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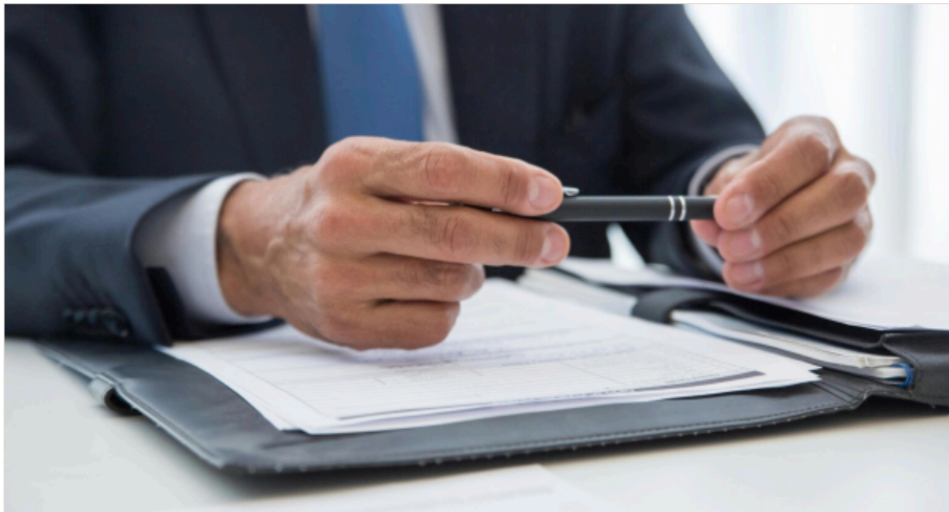
IN 2025

AMP UP YOUR LOI: HOW M&A EXPERTS IN THE TRENCHES ARE STRENGTHENING THE LOI

WITH **BUY AND BUILD ADVISORS**



BUY AND BUILD ADVISORS

AMP UP YOUR LOI
HOW M&A EXPERTS IN THE TRENCHES ARE STRENGTHENING THE LOI

With BUY AND BUILD ADVISORS
& Prencipe International

Presently lower and lower-mid market business acquirors are utilizing relatively archaic LOI terms and forms for their business acquisitions. The drivers of this trend vary according to the acquiror, such as legal counsel repurposing a 2010's mid market form for a 2025 SBA deal.

The problem is that these LOIs aren't curated to the market conditions that acquirors are facing today: to first-time sellers of relatively large businesses, to pushy brokers hasty to close 'right now', to the needs of equity sponsors, or to the ever-evolving landscape of SBA deal structures.

This article looks at the experience of acquirors in transactions of $1-50m in size, and draws out lessons that you can apply in your next LOI. The authors also offer to prepare your LOI for free in your deals, and their contact information can be found at the end of this article.

Non-Adjudicated Setoff

There are three key ways you protect your purchase post-close: (1) a promissory note with a non-adjudicated setoff provision, (2) the escrow holdback, and (3) upfront consent to injunctive relief. Many of the LOIs that come across our desk are missing at least one of these. Every LOI should have all three, in addition to other protective provisions.

The non-adjudicated setoff provision is a species of the garden variety setoff provision that you typically see in seller financing promissory notes. The garden variety setoff provision states that you, the acquiror, may choose to not pay all or part of the note where the seller breaches the reps and warranties or covenants of the transaction documents, causing you damages.

The problem with the vanilla version is that it requires one of three things, none of which are beneficial to you: (1) final adjudication by a court, (2) the decision of a mediator, or (3) the consent of the seller. However, when you are an acquiror in distress right after having closed a business purchase, time and money are not on your side. You need to move fast. You need to keep the business afloat. You need to keep your new employees happy.

You don't need a lawsuit. You don't need to pay tens of thousands of dollars for attorneys' fees. And you absolutely don't need to wait in court for potentially 2-3 years to solve for the seller's breach. Your company will be bankrupt by then. As it is said, 'justice delayed is justice denied'.

