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Getting to Know the Basics of Letters of Intent

The process of selling a privately-held business may be quite difficult and confusing for the owners, many of whom have never been involved in an acquisition. Their lack of familiarity with the process may create a feeling of unease, particularly once they have found a potential buyer for their business. At this point, many business owners enter the realm of the unknown with respect to the formal Letter of Intent (LOI) and the negotiating process and must rely upon their professional advisors whose experience guides them through what many perceive as the most difficult portion of the entire process. In order to facilitate the process for both parties, it is important that the seller of the business possess a firm understanding of the mechanics and the negotiation of the Letter of Intent. If the seller is cognizant of these issues prior to receiving a Letter of Intent, a great deal of confusion, friction, and anxiety, which could ultimately derail a potential deal, may be avoided, allowing for a smooth process that culminates with the closing of the deal—the shared objective of all parties.

The Letter of Intent may be a rather mysterious document to a business owner who is a novice to the acquisition process. This lack of familiarity results in many misconceptions regarding the LOI's nature and purpose. The LOI is basically an understanding between the parties that outlines the acquirer's interest in the seller's business and provides an indication of the price and other deal terms. Extensive attorney involvement at this stage is not necessary, as the transaction advisor representing the seller will already have been involved in the negotiating, will review the LOI, and further advise their client on key remaining issues. Too much attorney involvement at this point only serves to complicate the negotiations and flow of the deal process.

The Letter of Intent is non-binding on the parties. Either party may walk away from the deal for any reason, unless specifically stated otherwise in the LOI. As a result, the LOI typically favours the buyer, as it preempts a commitment to specific terms until the due diligence review is complete. Furthermore, it is important for the seller to remember that the Letter of Intent is not the Definitive Agreement and that portions of the document are subject to change during the due diligence review and until the Definitive Agreement is executed.

In order to understand the concept of the Letter of Intent, it is important to first become familiar with the key terms used in an LOI. Some of the most common terms found in the typical LOI are as follows:

Price and Terms—Though it may state the obvious, the price is the amount for which the seller's business will be acquired. The terms outline the metrics by which the price will be defined and include total consideration paid for the company. For example, RMC Corp. is acquiring the stock of RLH Industries for a price of $10,000,000. RMC Corp. will pay the owners of RLH Industries $3,500,000 in cash and $2,000,000 in the company stock at close for a 75% interest and will assume $2,000,000 in RLH Industries' debt. The values may be based on a multiple of EBIT, EBITDA, or some other measure; the buyer almost always requires that the figures be based upon the seller's audited financial results. RMC Corp. will purchase the remaining 25% interest in RLH Industries one year hence for $2,500,000 in cash and stock. The 25% buyout may be contingent on the company achieving some performance goals or other criteria. The price and terms are subject to change based upon information obtained during the due diligence review.

Due Diligence—Due diligence is the process by which the buyer examines more detailed information than was previously available regarding the acquisition target. In some LOIs, the acquirer provides a list of documents that are necessary to confirm the information that has previously been conveyed as well as a time table for achieving milestones in the due diligence review. The pace of this process is largely dependent upon the ability of the seller to compile and provide the requested information in a timely manner. It should be noted that the due diligence process is when "skeletons in the closet" of the target company, in any, will be discovered. This portion of the process is very intensive, and allows the buyer to determine if they are still interested in proceeding with the deal. Due diligence often involves the buyer talking to employees of the target company—communication which may have previously been restricted. Though due diligence can be excruciating from the seller's perspective, the seller has every incentive to cooperate fully in this phase of the process, as this is the "make or break" stage of the deal.

Confidentiality—Most LOIs include a confidentiality clause that is most often binding and intended to protect the interests of both the buyer and, perhaps more importantly, the seller. News of a pending transaction could ultimately have adverse consequences upon the seller's business particularly with respect to vendors, employees, or customers. Furthermore, the buyer will have access to the selling company's corporate information such as trade secrets, operations, and financial information. The selling company could be significantly damaged should any of this information be made public or be used by the buyer for purposes other than the contemplated acquisition. These factors necessitate strict confidentiality by both parties. The confidentiality clause is generally designed to survive the LOI, even if a deal is not consummated between the parties.

Exclusivity—The exclusivity clause is also generally binding on the seller, who, for a specified period of time, is prevented from discussing a possible sale of the company with other parties. A buyer would be reluctant to commit a great deal of time and financial resources to pursuing an acquisition following the issuance of a LOI if the seller were still able to basically "shop" the deal around. Most buyers demand an exclusivity clause to allow themselves the opportunity to proceed with the due diligence process without the threat of being derailed by another offer or being placed in a situation where they are forced to increase their original offer as a result of previously undisclosed competition for the acquisition target. The duration of the exclusivity period is generally tied to the length of time the buyer will require to conduct its due diligence review.

