Letters of Intent: An Increasingly Valuable Tool in an Uncertain Economy

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It was only a few years ago that many "Baby Boomer" business owners were beginning to strategically position their businesses for eventual sale. Unfortunately for many of these owners, the economic upheaval postponed their retirement schedules as caution pushed potential buyers to the sidelines. Navigating recent difficulties has left these business owners a bit older, hopefully wiser, and all the more eager for a targeted exit. Pent-up buyer demand means sale opportunities do exist. Thoughtful early-stage guidance from counsel can help weed out unsuitable suitors and maximize the client's shot at a successful deal.

Perhaps now more than ever, it is important that entrepreneurs seeking to buy or sell businesses conduct the necessary pre-sale diligence to ensure that the buyer and seller are willing and able to perform their respective obligations. A very valuable tool "to know sooner than later" if there is going to be a deal is a preliminary contract including both binding and nonbinding terms called a "letter of intent" ("LOI").

While negotiating the LOI, candor about important issues is key, before both parties invest more time, effort, and expense in further negotiations. Although every deal is unique, the following are some essential terms that nearly all buyers and sellers should consider when drafting an LOI that will assess the closing capabilities of both parties:

1. Confidentiality

At some point during the negotiation, each party will seek to identify—and hopefully resolve—problems by requesting documents and information. The materials provided may contain trade secrets or other confidential information, such as financial data. The LOI can include a confidentiality provision to protect sensitive information, 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, counsel should assist in carefully coordinating 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 unusual obligation on another party.

3. 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.

4. 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 a summary of the business to be sold. This approach clarifies 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

The pre-sale diligence of 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.

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