Therefore, your setoff provision needs to be drafted to ***exclude*** the requirements of adjudication, mediation, and seller consent. We prefer for acquirors "notice-only" setoff provisions, whereunder the acquiror may merely provide notice to the seller to exercise the setoff.

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Therefore, we recommend that you include the following language in your LOI to capture the need for a non-adjudicated setoff provision:

> "For the promissory note to act as valid and effective security for the Buyer, it shall include a setoff provision which may be exercised by the buyer upon delivery to seller of records evidencing the seller's breach and damages to be setoff, and it shall not require prior adjudication, mediation or third-party decision, or the seller's consent."

Bear in mind, with this provision and with any other provision we discuss in this article, the seller wants exactly the opposite of what you want. It is deeply in the seller's interest for you to have to spend tens of thousands of dollars and years in court just to exercise your setoff right. They want you to have to fight through the court system for it, because they know most buyers won't or can't.

Maximum Escrow Holdback

The theory underlying the escrow holdback is important to consider: the target retains inherent undiscovered risk until the acquiror has taken it over and determined that the reps and warranties are accurate, or as the acquiror understood them to be.

Now, let's add that together with the basic definition of the escrow holdback. 5-25% of the purchase price is deposited with a third party to be paid to the acquiror if the seller breaches a rep and warranty or covenant of the transaction documents. There are usually stringent dispute resolution requirements associated with this, like adjudication.

Very often, what we see in LOIs is that the acquiror has completely forgotten to include an escrow holdback, or had included a de minimis escrow holdback such as a mere 5% of the purchase price.

This is extremely unbeneficial to the acquiror. He has essentially foregone one of his key protections before the deal has even started.

When we then move on to the question of how large of an escrow holdback should we ask for between the range of 5-25%, let us again bear in mind it is inherent in the theory of the escrow holdback that you do not yet discover the actual scope of damages until after you have agreed to the escrow holdback terms.

Therefore, what we advise is that you get the maximum escrow holdback amount that you can in LOI. We suggest starting your form LOI in asking for 25% escrow holdback for a 6-month period, and being willing to negotiate it down to 15% depending on the transaction.

Not all sellers will agree to this or the other terms we advise in this article. However, that is the difference between getting a mediocre LOI signed and a great LOI signed.

Don't Say 'Customary Terms'

Amongst sophisticated parties, it is common to agree in an LOI that the purchase agreement will contain 'customary terms' of a like transaction. And even then, it is common amongst sophisticated parties for them to actually understand what the 'customary terms' are – and to not make the (bad taste) argument that obviously customary terms are absolutely not customary.

The problem is, this is exactly what first-time sellers occasionally do. The acquiror offers an LOI that he thinks is safe with this mid-market language that the deal will include 'customary terms'. The first-time seller of a $10m business signs the LOI. But then, two months later in the middle of the transaction, the seller's lawyer is telling you the acquiror that you aren't getting half of the terms that you thought were customary.

Now, you might say, this is an absurd outcome and we should be able to put this argument to rest fairly quickly. And, in some transactions, you would be right. However, in the other transactions, the seller's counsel is going to try and get any concession they can out of you. And you shouldn't even be negotiating the definition of 'customary terms' in the first place.

Instead of waiting for this land-mine to explode, what we advise is that you include in your LOI a literal list of all of the 'customary terms' that are going to be part of your transaction. You can obtain this list from your legal counsel. This way, you completely pre-empt the issue, and get all of your important provisions agreed to upfront before you have even begun the transaction.

Extending the LOI is a Losing Game

Imagine that you are dating, and every month you ask your date, "Do you think we should still continue dating? Will you agree in writing to keep dating me?"

This may be one of the most awkward things that you could ask. The very question itself almost assumes (and implies) that you are at the mercy of your date. And, even worse, it keeps reminding your date that she can (and should) think about not dating you anymore – and it opens the door for her to do just that.

