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Letter of Intent for Searchers

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Congratulations – you have set up your Search Fund or secured funding and now you have identified a target business to acquire! What's next?

As we continue to witness an increase in Entrepreneurship Through Acquisition ("**ETA**") activity in the UK and European markets, and following on from our article on *An introduction to Search Funds*, this article looks to continue our Searcher-focused article series and discusses the next step in the process to acquiring your business – the Letter of Intent ("**LOI**").

What is an LOI?

Also referred to as a "Term Sheet", the LOI is a non-binding indicative offer that outlines the key commercial terms of a deal. It formalises the understanding between the buyer and the seller(s) and provides a basis from which the formal transaction documents can be negotiated.

Why is it important to get an LOI right?

If prepared correctly, an LOI can significantly increase the ease of negotiations and generally aid the acquisition process. Conversely, a badly drafted LOI can lead to protracted negotiations, higher advisor costs and a greater chance of a deal becoming delayed or even aborting. Additionally, the preparation and negotiation of the LOI itself can help to identify and address any potential dealbreakers for either party.

A good LOI should be based on a solid understanding of the business being acquired and an awareness of some of the issues that will need to be negotiated during the process. This can only be obtained by undertaking some initial due diligence on the target business and, ideally, having high-level discussions (at the very least) with the seller(s) and / or the target business' management team.

A bad LOI, meanwhile, can entrench negotiations to the detriment of the deal. Agreeing terms from the offset can be beneficial if such agreement is based on a sound understanding. However, issues can crop up during due diligence that may require you to row back on certain terms that were deemed to be agreed in the LOI. Although not legally binding, doing so may cause tensions to fray and reduce your standing and trustworthiness in the eyes of the seller(s).

When should I enter into an LOI?

As stated above, you should seek to enter into in an LOI once you are comfortable that you wish to proceed with the acquisition of the target business. Although not legally binding, the LOI demonstrates that the parties are serious about entering into a formal agreement and represents the formalisation of such commitment.

Generally, LOIs will grant a buyer a right of exclusivity that enables them to proceed with more in-depth due diligence on the target business safe in the knowledge that they will not be wasting time and costs in the event that someone else comes in with an offer that is more attractive to the seller(s). Accordingly, the LOI should be entered into once you are ready to proceed with more rigorous due diligence following initial investigations into and discussions with the target business.

Is it legally binding?

In general, an LOI is not legally binding – it is more of an "agreement to agree", and care should be taken to ensure that the LOI is not drafted so as to bind you to its terms. If you entered into an LOI that states a purchase price and you spot an issue in your due diligence that reduces the value of the business, a well drafted LOI will ensure that you are not prevented from negotiating with the seller(s) on price.

That said, certain terms within the LOI should be drafted so it is clear that they are legally binding. In particular, we would expect clauses relating to *Confidentiality* and *Exclusivity* to be legally binding. Each of these will be considered in further detail below.

How long / detailed should it be?

There is no hard and fast rule. In general, an LOI needs to have enough detail that provides clarity as to what has been commercially agreed. An LOI that is too detailed may prove to be too rigid and limit your negotiation power going forward. A nice middle ground setting out the key terms in reasonable detail is the best starting point from which the lawyers can prepare the transaction documents.

Think of it like planning a road trip: you don't want to set off without plotting your route, but equally you don't want to hamstring yourself by setting out a rigid itinerary that prevents you from taking an alternative route in the event of road closures.

Key terms of an LOI

1. Legal effect

This clause should clearly set out that the LOI is not intended to have legal effect, save for certain exceptions such as *Confidentiality*, *Exclusivity* and *Governing Law & Jurisdiction (*discussed below).

2. Proposed transaction

A simple clause stating your intention as buyer will suffice. For example, that you intend to purchase the entire issued share capital of the target business from the seller(s) subject to the terms of the LOI.

3. Consideration / Price

This is where the purchase price and consideration structure should be set out. The aggregate price should be stated clearly followed by a summary of how this will be apportioned in the consideration structure. Is it a straight acquisition for cash on completion or are there deferred elements such as deferred consideration or earn-outs that need to be specified. Details of any working capital adjustments should also be provisioned, including whether you're closing on Locked-Box or Completion Accounts basis.

