

A photograph of three doors set in a white wall. The two doors on the left are white with silver handles, while the door on the right is a vibrant red with a silver handle. The floor is made of light-colored, distressed wood planks.

7 M&A DOCUMENTS DEMYSTIFIED

A CEO'S GUIDE TO M&A SUCCESS

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Selling a company requires many complicated documents.

These are required regardless of whether you're working with a strategic buyer, financial buyer, lender, or investor.

Expect marketing documents (teasers, confidential information memorandums, private placement memorandums, executive summaries, etc.), information requests (updated financial information, customer contracts, customer data, etc.), and legal documents that must be reviewed carefully before execution.

Preparing, producing, and reviewing all of these documents is an involved process, which is why many business owners retain the help of a banker, broker, lawyer, and accountant.

We suggest you do the same. Still, it's crucial that you as the business owner understand the essential components of key M&A documents in the transaction process.

In this ebook, you will learn:

- How to write great teasers that attract interest from the right buyers
- Marketing materials needed to sell your company
- Three key items to negotiate in the NDA
- How to review the indication of interest (IOI), letter of intent (LOI), and purchase agreement (PA) documents

The Investment Banking Engagement Letter

Choosing the right investment banker is one of the most important decisions when selling your business. The engagement letter is the first step in this process.

The engagement letter is an agreement between the business owner and the investment banker, and outlines the terms and scope of the advisory services provided. It also includes the economic points that go to the heart of the relationship. If negotiated and structured properly, the agreement should align the interests of both parties and properly incentivize the investment banker to close a deal. To successfully negotiate this letter, it is crucial that business owners understand the interests and position of the investment banker.

Here are six key points to cover when reviewing the engagement letter.

1 Fee Arrangement

Typically, investment bankers will charge a non-refundable deposit or retainer plus a success fee based on closing the transaction. This is a common and acceptable practice: The investment banker should be putting a significant amount of work into preparing your company for sale and should be compensated for his/her efforts as the work gets completed. Paying a mutually agreed-upon retainer also shows your level of commitment to the sale process. However, the retainer should never be paid upfront in its entirety.

In order to ensure your interests are aligned, the success fee should be the most significant component of total compensation. The deposit or retainer should be fully credited towards the success fee, which often includes a progressive pricing schedule. Above a certain agreed-upon sale price, the success fee will rise incrementally as the price increases. A progressive schedule provides a strong incentive for the investment banker to help you realize a valuation that exceeds your goals.

To successfully negotiate this letter, it is crucial that business owners understand the interests and position of the investment banker.

2 Exclusivity

Granting exclusivity to an investment banker can feel like a daunting proposition, and there is certainly a risk to doing so.

If a banker does not meet your expectations, it can be a tremendous setback. Not only have you lost time and financial resources, but the transaction has been significantly delayed. Additionally, if and when you go back to the market with a new investment banker, the fact that you were already out in the market and failed to sell could negatively impact potential buyers' views of your company.

That said, nearly all qualified investment bankers will require exclusivity. The sale process can take a number of months, and the banker wants to ensure that his or her time spent preparing your team and offering materials doesn't go to waste. Choosing not to give exclusivity to an investment banker may limit your ability to get a top professional in your corner.

To minimize your risk and ensure that your investment banker is committed, your deposit/retainer should be a small portion of the banker's overall compensation — not nearly enough to pay for total time spent on your deal.

3 Term of Engagement

The term of engagement specifies how long the agreement lasts. Terms usually span 6-12 months, allowing time for your investment banker to prepare a confidential information memorandum, send out summaries to potential buyers, solicit interest, receive offers, and negotiate a deal.

4 Termination and Tail Period

The engagement letter should explicitly state a right of termination after the term of engagement. Generally, the agreement will automatically renew on a monthly basis until canceled in writing by either the business owner or the investment banker. Additionally, it will include a "tail period" — a period of time after termination during which, if a transaction is completed, the investment banker will still be paid. Typically, the tail period will be two years, although business owners can push for a shorter period.

Some investment bankers may try to include the rights to a fee, regardless of whether they introduce you to the ultimate buyer. This is a gray area which you should negotiate with your banker before signing the agreement. For example, if a banker emerges two years later based on your efforts or those of another banker, most would agree it is unreasonable to pay the original investment banker. On the other hand, if the ultimate buyer is someone connected to the original banker, it may be reasonable to pay the original banker (subject to some time constraint). Different agreements may have different definitions of “connected.” At a minimum, you should restrict the buyers who would trigger payment during the tail period to those who received information from the investment banker, expressed interest, and signed a confidentiality agreement. : 6

5 Reimbursable Expenses

An investment banker will incur reimbursable out-of-pocket expenses such as travel, research, and material preparation during the sale process. Make sure the engagement letter allows you the ability to exercise some control over these expenses. It’s typical for the investment banker to provide a monthly report of expenses incurred.

