

Get a Letter of Intent (“LOI”) Before Starting Due Diligence

The Letter of Intent (LOI) is an essential step in facilitating the sale of a business. The purpose is to establish the economic framework for buyers and business sellers to move into the due diligence phase. Sellers should insist on receiving the LOI establishing the deal’s economics before allowing due diligence to begin. Buyers want the seller to commit to the terms before spending significant money doing due diligence.

Due diligence is an exhaustive exercise requiring significant resources from both the buyer and the seller invested in the process. Not only is it a resource drain, but the buyer learns all your company’s secrets, including strategy, pricing, customers, suppliers, and other critical proprietary information. No one should go through this process without first understanding your potential sale’s proposed terms and conditions.

The purpose of a letter of intent is to define the economic terms and conditions applicable to the pending business sale if the due diligence results in no material differences from the original representations. In other words, if the buyer verifies that everything previously presented checks out, they agree to pay you X dollars for your business under the set of Y terms specified in the LOI.

The Letter of Intent is non-binding so that if the buyer or seller discovers any surprises, either one can walk away with no penalty or, they can attempt to renegotiate the previously stated terms and conditions. The seller should negotiate or have his advisor negotiate before countersigning the LOI because buyers will lock up a seller for an exclusive due diligence period of 60 to 90 days. This lock-up means that the seller may not communicate with and other bidders until the lock-up period expires or until either party has canceled the LOI. Once the due diligence is completed, the deal is memorialized by a much more detailed definitive purchase agreement.

A purchase and sale agreement documents all terms agreed upon between the buyer and the seller in an M&A transaction. Sometimes, this document is referred to as the definitive agreement and is the controlling document used to close the transaction.

A purchase and sale agreement can take the form of a merger agreement, tender offer document, or a stock or asset purchase agreement. Each type of purchase and sale agreement contains all the terms and conditions of the transaction. Therefore, it’s vital for both the buyer and seller to have an experienced lawyer and a good M&A team to make sure the agreement is fair for both parties.

Below is a sample letter of intent to illustrate the preceding. LOI terms will vary significantly in every case.

This letter of intent by BUYER, its successors, or assigns (“BUYER”) is regarding a proposed acquisition by BUYER, through a newly formed company (“Newco”), of substantially all of the assets of SELLER. The transaction proposed below (the “Transaction”) is expressly subject to (i)

the satisfactory due diligence review of SELLER by BUYER, (ii) the successful negotiation, execution, and delivery of a definitive acquisition agreement, and (iii) the approval of our members and lenders.

SELLER's growing industry position and consistent operating history lead us to value the company at approximately \$00,000,000 (Total Valuation) based upon 5.0 times multiple of its trailing twelve months ("TTM") EBITDA of approximately \$0,000,000 for the period ending February 28, 2021, after adjusting for the appropriate add-backs of discretionary, extraordinary and nonrecurring items. This valuation will be adjusted based on the actual reviewed TTM EBITDA provided by SELLER's management pursuant to Section 7 below and an analysis of the appropriate add-backs of discretionary, extraordinary, and nonrecurring items.

The parties currently contemplate that the general terms and conditions of the transaction will be as follows:

1. **Structure of Transaction.** The transaction will be accomplished by the purchase of substantially all of the assets of SELLER including, but not limited to, the rights and title to all inventory, furniture, fixtures and equipment, plant and equipment, accounts receivable, accounts payable, loans, and other advances due, advertising, marketing, and collateral materials, intellectual property, trade names and trademarks, service marks, patents and royalty agreements, processes and contracts with customers, suppliers, contractors, and consultants.

2. **Consideration**
 - a. **Cash Portion:** At the close of the Transaction, BUYER will pay to SELLER (the "Seller") an amount in cash of \$0,000,000 (the "Cash Portion"). This amount assumes that (i) as of the closing, SELLER will have met the Net Working Capital requirement (as defined below); (ii) SELLER has verified its consolidated TTM EBITDA for the period ending December 31, 2020, based on reviewed financial statements recast to take into consideration appropriate adjustments for discretionary, extraordinary and nonrecurring items; and (iii) SELLER will not have any debt as of the closing other than trade account payables and other ordinary course liabilities. "**Net Working Capital**" is defined as the 1-month average of the most recent 12 full calendar month period immediately before the closing (i.e., the 12 complete months ended the last day of the month that precedes the closing) of the transaction of current assets minus current liabilities, excluding in each case any member related receivables or liabilities, interest-bearing debt, and cash. To the extent the Net Working Capital as of the closing date is less than the Net Working Capital determined in accordance with the above definition, the purchase price will be reduced dollar for dollar. To the extent the Net Working Capital as of the closing date is more than the Net Working Capital determined in accordance with the above definition, the purchase price will be increased dollar for dollar.