That's what it's like when you sign an LOI with a 30 or 60 day exclusivity provision. The deal isn't going to be done in 30 or 60 days (at least most of the time). So why are we writing that in the LOI? And then, because we wrote that in the LOI, every month we have to go back to the seller and ask them to agree to extend it in writing.

And, let me tell you, the seller's broker is often happy to say no to the extension and put the deal back on market even if you're highly committed to the deal and already spent $10,000+ on advisor fees.

Instead, what we advise is that you insist that the exclusivity provision stays in effect for the entire duration of the LOI. On top of that, that the LOI only terminates when either (1) the parties sign the definitive agreements, (2) the parties mutually agree to terminate the deal, or (3) the buyer is not approved for financing within 90 days, among other certain circumstances.

This way, you never need to ask to extend the LOI, and you will not only be spared the embarrassment thereof, your close rate will increase.

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Always Mandate Break-Up Fees

At the start of a transaction, it's not uncommon for all of the parties to be rosy-eyed. Everyone is excited about the opportunity, and they only need the 'paper and the process' to finish so they can get what they want.

The problem is that a large number of lower and lower-mid market LOIs don't close in a purchase. This gives you some insight into why business brokers are always in a rush, and always insisting on proof of funds and not allowing for any delay. It's because they've seen what a failed deal looks like before, and they're going to cut this one if it starts showing even one or two signs of failing.

At the start of a deal, when you ask for the seller to pay for your advisory fees under a break-up provision should the deal fall through, the seller or listing broker's typical response is in the negative, or to insist that they are the ones incurring advisor fees and that you should be paying them.

This conversation can be particularly hard for a first-time buyer, who is not yet adept at the ins-and-outs of negotiating an LOI, and who doesn't want to push the seller from signing the LOI.

What we advise is that you (or your advisor) works together with the seller to draft a break-up fee provision that is amenable to both sides. It should protect you from the common ways a seller terminates a deal: (i) the seller unilaterally terminates the transaction, (ii) the seller unreasonably delays the transaction by not responding to due diligence requests or finalizing the purchase agreement, and (iii) the seller causes or allows a material adverse change to the target to occur. If any of those events occur, the seller must pay your advisor fees (and you not theirs).

Don't do a deal without this. You will not only increase your close rate, but you mitigate your cost on failed deals.

Delaware, Delaware, and Delaware

Let's piggy-back on the last conversation point to elucidate this one. Say that the seller in your transaction agrees to the break-up fee provision, but then terminates the deal and refuses to pay it. In nearly all states, this is treated as a breach of contract case and now you need to sue the seller in court.

The problem with that is, in most states, the simplest breach of contract case will take 12-30 months to adjudicate, and at minimum tens of thousands of dollars in attorneys' fees.

You've just been shafted on advisor's fees, and now you're going to spend significantly more than that to try and potentially recover it? That doesn't make much sense, does it?

This is one of the many reasons why M&A professionals use Delaware as the governing law of their deal, the exclusive jurisdiction in which any court case may be brought, and the state of incorporation of their entities.

Because, in Delaware, there is a special court called the Court of Chancery where the judges are on par with the best M&A professionals in their M&A knowledge and experience. They not only can adjudicate your case faster, but they are much less likely to come to a wrong conclusion, and their existing body of law is well developed on every aspect of M&A. Net-net, Delaware will often cost you much less in legal fees because of the speed and competency with which the court operates. Try comparing that with a court in the back country in Alabama, and you'll start to wish you had never brought a case in the first place.

Sellers in these lower and lower-mid market deals always ask (and we mean every time) to use the law of the state in which their business operates. In other words, that could be Alabama, Florida, or even Wisconsin. It might sound like a broad statement, but let me tell you, you will wish you had been in Delaware court (and law) every time. These first-time sellers and their business brokers are just used to using the law of the state in which they do business, so they aren't familiar with the fact that Delaware is even more beneficial to them than the state where they are operating.

