement is never signed, the binding terms in the LOI continue to govern the parties.

Some of the more important and common binding terms include the following:

Binding vs. Non-Binding Terms. To reduce the risk of disputes, the LOI should clearly identify which of its terms are legally binding and which are only statements of intent that are not legally binding. In particular, there should be language clearly stating that the terms of the sale are not legally binding. In the author's opinion, there should also be a statement expressly disavowing the parties' obligation to negotiate the terms of the sale. This is particularly important for the seller; if the deal with the buyer does not work out, the seller wants it to be as clear as possible that the seller is free to negotiate a sale with someone else. The provision specifying which terms are binding and which are not binding should itself be identified as a binding term.[6]

No-Shop (Exclusivity). The seller's agreement not to negotiate with a third party for the sale of the business during a specified period of time. This agreement is usually provided by both the entity owning the business with respect to the business assets[7] and the seller with respect to the seller's ownership interest in the business.

Investigation. The buyer is given the right to access information about the business.[8] This right to information is subject to the confidentiality obligation noted below. To avoid disruption with the business's employees, customers, and suppliers and a resulting potential loss of value, a seller typically wants to keep the fact that the seller is negotiating for the sale of the business secret as long as possible, and in any event at least until a purchase agreement is signed. To that end, the LOI can include terms governing how the buyer is given access to the business, such as requiring that all contacts will be made through a specified seller representative, that copies of documents will be provided electronically or otherwise not on the site of the business, that any site visits will be conducted after hours, etc.

The seller may also want the right to information about the buyer, especially regarding the buyer's financial ability to pay the price for the business, or when some or all of the price consists of an equity interest in the buyer's entity.

***Confidentiality*.** If the parties have not already signed a confidentiality agreement requiring the buyer's confidential treatment of information provided about the business, restricting the buyer's use of that information only for purposes of the sale, and requiring the parties to keep the existence of their negotiations secret, these provisions can be included in the LOI. If a confidentiality agreement has already been entered, the LOI should reference the earlier confidentiality agreement as continuing to apply subject to including in the LOI any desired supplemental provisions.

***Key Employees*.** The seller may want to protect its key employees from "poaching" by the buyer if the sale does not occur by including in the LOI a term prohibiting the buyer from hiring the employees until the sale closes or, if the sale does not occur, for a period of time after the sale negotiations terminate (e.g., a year).

***Miscellaneous*.** Customary terms often found in contracts generally, such as terms addressing governing law, amendment and termination of the LOI, dispute resolution (arbitration or selection of court jurisdiction, award of attorney fees), and the burden of expenses incurred by the parties.

Conclusion. Instead of being only a brief prelude to the purchase agreement, the parties should consider making the LOI the main event. This is likely to benefit both parties significantly in terms of time and expense and in terms of bargaining power, especially the seller.

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[1] This article focuses on the sale of a private, closely-held business. The sale of a business owned by a publicly traded company involves additional considerations not addressed in this article.

[2] Two levels of tax can occur when an entity classified as a C corporation sells its assets (one level of tax) and distributes the sales proceeds to its owners (the second level of tax).

[3] Selling ownership interests in the entity owning the business also may reduce the amount of approvals or consents required of third parties.

[4] In general, payments for covenants not to compete are taxed to the seller at the rate applying to ordinary income, which is usually much higher for a seller than the rate applying to long-term capital gain, so the seller usually prefers to allocate as little price as possible to the covenants.

[5] The purchase agreement should address its effect on the LOI. Typically the purchase agreement provides that it supersedes the LOI subject to any exceptions for any particular terms of the LOI that the parties desire to bring forward.

[6] The parties should consider putting the terms of the sale that are non-binding on a term sheet that is attached to the letter as an exhibit, while the binding terms are included in the letter itself. In addition to helping identify what is binding and what is not binding, this approach helps the parties negotiate the sale terms by not cluttering them up with terms that relate to the process between the parties leading up to the sale.

[7] Sometimes the "no shop" provided by the entity owning the business is subject to an exception for the right to respond to a third party's offer to avoid a claim by the entity's owners of a breach of fiduciary duty by the entity's directors or managers unless the owners are also parties to the LOI. This exception may be coupled with a payment to the buyer (a "break-up fee") and/or reimbursement of the buyer's expenses if the exception is invoked and the business is sold to the third party.

[8] The seller may want to restrict access to especially sensitive information until after a purchase agreement is signed and/or provide for a special means of disclosure, especially if the buyer is a competitor. Similarly, the seller may want to restrict access to the business's customers, suppliers, and employees until after a purchase agreement is signed.

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