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Strictly Business

A Business Law Blog for Entrepreneurs, Emerging Companies, and the Investment Management Industry.

ABOUT THE AUTHOR

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In his corporate practice, Mr. Davie has worked extensively with his clients on all aspects of their businesses, including company formation, business planning, mergers and acquisitions, vendor and customer contracts, corporate governance, debt and equity financings, and securities offerings. In addition, he has represented investment advisors, securities brokers, hedge funds, private equity funds, and real estate partnership syndicators in numerous private offerings of securities and in ongoing compliance. Prior to returning to private practice, Mr. Davie served as the general counsel to a private investment fund manager.

In his real estate practice, he has participated in property acquisitions, mortgage financings, and commercial leasing matters throughout the United States. He has represented developers, governmental entities, life insurance companies, banks, and owners of malls, shopping centers, industrial parks, and office towers. He has worked on a number of transactions involving the syndication of real estate partnerships, advising sponsors on both real estate and securities issues.

Buying a business? Here are 6 items that should be in your letter of intent.

One of the first formal steps in the process of buying a business is drafting a letter of intent. It's important to understand that a letter of intent is not the end of the negotiation process but merely the beginning of formalizing it. But it is a crucial step. A well-written letter of intent can reduce the potential for misunderstandings later and will get all of the parties' assumptions and views on the critical terms of the deal on paper. A letter of intent is not, however, the actual agreement that governs the terms of the purchase, and in fact, if written properly is not an agreement at all.[1]

Here are some items that should be included in a letter of intent to purchase a business:

1. <u>The document must be clearly identified as a letter of intent</u>. The document should make it clear that it is not a binding contract to buy or sell the business. The parties may want to include, and some states will impose automatically, a duty to negotiate in good faith. A good faith provision can be useful, especially for the seller, to prevent one party from using the negotiation and due diligence process solely to collect information about the other party and their business.

2. <u>The letter of intent should state from the outset whether the deal will involve the sale of stock or the sale of assets</u>. It would be unfortunate if both sides spent significant amounts of money but one party thought from the outset that they were talking about a stock sale and the other party thought they were talking about an asset sale. If this point is not discussed from the very beginning, the deal could fall apart as the deal structure that is preferred by one party may not be feasible for the other party.

3. <u>The letter of intent should include both a purchase price and an explanation of the assumptions that the purchase price is based upon</u>. During the due diligence process, it may turn out that many of the early assumptions used in calculating the purchase price will

turn out not to be true. If the method for calculating the purchase price is included in the letter, the parties have a road map on how the purchase price should be adjusted.

4. If the deal is a purchase of assets, the parties should allocate the purchase price to the different assets on the acquisition target's balance sheet. This allocation can have great effect on the tax implications of the deal for the parties. Since tax considerations are often critical to whether a deal is feasible, there needs to be a common understanding of purchase price allocations at a very early stage of the deal process.

5. The method of payment should be set out. As in point 2, if one party has in mind an all cash deal, and the other party has in mind a deal where the seller will hold onto a note or some other retained interest in the acquisition target, then it is a good idea for the parties to get on the same page from the outset, before either party has spent significant amounts of time and money on the deal.

6. All other major deal points that are important to either party should be included. If either party has any other deal points that are crucial to them, they should let the other party know relatively early. Examples of these include: whether key employees must be retained for the deal to close, any expected non-compete agreements that the seller will sign, and if the buyer will be assuming any liabilities of the seller. Springing these on the other party late in the process may result in a failed deal after everybody has spent a lot of time and money.

Many times parties try to get away with vague letters of intent with the assumption that the details will be ironed out later. The problem is, the details are often what kills the deal. Parties may also assume that it is a good idea not to put too much in writing because they will be "boxed in" when negotiating the definitive purchase and sale agreement. But if a letter of intent is drafted properly, the parties will not be boxed in; rather they will have an easier time agreeing to changes in the deal as circumstances change because the assumptions they used will be included in the letter of intent. The non-binding nature of a letter of intent always gives one party the option to walk away if things turn out not to be the way they expected. The effort spent on drafting a letter of intent will be helpful later by smoothing future negotiations and by eliminating unfeasible deals from the outset.

Footnotes

[1] Letters of intent will often have certain parts which are enforceable, such as a covenant not to sue. So saying that it is not an agreement at all is somewhat misleading. Rather, the substantive terms of the acquisition are not considered to be part of any enforceable agreement.

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