Never sign an LOI without breakup fees and without Delaware governing law and exclusive jurisdiction.

Don't Forget the Tax Election

Most of the LOIs brought to us aren't structured correctly, and we have to *start off* the deal by restructuring it. This is a nuisance, but we frequently navigate it with zero to minimal effect on any of the transaction parties.

The problem is when the acquiror forgets to make the correct tax election directly in the LOI itself, and when the tax structure wasn't clearly stated in the CIM. Outside of asset deals, when acquiring an S Corporation, this leaves sellers to assume that you are not making any tax election, and they would be right to assume as much.

However, as an acquiror of an S Corporation, you always want to be doing one of three things: (1) the 338(h)(10) election, (2) the 336(e) election, or (3) an F-Reorganization. We recommend to do an F-Reorganization, because it allows you to obtain a step-up in the tax basis of the target's assets like an asset purchase deal, all the while protecting you from issues related to maintaining the S Corporation status of the target.

Instead of performing the analysis yourself of what structure and election you want to utilize with your specific transaction, what we recommend is instead to insert this blanket language into the LOI:

> "The structure of the acquisition (i.e. asset purchase or equity purchase) shall be proposed to Seller's legal counsel by Buyer's counsel after execution of the Letter. Notwithstanding the foregoing, if the transaction is structured as an equity sale, the Parties agree to treat it as an asset sale purpose for tax purposes either through a pre-closing Formation, Contribution, QSub Election and Conversion tax-free "F-Reorganization" pursuant to Rev. Rul 2008-18, or through a 338(h)(10) or 336(e) election."

LOI Mistakes Are Costly. We'll Prepare Your LOI Without Mistakes For Free.

One of the biggest problems we are dealing with regarding LOIs right now is that many acquirors have become accustomed to preparing their own LOIs. We are even part to blame for that, because we ourselves have been compliant with our clients who request to prepare their own LOIs. It is hard to say no, when the industry trend and many online coaches advise acquirors to shoot out their own simple LOIs, like casting a fishing line in a lake.

But preparing your own LOI, as emphasized in this article, is deceptively simple. It appears easy, but is sufficiently complex not only to waste your time, but to cause you significant trouble later.

This is why we are now advising all of our clients to work with us on preparing their LOI, and we advise you to do the same.

The thing is, it's not even expensive to do so. We aren't even charging for it, as long as you engage us for the acquisition.

ABOUT THE AUTHORS

BUY AND BUILD ADVISORS

SHAPING INVESTMENTS, BUILDING FUTURES

Buy and Build Advisors specializes in comprehensive buy-side financial, operational, and legal due diligence for lower and lower- middle market mergers and acquisitions, ensuring a smooth transition and sustainable growth. Our expert team uncovers critical insights to help you make informed decisions and successfully integrate new businesses.

Learn more at www.buyandbuildadvisors.com or to gain insights into our unique processes and learn how to engage us go to www.dealclosinginsurance.com

David Girault

David Girault is a Senior Partner and Founder of Buy and Build Advisors, offering 35+ years of experience as a strategic and legal advisor and consulting CFO with specialized expertise providing personal and business financial strategies to privately held businesses and their owners.

Regarded as a trusted advisor with significant experience in strategic planning, startups, business transitions/exits, investments, and complex financial management, David is committed to ensuring longevity, security, liquidity, and growth. Over the last 15+ years, David has provided sourcing, structuring and advisory services impacting over $150 million in transaction value, exclusively to lower and lower-middle market businesses.

Prencipe International

Joe Prencipe

Prencipe International is a top-tier M&A legal advisory boutique. With over $100bn in transactions under our belt, we advise acquirors on national and cross-border transactions valued between $5-250m. Firm principal Joe Prencipe previously worked at globally top-ranked M&A law firms, including Freshfields Bruckhaus Deringer LLP and Baker McKenzie LLP. For more details, please visit www.linkedin.com/in/joeprencipe.

Please direct all inquiries for legal services to BBA as we work in partnership.

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