

## **Letters of Intent: An Underused Tool to Get a Deal to “Done”**

**by James P. O’Sullivan, Esq. & Daniel R. Siburg, CPA, CVA**

Entrepreneurs seeking to buy or sell businesses may start the process informally, but all deals conclude with some form of binding written agreement. A preliminary and often largely nonbinding document called a “letter of intent” (LOI) or “memorandum of understanding” can be a great way “to know sooner than later” if there is going to be a deal.

Similar to the courtship process of a new couple where everyone is on their best behavior, sellers and buyers begin their relationship by “putting their best foot forward” to encourage the other party to continue the negotiations. Nevertheless, it is not impolite to be candid about important issues in the early discussion, before both parties invest more time, effort, and expense in the negotiations. Although every deal is unique, the following are some key terms that nearly all buyers and sellers should consider when drafting the LOI as if they were negotiating the final agreement:

### **1. Confidentiality**

At some point during the sale negotiation process, the potential buyer will request documents and information from the seller to conduct its “due diligence” investigation to learn the business and identify problems. The documents and other information provided may contain trade secrets or other confidential information, such as financial information, that the seller does not want disclosed to others. A confidentiality provision can be inserted into the LOI to protect the seller. Likewise, if the potential buyer is revealing confidential information about its business practices to the seller during the negotiation, the buyer may also need to be protected. In addition, the seller should consider conducting its own due diligence to confirm that it has a capable buyer. Such due diligence may also reveal confidential information about the potential buyer that the buyer wants protected. As a result, the confidentiality provision is commonly drafted to bind the parties even if the negotiations and the LOI terminate.

Finally, it is often preferable for the parties to sign a confidentiality agreement prior to signing the LOI. If so, care should be taken to coordinate the terms of these two documents.

### **2. Representations and Warranties**

Purchase agreements often contain highly-negotiated representations and warranties of business conditions from both the buyer and seller. Discussing these expected risk allocations upfront in the negotiation process may help identify difficult issues that the parties will have to resolve if the sale is to occur. Moreover, it may help avoid important misconceptions at an early stage. Consequently, the parties are well advised to describe in the LOI at least the general parameters of the representations and warranties that are to be included in the final purchase agreement – especially if any party expects to impose an obligation on another party other than usual and customary representations and warranties.

### **3. Baskets and Caps**

Sometimes an unintended event affects the deal after closing. Including a provision in the final purchase agreement outlining these unintended consequences can minimize disputes about later allocation of liability. The premise is that events that only have a minor adverse effect on the deal should be borne by the party so affected, but events that have a “material adverse effect” on the deal should create some form of liability. Defining “material adverse effect” is where baskets and caps become important. A “basket” refers typically to a certain amount of damages, either individually or in the aggregate, that would need to be reached before an event is deemed a “material adverse effect.” The basket often operates like the deductible in an insurance policy. In addition, the amount of damages that a party could be liable for can be “capped” at a certain amount. Negotiating baskets and caps can be complex. As a side benefit, these early discussions may also provide a glimpse into how the parties will react to other complicated provisions in the final purchase agreement.

### **4. Exclusivity**

If the negotiations are to be exclusive, the parties should consider the length of the exclusivity, i.e., until the LOI is terminated, until the due diligence period is over, or a specific number of days or months. A provision regarding the non-breaching party’s remedies in the event of a breach of the exclusivity term should also be included. For example, the non-breaching party may want a right to enforce a monetary penalty (sometimes called a “break-up fee”), or to seek a court order preventing the competing transaction from proceeding.

### **5. Dispute Resolution**

A provision outlining how the parties will resolve disputes about the LOI and the negotiating the final purchase agreement can be essential to avoiding costly litigation. Requiring informal negotiation before initiation of any formal proceedings forces the parties to at least communicate with each other about the dispute and attempt to reach a resolution. A standard of committed effort, i.e., best efforts, reasonable efforts, or good faith, should be imposed on both the parties’ efforts during the informal negotiation phase. The dispute resolution provision can require professional mediation and arbitration before a party can initiate litigation. The parties may also want to provide that if mediation is failing to solve the problem, the parties will at least continue the mediation to establish rules to avoid unnecessary cost and delay in future arbitration or litigation. For example, the parties can allocate responsibility for costs and expenses if there is a dispute. Once the parties agree to a dispute resolution provision, a parallel provision can be used in the purchase agreement.

### **6. Binding vs. Nonbinding Terms**

All letters of intent should clearly specify which terms, if any, will be binding and which will be nonbinding. Nonbinding terms usually describe the business provisions of the deal such as purchase price and the description of the business to be sold. Doing so will clarify the rights and risks in the event of termination of the negotiations and the LOI. Failing to specify binding versus nonbinding provisions can lead to unnecessary and expensive litigation as one disappointed party seeks to enforce the LOI as a binding contract to buy or sell a business.

## **Conclusion**

Putting the necessary efforts into negotiating the LOI can evidence the parties’ good faith intentions to sign a final binding agreement. Setting reasonable expectations at the start of the process can prevent future impediments to the negotiations later in the deal process. Experience demonstrates that if the parties negotiate and draft the LOI with the same care as if they were negotiating the final agreement, then the better the chance that the deal can get done to their mutual satisfaction.

## **About the Authors**

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