- b. Equity Portion: In addition to the Cash Portion above, the Seller will receive a 25% equity position in Newco, which will allow the Seller to participate in the growth of SELLER following the Transaction. The intent for the Transaction structure will encompass a tax-free distribution of the assets to the Seller. SELLER would have shareholder rights and protective provisions that would include pre-emptive rights, tag-along rights, including anti-dilution protections.
 - c. Note: In addition to the Cash and Equity Portions above, the Seller will receive a \$0,000,000 note with 6% interest. The first payment will be for \$000,000 plus 6% interest and be paid at the second anniversary of the transaction's closing. The second payment will be for \$000,000 plus 6% interest and be paid at the third anniversary of the transaction's closing. The third payment will be for \$000,000 plus 6% interest and be paid at the fourth anniversary of the transaction's closing, and \$000,000 plus X% interest will be paid at the fifth anniversary of the transaction's closing.
3. **Capital and Management Structure of Newco.** BUYER's capital investment in Newco will be in the form of both preferred and common equity. Both BUYER's and SELLER's ownership in Newco will be subject to pro-rata dilution for any warrants issued to the Lenders if any (defined in Section 6 below) and options reserved for the management team.
- a. Capital Structure and Funding Sources: The capitalization structure will include cash invested by BUYER's Lenders in an amount and on terms to ensure that the debt and debt service are not a burden to Newco. In addition, BUYER will invest its cash as required by the Lenders to satisfy the amounts required to fund the transaction and any growth initiatives identified by management.
 - b. Management Structure: Newco will be governed by a board of managers that will include representatives from BUYER, the Seller, and the Lenders. All members and managers of Newco will enter into an organizational operating agreement in support of the governance structure for Newco, which operating agreement shall be in a form reasonably acceptable to the former SELLER shareholders.
 - c. Management Fee: BUYER will receive an annual management fee in an amount equal to the greater of \$300,000 or 5% of Newco's EBITDA. Except for the amounts in this Section and annual tax distributions, no member of Newco will receive any other cash distributions or payments following the close of the Transaction unless pro-rata distributions are made to all Newco's members
4. **The Definitive Documents.**
- a. Purchase Agreement: The parties agree to negotiate in good faith the proposed terms of a definitive purchase agreement (the "Definitive Agreement") and any ancillary documents thereto and acknowledge that the Definitive Agreement and such ancillary documents would include customary reasonable representations,

warranties, covenants, closing conditions, legal opinions, indemnities, escrows, shareholder, partnership or operating agreements and non-competition agreements (with SELLER and the SELLER shareholder) that are usual and customary for this type of transaction. The Definitive Agreement will provide a “cap” and “basket” on the indemnity obligations as mutually agreed upon by the parties.

- b. **Noncompetition:** As part of the Transaction, the Seller and any other holders of SELLER’s equity will be required to sign five-year non-competition agreements.
 - c. **Escrow:** We presently expect the amount of the post-closing escrow to be 5% of the Cash Portion. A mutually agreeable financial institution will hold the escrow for twelve (12) months, and any earnings on the escrow account will be distributed to the party receiving the escrow proceeds; provided, however, that if no claim has been made as of the end of the first six (6) months following the closing of the Transaction, 2.5% of the Cash Portion, plus earnings thereon will be released from the escrow. The remaining 2.5% will be distributed pro rata upon the end of the 12 months with no claims filed.
5. **Employment and Compensation.** At BUYER’s s request, certain SELLER’s management team members will enter into mutually acceptable employment or consulting agreements. The consulting agreement will include a one-year non-competition clause. Specifically, it is anticipated that Mr. CEO and Mr. COO will enter into employment agreements with an annual base compensation at market rate and a bonus to be determined before closing and commensurate with the roles, time commitments, and responsibilities.
 6. **Due Diligence:** SELLER will provide access to BUYER’s designated agents to perform a due diligence review of all matters pertaining to the operations of SELLER, including, but not limited to, its employees, contractors, customers, vendors, suppliers, consultants, and financial, contractual, legal, and all other matters it deems necessary for the performance of its review. Since this Transaction will have a financing component that one or more third-party lenders will provide (collectively, the “Lender”), the SELLER will also provide reasonable access upon advance notice to the Lender for their due diligence review. The Transaction is expressly subject to BUYER’s and the Lender’s satisfactory due diligence review, acceptance, and execution of the Definitive Agreement with Newco and its Lenders.
 7. **Review of Financials.** In connection with the proposed Transaction, the SELLER must provide proof of the _____, 2021 adjusted TTM EBITDA by a third party. In connection with the proposed Transaction, promptly following the execution of this letter of intent, SELLER, at its sole expense, will hire a mutually acceptable accounting firm to conduct a quality of earnings review on its financial statements for the TTM period ended on _____, 2021 (the “Review”). BUYER will reimburse SELLER 50% of the expense for the review at the closing of the transaction.

