EquiCap Partners, LLC
Suite 1000
13455Noel Road
Dallas TX 75240
972 233-8282

How To Write A Letter of Intent.

The discipline of putting a prospective acquisition transaction in writing is helpful to both parties for the sake of clarity and understanding. A letter of intent ("LOI") is sometimes called a term sheet or simply a purchase proposal. The parties use the LOI to determine whether or not there is an agreement sufficient between the parties in order for them to proceed with the transaction and the expense of drafting a comprehensive acquisition transaction agreement. Sometimes a term sheet is first drafted which sets forth the basic terms of the proposed deal and then a more comprehensive LOI is used to set forth more of the details related to the transaction.

Importance of The Letter of Intent. The LOI is not necessary to close a deal. However, it is frequently used to narrow down the parties' agreement on the major issues related to the proposed transaction. By using a LOI, the parties can limit the amount of expense and time in determining whether a proposed transaction is even feasible between the parties. A well-crafted LOI is especially beneficial when it comes time to draft the definitive agreement.

Timing. The acquirer usually creates the LOI after 2 or 3 visits with the seller and the parties have agreed to proceed to the next step. After the LOI is signed by the seller, acquirer usually enters into a due diligence period where significant time and expense is spent investigating the business of the seller.

Simple Letter of Intent. Letters of intent can be relatively simple documents that basically set forth the purchase price and what is being acquired. More often the LOI can be a much more complex document that really sets forth the structure of the proposed transaction. From an acquirer's perspective, a shorter LOI may be advantageous in that the seller is more likely to be more comfortable with by a shorter document, and as such, may allow the acquirer to begin performing due diligence on the company. Additionally, psychologically a seller will become more invested in the transaction after the LOI is signed because they switch into a "sell mode." A shorter LOI may facilitate momentum thereby serving both parties. For these reasons, some acquirers prefer to use a relatively simple LOI.

Detailed Letter of Intent. The advantage of a longer form LOI is that if the deal is going to fall apart because of deal structure or other details that are important to the acquirer but are not agreeable to the seller, the acquirer will hopefully be able to discover the problem areas prior to spending significant amounts of time and expense in due diligence and documentation. The parties can then negotiate some of these "hot button" areas before incurring other expenses. Once these issues have been negotiated, the longer form LOI will often be used by the parties as the blueprint for creating the final transaction documents even if the LOI provides that its terms are non-binding. Therefore a more comprehensive LOI can actually save the parties considerable expense on the back end when negotiating the final definitive acquisition agreement. Seller's attorneys will generally prefer a more detailed LOI so their client is fairly comfortable with the proposed sale details before taking the business off the market.

Exclusive Period. The acquirer should carefully draft the LOI to provide that the seller will provide the acquirer with the exclusive right to purchase the business for a certain period of time after the LOI is executed. The LOI would usually also provide that the seller ceases the active marketing of the business. If the acquirer does not have such an exclusive right, the acquirer will bear the risk of entering into an expensive due diligence process only to find that the seller has sold the business to another acquirer.

A seller may be hesitant to provide exclusivity because of a desire to maximize the sales price and to shop the business to other potential acquirers. Additionally, a seller's board of directors may have a fiduciary duty to present to the shareholders all potential deals and the seller's investment banker may only be able to negotiate a limitation on the active marketing of the business. The acquirer never wants to be a "stalking horse" as the price to beat. The acquirer will usually desire a longer period of exclusivity; whereas, the seller may only want to provide for a 30 day period that can be extended if the negotiations with the acquirer are progressing well.

Earnest Money. In order to provide exclusivity, some sellers will ask for the acquirer to provide earnest money. This can be a hotly negotiated issue both as to amount and the conditions upon which the earnest money should be returned. Most investment bankers (including this one) advise their clients to not request earnest money. The arguments against earnest money are that it provides little additional substance. Additionally, it often increases the amount of legal fees and time spent negotiating. And it ultimately may lead to more expensive litigation when the buyer tries to get the earnest money back if the transaction does not close.

Non Binding Nature. Most experienced investment bankers advise that the LOI be non-binding other than for certain provisions such as exclusivity, confidentiality, and enforcement. The provision making the LOI non-binding should be carefully drafted or the parties may very well find themselves in expensive litigation trying to sue for or defend against damages for breach of a binding sales agreement. A detailed LOI typically lists some conditions that need to be met prior to proceeding with the transaction such as obtaining adequate acquirer financing, satisfactory lease or other contractual negotiations, and obtaining required third-party approvals from franchisers, or regulators, or contracted customers.

Due Diligence. Though the LOI is technically non-binding, as mentioned previously, the LOI is often used as a blueprint for the final acquisition agreement. Just as blueprints often change during the construction process, the due diligence process will often result in a modification of the terms of the deal (e.g. an alteration to purchase price). Due diligence may also result in a deal structure change. For example what begins as a stock purchase deal may turn into an asset purchase deal. So long as the parties are negotiating in good faith and solid reasons are given for proposed changes to the final deal structure, variations from the LOI should not be fatal to the transaction.

Summary. In summary, a good LOI assists in moving the transaction forward by detailing the understanding of the principals at a given point in the process. It presumes that the parties are acting in good faith and the LOI is a stabilizing aid to communication in what can be angst filled discussions.