Closing Date—The closing date is the projected day before which the transaction will be closed. Given that unforeseen circumstances may prolong the due diligence process, the closing date may change. In many cases, the closing date must be extended before the transaction is consummated, as legitimate issues may still remain as of the closing date suggested in the LOI. Though the seller would undoubtedly like to have the deal closed "yesterday," he must be patient as the process draws to a close. Tensions typically mount if the closing date is extended. However, everyone is able to breathe a sigh of relief when the closing documents are signed.

Management Contracts/Covenants Not to Compete—Most of the time, the acquirer will offer the current senior management contracts to continue employment with the company following the acquisition. For example, RMC Corp. offered the President and Vice President of RLH Industries five-year employment contracts which defined their compensation as: market rate salaries in the amount of $350,000 and $250,000, respectively, benefits that included health insurance and pension plan, perquisites such as use of the company car, and performance bonuses consisting of cash and shares of stock to be determined annually. The management contract provides a valuable opportunity to negotiate a favourable compensation package that may allow significant upside, particularly in the case of performance bonuses such as stock options. The acquirer of a company also wants to be sure that management does not seek employment with a competitor once the deal is consummated. RLH Industries' Chief Financial Officer, for example, who was also a shareholder in the company decided to leave the organization following the closing of the transaction. Therefore, he was required to sign a covenant not to seek employment with any of RMC Corp.'s competitors for a specified period of time. In his case, he was prevented from working for a competitor for a period of three years.

Real Estate—If the target company owns its real estate, the acquirer may choose to purchase this as part of the transaction or, instead, may opt to lease the real estate from the current owners. The intention of the acquirer with respect to the real estate is generally outlined in the LOI. RMC Corp., for example, did not want to acquire the real estate owned by RLH Industries at the present time. Instead, it chose to lease the facilities from the owners at a market rate for a period of ten years, at the end of which it would have the option to purchase the real estate for its appraised value. There

are pros and cons to both options, which must be weighed by each party in the transaction. The seller's transaction advisor will generally advise its client on what it feels is the most advantageous position to take with respect to the real estate.

Allocation of Purchase Price—In an asset sale, the amount by which the purchase price exceeds the market value of the assets must be allocated for tax purposes. Since this will have tax consequences for the seller, it is advisable to have this issue clarified as soon as possible so that the seller will be cognizant of the potential tax implications. A well-drafted LOI typically will include a tentative allocation of purchase price, which is mandated by the IRS. This will avoid any last minute haggling by attorneys and tax advisors over the appropriate allocation, which may delay the closing and adversely impact the expectations of the seller.

Good Faith—Along with the Letter of Intent, a seller's transaction advisor may require earnest money from the potential acquirer. This request, of course, varies based on the circumstances of the deal. If an individual or a very small business is acquiring the company, the advisor will most likely request non-refundable earnest money to both show financial commitment and personal commitment to conducting the transaction; the earnest money would then be applied to the purchase price at closing. However, if the acquirer is a large, publicly-traded company or private equity (LBO) fund, no earnest money is generally required. In the latter case, the acquirer will make sizable financial commitments in the process of closing the deal; in some cases (mostly larger deals), the acquirer's expenses for a single acquisition (even of a relatively small target) may approach or exceed a million dollars.

The negotiating process that is ultimately intended to generate a Letter of Intent is the most difficult phase of the deal making process. It is during this period that the seller generally has the upper hand, for he has what the buyer apparently wants. The challenge now is to find terms on which both parties can mutually satisfy their requirements.

Throughout the negotiating process, the transaction advisor acts as a limited agent for the seller and, as such, is unable to bind his client without the seller's consent. As the intermediary, the transaction advisor will negotiate with the buyer without making any commitments on behalf of the seller. This position enables the intermediary a great deal of latitude in the negotiating process, as it provides a way to both advance and to retreat during the negotiations—depending upon the desires of the seller. A buyer understands and respects the intermediary's position that he must consult with the seller, his client, who has the final say in either accepting or declining an offer or a particular aspect of the deal. If a seller were negotiating directly with the buyer and decided to retreat on an issue, it may undermine his credibility or call into question his commitment to consummating a deal. As such, the interests of a seller are generally well served with the use of an intermediary such as a transaction advisor.

Negotiating on the merits is generally a better option than positional negotiating, which occurs when a buyer and seller simply take competing positions and demand that

the other side give in "or there is no deal." Whilst this might work, it will likely hurt the relationship and may end in lawsuits later if either side is "forced" to succumb to demand that don't meet its interests. Negotiating on the merits rather than on positions follows the framework outlined in Roger Fisher and William Ury's authoritative 1981 handbook on negotiation, *Getting to Yes: Negotiating Agreement Without Giving In*. Fisher and Ury conclude "negotiating is a series of relationship-building, option-creating, and communication-enhancing steps between parties."[1] Given this perspective, there are four main issues related to negotiation that the seller of the business should recognize and understand.