Additionally, the engagement letter should require the investment banker to obtain prior written approval for individual expenses above a certain threshold as well as once an agreed-upon aggregate total expense threshold has been reached. The agreement should explicitly state that violations of these provisions will result in the expenses not being reimbursable.

6 Covered Transactions

A sale process can result in a wide range of outcomes, from selling only a portion of the company for a minority equity position to raising mezzanine capital. In order to ensure that certain transactions are not unintentionally included or subject to inappropriate fee structures, it is important to clearly define the scope of services provided and transactions covered.

For example, while raising mezzanine capital may be a great outcome for you, the fees due to an investment banker for raising mezzanine capital are usually significantly lower than raising equity capital. In the end, negotiating the covered transactions will be unique to your specific situation. Make sure you are balancing a well-defined scope of engagement while maximizing the services of the investment banker to explore all possible outcomes that will satisfy your goals.

Clearly define the scope of services provided and transactions covered.

The Investment Teaser

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6 KEYS TO WRITING GREAT INVESTMENT TEASERS

The investment teaser, or simply, “teaser,” is the first document that prospective buyers will review about your company. The teaser is arguably the most important document in the transaction process.

The teaser is the first filter prospective buyers will pass through before moving forward. The document should help attract the right potential buyers and screen out irrelevant ones — making your sale or financing process simpler and more efficient.

Active strategic buyers typically review more than 250 acquisition opportunities each year and buy approximately 1-2% of them. Private equity firms, because they have a broader and more flexible acquisition criteria than strategic buyers, often review over 500 businesses a year and will often only make investments in up to five of those companies. For business owners and CEOs of companies looking to successfully sell their business or raise growth capital financing, these odds place tremendous emphasis on the quality of the offering materials that you’ll prepare for prospective buyers.

Writing an excellent teaser isn’t rocket science. A teaser provides a bird’s-eye view of your company, and gives potential buyers an overview of your company’s business model, history, financials, and desired transaction.

The goal of the teaser is not to sell your company, but to pique buyers’ interest to find out more.

Here are six tips for writing highly effective teasers.

1 Don’t leave out the basics.

Buyers should have a clear understanding of a company after reading the teaser. Be sure to include:

- How the company generates revenue
- When the company was founded
- Sales and revenue mix of products and/or services
- The various industry categories sold into
- How the company distributes its products/services
- The general background of the management team
- Overall financial profile: three years of historical revenue and EBIT/EBITDA and at least two years of projected revenue and EBIT/EBITDA

The teaser helps you attract the right potential buyers and screen out the wrong ones.

- Four to seven investment highlights that discuss the unique strengths of the company (e.g., market share leader, owns significant intellectual property, three-year historical revenue growth of 20+%, etc.)

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2 Clearly state your goals.

Are you looking for growth capital, an ownership transition, recapitalization, liquidity event, or consolidation of the shareholder base? Are you looking for a hands-on partner to work through important issues or challenges, or are you primarily looking for capital to scale your existing business? Prospective buyers will appreciate business owners who are upfront about their goals and their reasoning for wanting to conduct a transaction. This type of behavior builds a foundation of trust between you and any buyer(s) you decide to engage.

3 Let the hard facts do the talking.

Make sure your teaser is professional in appearance and tone.

- Always use a professional font (e.g., Times New Roman or Arial).
- Send the teaser as a PDF file.
- Do not capitalize words (e.g., AUTOMOTIVE AFTERPARTS SUPPLIER).
- Avoid flowery language and gushing superlatives (e.g., “once-in-a-lifetime business opportunity”) or hyped-up adjectives (e.g., “wildly profitable”) to describe your business. These will hurt your credibility.
- Triple check for flawless grammar and error-free spelling.

4 Tell the truth.

The worst way to start a transaction process is by being dishonest, withholding basic information, or exaggerating the actual or projected financial performance of your company. The odds are incredibly high that buyers will uncover any dishonesty at some stage of the due diligence process. If they do, your credibility will never recover.

Prospective buyers appreciate business owners who are upfront about their goals for a transaction.