8. **Confidentiality.** Each party hereto agrees that it will not make any public disclosure, other than to attorneys, accountants, consultants, financial advisors, and financing sources (who will be advised of the existence of the restrictions contained in this paragraph before disclosure), of the existence of this letter or any of its terms without first notifying the other parties and obtaining the written consent of such other parties to the proposed disclosure, unless such disclosure is required by applicable law or regulation (including applicable franchise laws), in which event the party contemplating disclosure will inform the other parties of and obtain their consent to the form and content of such disclosure, which consent will not be unreasonably withheld or delayed. Upon request by either party, the parties will return all written material delivered to it by the other party and not retain any copies.
9. **Exclusivity.** For a period commencing on the date this letter is signed by you and ending on either the termination of this agreement or the close of the Transaction (the “Exclusivity Period”), SELLER will negotiate exclusively and in good faith with BUYER in relation to the Transaction (the “Exclusivity Period”) and will not, directly or indirectly, whether through any officers, directors, members, partners, employees, shareholders, affiliates, representatives or agents or otherwise, encourage or solicit any inquiries or accept proposals by, or engage in any discussions or negotiations with, or furnish any non-public information to, any person regarding alternative transactions and will promptly notify BUYER of the substance of any inquiry, proposal or discussions concerning any such transaction which SELLER receives; provided that either party may terminate the Exclusivity Period at any time upon written notice.
10. **Ordinary Course.** SELLER agrees that it will conduct its business in the ordinary course consistent with past practice and notify BUYER before entering into any material or extraordinary transactions or other events outside the ordinary course during the Exclusivity Period. SELLER may distribute cash and non-operating assets to the shareholders as they deem appropriate. Without limiting the generality of the foregoing, SELLER will not change its revenue recognition or bad debt policies, pricing, sales and marketing, billing, terms and reserve policies, shipments of inventory, which will reflect normal historical patterns.
11. **Information.** During the Exclusivity Period, SELLER and its representatives will provide BUYER and its Lenders, representatives, advisors, and counsel with: (i) such information (including copies of documents) relating to SELLER as BUYER may reasonably request and (ii) access to the books, records, facilities and personnel of SELLER and certain customers and suppliers as BUYER may reasonably request, except that BUYER will contact no customer or supplier without prior express written consent of SELLER. Inquiries to SELLER or its customers, referral sources, and suppliers will only be made through SELLER or its designs. BUYER commits to make its best efforts to minimize the length and magnitude of this due diligence period, providing it is able to review and consider the necessary information to reach an informed opinion of SELLER.
12. **Closing.** If the final LOI is executed by _____, 2021, we anticipate closing should occur on or before _____, 2021.

13. **Material Adverse Conditions.** During the Exclusivity Period, any material adverse change shall result, at the sole and exclusive option of BUYER or BUYER's Lenders, in (i) a change in the terms and conditions of this Transaction, or (ii) a cancellation of their commitments(s) regarding the Transaction. As it refers to in this paragraph, a "material adverse change" shall mean to include but not be limited to an adverse change in the interest rate, in the economy, or the general business climate.
14. **Expenses.** Before executing the Definitive Agreement, each party will pay its expenses in connection with the Transaction.
15. **Finder's Fees.** Each party represents to the other that any agent, brokerage, or finder fees due in connection with the Transaction will be borne by the party who has agreed to pay.
16. **Termination.** If it becomes apparent to either party that they will not reach agreement on a Definitive Agreement, either party may terminate this letter by giving written notice to the other. The terms of this letter will thereafter be of no further force or effect except for Sections 8 (Confidentiality) and 14 (Expenses).
17. **Governing Law.** This letter will be governed by the internal laws of the State of _____.
18. **Binding Effect.** Except for Sections 6, 7, 8, 9, 10, 11, 13, 14, 15, and 16, which are intended to create binding obligations, it is understood that no legal obligation or liability to close the Transaction will be created by this letter and that the legal obligations and the liabilities of the parties to close the Transaction are to arise only upon the duly authorized execution and delivery of the Definitive Agreement.

If you agree in principle with the terms and conditions of the proposal herein, please acknowledge by executing an original of this letter and returning it to BUYER. This letter may be executed in multiple counterparts, each deemed an original, and such counterparts together will constitute the same instrument. This letter is not valid if not countersigned and returned to BUYER by _____, 2021.