Subject to the structure of the transaction, you may wish to include additional wording to state that the target business is being acquired on a debt- and cash-free basis and that the purchase price is subject to due diligence.

4. Conditions

Continuing on the same theme, this provision sets out the conditions to which the transaction is conditional on. We would ordinarily expect a re-iteration that the transaction is conditional on a proper due diligence exercise taking place and there being no material adverse changes to the target business following the signing of the LOI.

We would additionally expect this clause to contain any transaction-specific elements, such as a requirement for certain seller(s) or members of the management team to enter into new service agreements or post-completion restrictive covenants. Care should also be given to any regulatory or legal requirement, such as FCA authorisation or Secretary of State approval under the NSIA.

5. Share purchase agreement ("SPA")

Responsibility for providing a first draft of the SPA will generally be set out here, noting that it is generally expected that the buyer's solicitors will prepare this.

In addition, this clause will ordinarily state that the SPA will be drafted on the terms of the LOI and can additionally provide clarity on terms such as limitations on liability (including timing for bringing any warranty claim). It may be sensible to ensure wording is included to the effect that any warranties, representations and covenants in the SPA will be customary.

Providing details like these should expedite the SPA-drafting process by clarifying certain provision that can take up significant time if left for negotiation later on.

6. Confidentiality

This clause sees the parties agree that the contents of the LOI are confidential and won't be shared with third parties (e.g. rival bidders) unless otherwise agreed in writing or required by law.

This must be a legally binding term in the LOI to ensure it is enforceable in the event that the seller(s) share the terms of your deal with other prospective buyers after the LOI has been signed in the hope of securing a better deal for themselves.

7. Proposed closing timeline

In order to focus minds and provide clarity on the timings for the transaction, the parties may wish to agree a target completion date to work towards.

An indicative timeline can also be added setting out the specific transaction steps, for example the target number of weeks that the parties will conduct due diligence and how long will be allotted for the preparation, review and finalisation of the key transaction documents.

8. Exclusivity

Given the time and costs involved in conducting a thorough due diligence process, you will want to ensure that you have exclusivity rights ensuring that the seller(s) can't enter into negotiations with third parties in relation to the sale of the target business.

This clause re-affirms the parties' commitment to the acquisition process and provides breathing space in which you can make further investigations and enquiries with the seller(s) sole attention. We would usually expect to see the target business provide an indemnity in respect of any costs incurred by the buyer in the event of any breach of this provision.

The timings for exclusivity are to be agreed between the parties, but we would ordinarily expect this to be between sixty and ninety days to accommodate sufficient time for due diligence and the preparation and negotiation of the transaction documents.

As per the *Confidentiality* clause, we would again expect this to be legally binding so that, in the event of a breach, you could enforce the indemnity.

9. Costs

If there has been an agreement between the parties in respect of the payment of costs, this should be set out here. Although we would normally expect each party to bear its own costs in relation to the transaction, it is not uncommon to see agreements in which one party agrees to bear certain costs (such as a proportion of the costs incurred in relation to due diligence or the agreement of any financial documents).

Again, we would expect this to be legally binding so that the parties have financial certainty.

10. Boilerplate

This is legal jargon for the "boring" (but nevertheless important) provisions that you see in most legal documentation that help to govern the way in which the agreement operates.

Here, we would expect to see clauses outlining provisions relating third party rights, variation of the LOI and governing law.

11. Expiration

This clause simply sets out the date that the offer will expire if not accepted and is another helpful provision to focus the attention of the seller(s) and prevent any undue strategic delay.

Other key drafting points to note

It is important that the LOI is headed so it is clear that its contents are confidential. A simple statement above the addresses stating "***Strictly private and confidential***" should be sufficient to prevent the seller(s) from parading the LOI in the hope of attracting a better offer.

In addition, we would generally expect the LOI to be:

- Addressed to the target company, not the selling shareholder(s); and
- Sent by the proposed buyer,

in order to ensure that the correct parties are committed to the terms of the LOI that are stated as being legally binding.

Next steps

The LOI is an important step on the road to acquiring your target business and, if done well, it will provide the re-assurance for you to carry out more thorough negotiation and due diligence before committing to formal legal agreements.

We at Fox Williams are happy to provide pro-bono support and guidance for Searchers in the LOI process. If you have any questions contact our Corporate team - Bryan Shaw and James Coulthard.