M&A Letter of Intent – Critical Negotiation Points

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Previously, I wrote an article regarding ten (10) key issues worth considering in negotiating a letter of intent (LOI) in the context of an acquisition transaction. As a follow up to that article, this piece examines a handful of key LOI negotiation points. Bargaining strategy is highly dependent on whether the negotiating party is the buyer or the seller. A buyer generally favors a more generic LOI with details to follow in a definitive acquisition agreement. A seller often prefers a more detailed LOI addressing material issues that may surface during the transaction process. It has been my experience that a seller often loses leverage in terms of bargaining power once an LOI has been signed. As a result, it makes sense for a seller to address more contentious issues at an earlier stage.

Purchase Price

A buyer often prefers to include a purchase price that targets a range based on a due diligence review. From a seller perspective, it is advisable to include a detailed purchase price referenced in the LOI. Setting forth a specific purchase price will help to establish whether: (1) there are any conditions attached to the purchase price (i.e., a seller is required to meet projected targets); (2) there is an earn-out or other form of contingent consideration; and (3) there is an escrow or holdback of funds. Since consideration is customarily the most critical issue for a seller, it is best to understand the position of the buyer prior to executing an LOI and any conditions imposed on payment. LOIs, in most instances, with some exceptions, are non-binding. A buyer is not harmed by including specific details regarding the purchase price in the LOI as the LOI and its terms remain subject to revision based on a buyer's due diligence investigation.

Contingent Consideration

In many instances, if there is a disagreement as to the acquisition purchase price, the parties will try to bridge the gap by including a contingent consideration (earn-out). A buyer includes an earn-out to ensure that a seller delivers on expected future performance. A seller disfavors earn-outs and generally seeks to get as much consideration up front as possible. To the extent that contingent consideration is part of the deal, we counsel clients to carefully describe in as much detail as possible the methodology regarding how the earn-out is to be achieved in the LOI. Will the contingent consideration be based on gross revenues, net revenues (if so, how is that defined), EBITDA calculation, or some other formula? Will the target for the earn-out be calculated based on a seller's historical accounting practices, GAAP, or a buyer's accounting practices? Will the seller be entitled to receive a portion of the earn-out if 100% of the target is not achieved? In addition, a seller will want to include certain protections in connection with the operation of the business following the closing to maximize the possibility of achieving the earn-out. In contrast, a buyer will want to preserve full operational control over the post-closing business. A buyer generally prefers to address the earn-out mechanics in connection with the negotiation of the definitive agreement. If the earn-out is important to the seller, we advise a seller to take the time to discuss and put pen to paper at the LOI stage so the seller can best

make an assessment as to the likelihood of achieving the earn-out.

Indemnification Provisions

A seller is sometimes surprised to learn that it might be possible for a buyer to claw back part, or all, of the purchase price post-closing based on activity of the seller prior to closing. In the definitive agreement, a seller will be required to make numerous representations and warranties regarding the seller's business prior to closing. If the seller's statements regarding its business prior to closing prove inaccurate, without qualification in the seller's disclosure schedules, a buyer may be able to seek indemnification from the seller to make the buyer whole for the misrepresentation or misstatement. The seller and seller's counsel should try to limit the indemnification rights of the buyer. I recommend that a seller include in the LOI a statement concerning (1) the survival periods for representations and warranties (generally between 12-24 months) with longer survival periods for certain fundamental representations and warranties (described below) which will often survive for longer time frames, (2) the identification of fundamental representations and warranties such as the authority to enter into the transaction, title to assets, ownership of the seller, environmental matters, and taxes, among others, (3) the inclusion of a true deductible or tipping basket which prevents a buyer from seeking recovery for de minimis claims (claim must be a certain dollar size to seek recovery), (4) cap on liability for indemnification claims for breaches of general representations and warranties, and a higher cap for breaches of fundamental representations and warranties. In many instances, a buyer will push back and argue that these types of provisions should be negotiated in connection with the definitive agreement after a buyer has conducted due diligence. We advise sellers that many terms in the LOI are subject to due diligence, so there is no reason not to address these issues at the LOI stage. Finally, depending on the size of the transaction, the parties may wish to consider whether it is worth pursuing representations and warranties insurance which can help minimize the seller's post-closing liability for breaches of representations and warranties.

Employment Agreements

A buyer may require certain of a seller's key employees to enter into employment agreements following the closing of the transaction. The key employees may be open to entering into employment agreements. I recommend that if continued employment is a critical aspect to the transaction, that the parties should include the principal terms of the employment agreement in the LOI. As with many other issues, a buyer will prefer to reserve the negotiation of the employment terms to a period following the signing of the LOI. Particularly, if these terms are an important aspect of the transaction, a seller should push to include high level terms – term of agreement, compensation, benefits, and equity awards – in the LOI.

Conclusion

The negotiation of an LOI is critical to the acquisition process. The parties should devote significant time and effort to constructing the LOI. While a buyer may favor a less detailed LOI and reserve substantive issues for the definitive agreement, my recommendation to a seller is to take the time to include key deal points in the LOI. This allows a seller to identify any sticking points in the negotiation process with a buyer. It may also give the seller a sense of how the buyer will be to deal with during the transaction process. It may be possible to save significant resources (time and expense) by having difficult discussions up front, rather than delaying the discussions until later and running into an impasse further down the road.

For more information on LOI negotiation points, contact Joe Marrow.