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In A Difficult Environment, A Strong Letter of Intent Delivers a Successful Closing

By: John B. McGannon, Managing Director, Frontier Investment Banking & Gerald W. Brenneman, Partner, Polsinelli Shughart PC

Even amid market turmoil, those who have acquired or sold a business in the past know that a well-drafted Letter of Intent (LOI) will dramatically increase the chances of a completed transaction. The LOI is the preliminary and mostly non-binding document between the buyer of a company and a seller that is intended to set forth the substantive terms and conditions of the contemplated transaction. As such, it lays the foundation for an orderly and successful acquisition process, a process that necessarily includes extensive due diligence activities and the negotiation of definitive agreements.

The underlying rationale for the LOI is to provide a practical framework in which a buyer and seller can seriously pursue the work required to accomplish a transaction as substantial as the sale of a company. This objective is accomplished principally by (a) establishing expectations regarding sales price, payment structure and other key transaction terms; (b) granting exclusivity to the buyer; and (c) obtaining confidentiality obligations from the buyer regarding the seller's business information. It is the entirety of a well-drafted LOI, though, that will help avoid unnecessary delays in, and possibly unwanted terminations to, an otherwise mutually beneficial acquisition process.

The more prominent components of an effective LOI include the following non-binding deal terms:

- Purchase Price: Although the price specified is non-binding, this provision sets a strong expectation. A buyer or seller should expect to change it only after the discovery of new, material information, for example, about the target company or industry conditions. Perhaps the LOI can anticipate such changes by tying the price to certain objective criteria, such as trailing twelve months' EBITDA (earnings before interest, taxes, depreciation and amortization), or the "book" value of the target company at closing. In one recent transaction involving the acquisition of a large company in the food sector, the price for which was to be based on trailing EBITDA, the seller used the LOI document to specifically list all acceptable normalization, or "add back", adjustments to EBITDA, in order to ensure that there would be no slippage in the purchase price when negotiation of the definitive agreements began.

  Consideration to be paid can also include the assumption of interest-bearing debt or sometimes other liabilities owed by the target company, so the LOI should clearly state the debt amounts that will be assumed and those that will not be assumed.

- Payment Structure: The LOI should also specify the amount to be paid in the form of cash, securities, notes or other assets. In the case of notes used with seller financing, it

should describe the total note amount, the interest rate, the principal amortization schedule as well as any collateral or other security in favor of the seller.

- Key Employees: If the buyer wants key employees and/or selling shareholders to remain with the company, that requirement is best specified in the LOI along with non-compete and non-solicitation restrictions. In almost all cases, for example, the LOI should require that key employees and sellers enter into non-compete agreements for a specified period of time (two to five years is most common, depending on the seniority of the employee).

- Closing Balance Sheet Items: Working capital levels and other key asset accounts expected to be received at closing are also typically negotiated in the transaction. Most LOIs will call for a "normal" or "customary" level of working capital (current assets less current liabilities) to be delivered at closing and typically provide that "excess cash" will be distributed to company owners prior to closing.

  In one recent trucking company acquisition, the LOI included a provision for a purchase price adjustment in the event the buyer did not receive a certain number of tractors and trailers that comprised a certain average fleet age (designated in number of months). In the trucking industry, capital expenditures are substantial and ongoing, so the buyer and seller in that case sought to specify an adjustment mechanism early on, at the LOI level, even to the point of specifying the dollar amount of adjustment that would be made, at closing, per month of deviation from the targeted average fleet age.

- Post-Closing Liabilities: Buyers will often seek to set aside a portion of the purchase price into an escrow account to facilitate post-closing indemnification for breach of representations and warranties made by the seller. Often the precise amount to be held in escrow will be determined after the LOI is signed and due diligence has been mostly completed, but when parties do seek to specify an escrow amount in the LOI, that amount often falls within a range of 2-15% of the total deal consideration. The escrow account and its operation are not to be confused with any seller financing that is outstanding at closing, which may include rights of setoff for the buyer, and which in turn may reduce the need for a significant escrow.

  In addition, some transactions may involve important contingent liabilities that must be addressed in the LOI. For example, in the recent acquisition of a home health service provider, the LOI included language providing that liability stemming from any post-closing Medicare and Medicaid audits of pre-closing patient claims be allocated in certain percentages to each of buyer and seller. Because post-closing liability exposure from governmental reimbursement authorities is a material issue for healthcare service providers, buyers and sellers of such entities are advised to address this question early on in the acquisition process, preferably at the LOI stage.

