

Letters of Intent

This newsletter continues our recent theme on the steps involved in acquiring a business. Once a decision to acquire a business is made, a buyer will communicate its intentions by issuing a letter of intent (“LOI”) to the seller. The LOI is usually non-binding and subject to a number of caveats including satisfactory completion of due diligence. Below are some of the key items that should be included in an LOI:

1. Acquisition Price, Form and Timing of Payment

Ultimately, whether a deal can be consummated is usually determined by the purchase price, when it will be paid and in what form. A seller will normally prefer all cash on closing. Buyers may want to mitigate valuation risk by paying as little up front as possible and tying future payments to performance by way of an earn-out or some other contingent formula. A buyer may also offer its shares as part of the consideration or ask the seller to take back a note (i.e. a vendor take back) thereby paying a portion of the purchase price with the future cash flows of the target.

2. Form of Transaction

The three most common methods of acquiring a business are:

- a. Purchase of assets. Usually favoured by buyers since liabilities (known and unknown) are not assumed. However in certain jurisdictions, (ex. Ontario) legislation exists that requires payment to the seller’s creditors if the majority of the assets are sold. If creditors are not paid, the buyer would then be liable for these payments.
- b. Purchase of shares. Usually favoured by sellers for tax purposes since the first \$750,000 of sale proceeds are tax free in Canada.
- c. Merger or consolidation. This involves an exchange of shares between the buyer and seller such that the seller becomes a part owner of the buyer.

3. Timing and Deadlines

The buyer would indicate the expected close date of the transaction and all steps required prior to closing to insure the deadline is met. For example, the timing and targeted completion date of due diligence would be outlined in this section.

4. Representations and Warranties

The buyer will want the seller to assume any environmental, product or legal liabilities resulting from existing or future lawsuits. The LOI may require the seller to provide to the buyer all brand names, patents, trademarks, customer lists and other intangible assets at closing. The transfer of all tangible assets may also be addressed. A savvy buyer will want to hold back a portion of the purchase price for a period of time in the event that a contingent liability assumed by the seller arises after the sale is consummated. The hold back can be used by the buyer to extinguish the liability and avoid a lawsuit from the claimant.

5. Employment and Non-Competition Agreements

If the seller or other key management members are expected to remain after the sale, the buyer will want to secure these individuals by having them sign employment agreements. If the seller is expected to leave the company after the sale, a non-competition agreement will be required. The LOI will outline which agreements will be required to be executed prior to the consummation of the sale.

6. Risk Management

These clauses revolve around the risk that the transaction will not close and how they will be mitigated. For example:

- a. Entrance of a competing offer. The buyer should include a “lock-up” provision granting it exclusivity for a period of time to negotiate with the seller and consummate the sale.
- b. Fickle party to the deal. Should either party decide to walk away from the deal for whatever reason, the other party would receive a termination fee and payment of its transaction costs.
- c. Share price variation. In a share-for-share exchange, if the buyer’s share price deteriorates or appreciates by a specified percentage, a floor or ceiling is established to lock in a price between the established boundaries.

The above list is by no means exhaustive. Depending on the type of business being acquired, there will be many other clauses specific to the particular transaction.

Aries Advisory Group has extensive experience in drafting of and reviewing letters of intent. No matter what side of the transaction you are on, we can provide expert advice to ensure that all contingencies and “what-if” scenarios are covered. If you are planning to acquire or sell a business, please contact us at info@ariesag.com or at (416) 467-7878 to see how we can help.