1. **People—**There are two sides to every transaction. The relationship between the parties may vary from friends to strangers to enemies. During the negotiations, each side should seek to build and maintain a good relationship between the parties, even though they may have conflicting objectives. To be effective, they must separate the people from the problem. At times, tempers may become flared and personal attacks may be launched. Despite emotional involvement, especially by the seller, this issue can be effectively managed by focusing on the problem at hand—which is to reach an outcome that is satisfactory to both parties.

2. **Interests—**Both parties are ultimately seeking to maximize the return on their investment. For the seller, this entails securing the highest price possible for the business. For the buyer, this generally means acquiring the business at the lowest possible price that the seller will accept up to a certain level, beyond which the deal is no longer feasible for the buyer. Fisher and Ury suggest that the most effective way of persuading someone is to understand their interests—their wants, needs, hopes, and fears. Though money is typically the issue emphasized in negotiations, there are other (sometimes more important) factors to be considered, such as fair treatment for both sides and expeditiously and smoothly completing the transaction.

   Sometimes, both parties lose sight of the interests of the other and how to best serve those interests—such a loss of focus ultimately may lead to positional negotiating and to a result that is less than optimal for each side. By way of illustration, two young sisters, Jane and Mary, were fighting over the last orange in the house. Ultimately, they negotiated and decided to cut the orange into two equal halves. Mary ate the pulp then threw away the rind and zest. Jane used the zest from her half of the orange to make orange marmalade but discarded the pulp. What if each had more fully understood the other's interest in the orange? Could they have arrived at a better solution? If the sisters had considered the interests of each other whilst they were negotiating, they could have optimized the outcome that served each individual's interests best. In negotiation, it pays to know the interests of the party with whom you are negotiating. This can generally be accomplished by

[1] "Getting the Other Side to Say Yes," A CFO Interview with Roger Fisher, CFO.com, September 14, 2001.

asking them directly what their interests are, especially where there exists an ambiguous or "gray" area, and listening very carefully to their answer.

3. **Options—**Typically, both sides are attempting to serve their own interests, as is human nature. The seller may feel that since he could be holding the trump card (the asset that the buyer wants) he should be able to dictate price and terms. In the seller's mind, the buyer may then take it or leave it. However, such a mindset by the seller may only derail the deal, which must be a win-win for both parties. Arriving at a win-win deal structure necessitates compromise by both buyer and seller, even though this may result in both parties not getting exactly what they would like with respect to price, terms, or other aspects of a deal structure. Once the interests of each party are discussed, the parties are in a much better position to suggest options that satisfy their respective interests. By focusing on the problem and on the interests, rather than taking a one-sided, inflexible position, the parties are forced to work together to craft a deal that will truly be a win-win.

   Both parties should enter the negotiations knowing their respective BATNAs[2]—Best Alternative to a Negotiated Agreement. What is the alternative for the seller if he walks away from negotiations? Though he is able to keep his business, he may have foregone the opportunity to best serve his own interests with respect to a potential sale of his company. Knowing clearly what one gets by walking away will provide leverage in the negotiations. With respect to BATNA, maximum market exposure provided by the intermediary hopefully provides the seller with an alternative deal.

4. **Criteria—**In many situations where there is an anticipated transaction, there may be disagreement between the parties as to the value of certain tangible or intangible assets—real estate or customer lists, for example. In such a case, it is best to have an independent third party provide an objective opinion with respect to value. The independent third party, of course, must be acceptable to both buyer and seller. More generally, an objective set of criteria, agreed by both parties, with respect to certain deal metrics or structure will significantly facilitate the remaining negotiations and potentially enable both sides to arrive at a win-win conclusion.

An owner who is involved in selling his privately-held business may be overwhelmed by the deal-making process—especially certain aspects such as the Letter of Intent and negotiation of price and other terms. To facilitate the process, the professional advisors may assist the seller in understanding the mechanics of the Letter of Intent and may dispel any misconceptions regarding the nature and purpose of the document. Furthermore, the seller's advisors or intermediaries should be skilled negotiators who perform functions such as: building and maintaining relationships

[2] From *Getting to Yes: Negotiating Agreement Without Giving In* (Houghton Mifflin) by Roger Fisher and William Ury as discussed in "Getting the Other Side to Say Yes," A CFO Interview with Roger Fisher, CFO.com, September 14, 2001.

among the people involved in the process, managing the interests of the parties (especially the seller), identifying and discussing the seller's options, and assisting in determining a set of objective criteria to facilitate the negotiation process. If these issues are fully recognized by the seller prior to negotiations, the deal making process should be greatly facilitated, helping to ensure a smooth transaction that enables both parties to achieve their individual objectives.