- Conditions To Closing: These conditions often include: (a) the completion of a due diligence investigation satisfactory to the buyer (which would likely include interviews with key employees and key customers, usually done shortly before closing); (b) the continuation of the target's business operations with no material adverse change; (c) the inclusion of customary representations and warranties by both parties; (d) the receipt of required regulatory and other third party approvals; (e) the execution of definitive documents; and, possibly, (f) the procurement of acquisition financing.

While the deal terms are non-binding, the LOI will typically have many binding and legally enforceable contract terms, including the following:

- Exclusivity: Also sometimes called a "no-shop" clause, this part of the LOI can be extremely important, as nearly all buyers will want such protection from competitive

bidders while expending a large amount of time, effort and expense in due diligence and in negotiating definitive agreements. Nonetheless, there are buyers who occasionally do not seek exclusivity, and some, in a full-scale competitive auction process, who may seek exclusivity from the seller but do not obtain it.

The length of the exclusivity period will vary from deal to deal, as different time periods fit different situations. Sometimes, for example, if the buyer will need to raise equity financing, the seller may ask for some kind of milestone achievement – perhaps a signed term sheet from an equity sponsor approved by the seller -- before extending the original exclusivity period by another 60 days or so to allow for closing.

Another useful device to accommodate the possibility of a slow-moving process is an open-ended mechanism for automatically extending the exclusivity period. For example, exclusivity could be established initially for 60 days and then be automatically extended unless one of the parties terminates the LOI in writing, with a seven-day notice included in the right to terminate (thus giving the other party time to make amends if desired). Though such a provision might appear to render the buyer vulnerable, in practice, if the two parties are still negotiating in good faith and expending time and effort toward achieving a close, the exclusivity tends to continue without controversy.

- Confidentiality: The seller naturally desires to obligate the buyer to maintain confidentiality with respect to information about the target company learned during the due diligence process prior to closing. The LOI may create this obligation or refer to a previously executed Confidentiality Agreement already in place between the buyer and the seller. Strategic buyers will ask for and obtain similar protection for information about their own operations that might be divulged in dialogue with the seller. In addition, a related provision could restrict parties from soliciting each other's key employees if the transaction is not closed.

- Due Diligence Access: Through binding language in the LOI, the buyer will want to ensure reasonable access to the seller's financial information, books and records in order to conduct its due diligence. On the other hand, the seller may want to prevent the buyer from communicating with the seller's customers or employees until a definitive agreement is executed and a closing more likely and will likely want all due diligence inquiries coordinated through one person, whose name can be designated in the LOI.

- Fees: It is also advisable to state specifically which party will pay for some of the expected costs of the contemplated transaction such as those associated with accounting audits or environmental studies. Also, it is typical to specify that each party will pay the fees of their own advisors.

  In addition, break-up fees are sometimes negotiated in the LOI to protect one party to an acquisition from the wasted expense and disruption caused when the other party withdraws from or terminates the deal. These types of fees were originally more common in transactions involving publicly traded companies but have also been employed frequently in larger private deals.

- Other Binding Provisions: Some other typical binding provisions in an LOI would include a restriction regarding non-disclosure of the transaction, and language regarding the applicable governing law and the proper court or arbitration panel to hear a dispute.

Of course, the LOI is only one part of a very substantial process, as the entire effort to acquire a company calls for keen negotiating acumen, well-developed strategies on the part of the buyer and seller, and experienced advisors for both parties. Each transaction, furthermore, will present circumstances that may call for different priorities in the drafting of the LOI and quite possibly terms and provisions that are not

included among those reviewed above. Nonetheless, we caution against seeking to accommodate all of a party's concerns in the LOI as too many negotiating battles may fatigue some counterparties and cause them to withdraw from dialogue. Experienced legal and investment banking advisors can assist with such challenges in order to produce a well-engineered Letter of Intent that will drive the deal to a successful close.

This article was co-authored by John B. McGannon, Managing Director with Frontier Investment Banking, and Gerald W. Brenneman, Partner with the law firm of Polsinelli Shughart PC.