5 Keep it concise.

In almost all cases, it's best to keep the teaser to one full page in length. This forces you to be concise and ensure every word is adding value. Buyers review hundreds of acquisition opportunities each year. Make their time count. You want them spending time thinking about how interesting your company is, not trying to understand what your company does and who it serves.

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6 Keep it anonymous.

Never prematurely disclose the name of your company or other identifying information in the teaser. Prospective buyers will review the teaser prior to executing a confidentiality agreement, so make sure they cannot identify your company based on information in the teaser. This will preserve your company's freedom of action, avoid having competitors spread false or damaging rumors, and avoid alarming your employees.

THE ONE CRITICAL ELEMENT EVERY TEASER MUST HAVE

Every teaser must clearly answer the following question:

“What is the source of your company’s competitive advantage?”

The essence of your company’s value is tied to how sustainable its competitive advantage is. Competitive advantage dictates your company’s ability to generate, maintain, and grow profitable operations over the long term. Investors use this outlook as the basis for their estimation for your business’s valuation.

Competitive advantage can have many sources: customer entrenchment and high switching costs (e.g., database software), long-term contracts (e.g., equipment service companies, defense and government contractors), brand recognition (e.g., certain consumer products), intellectual property, devoted and stable management teams, culture, and on and on.

If there are financial buyers evaluating your company, they are going to rely on the sustainability of the competitive advantage to generate a return on their investment. The price they are comfortable paying for the business is directly impacted by how protected the firm’s stream of revenues and profits appears to be. The more protected, the more the buyer is willing to pay to acquire your company. If you want to achieve a high price multiple for your company, you must demonstrate that your company has sustainable growth potential based on competitive advantage.

If there are strategic buyers evaluating your company, they may have most or all of the necessary in-house resources to try to reproduce your company’s products and services. These buyers must decide whether to “build or buy” when evaluating your company. The more powerful and complex they perceive your competitive advantage to be, the more likely they will buy your company rather than attempt to build their own version of your offering.

Note that stating the competitive advantage of your business doesn’t mean explaining or revealing its details or intricacies. The teaser is designed to generate curiosity. Other materials and in-person meetings (which happen after an NDA has been signed) will serve as a better forum to explain your company’s operations and competitive advantage.

The NDA

The first document produced and executed over the course of an M&A transaction is typically a non-disclosure agreement (NDA), sometimes known as a confidentiality agreement (CA). The NDA is designed to enforce confidentiality among buyers, define terms of engagement, limit what can be disclosed to third parties, and dictate other terms to which counterparties must agree.

WHY USE AN NDA?

NDAs are legal documents designed to protect confidential information from being disclosed to a third party, or being negatively used against the party disclosing the information — often a private business. Having an NDA in place makes good business sense. As a business owner or CEO considering the sale of your business, you will need to consider how and when to use an NDA to protect your company.

Perhaps a private equity group has recently approached you to discuss the possibility of selling your company, even though your business is not for sale at the present time. Or perhaps a competitor at a trade show spoke to you about forming a joint venture. It's important that when these situations emerge you have a basic understanding of NDAs, their key elements, and how to use them to protect yourself and your business. Of course, you should always seek the advice of professional counsel when writing or structuring an NDA.

You can find a free [sample NDA template here](#).

ONE-WAY VS. MUTUAL NDAS

NDAs can typically be structured in two formats: a one-way NDA or a mutual NDA. In a one-way NDA, also known as a unilateral NDA, the receiving party of the confidential information is bound to protect such information. For example, if you have been approached by a private equity group, you could require them to sign a one-way NDA; doing so would protect any confidential information you disclose to the private equity group, but you would not be bound if the private equity group disclosed confidential information to you. A one-way NDA protects your information, but not the information of the other party.

By contrast, if a competitor approached you at a trade show, they may require that you sign a mutual NDA. In this case, any confidential information that you disclose, and any confidential information that the competitor discloses, is protected by the NDA.

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Never sign an NDA that does not specifically indicate what constitutes confidential information.

DEFINE CONFIDENTIAL INFORMATION

What constitutes confidential information? The answer is different in many cases.

A proper NDA should clearly define what is considered confidential information and what is not. Never sign an NDA that does not specifically indicate this — you don't want the courts to interpret the decision for you.

Usually an NDA stipulates that any information relating to products, services, markets, customers, research, software, developments, inventions, designs, drawings, financials, and other items is to be kept confidential. Exclusions to confidential information may include information already in possession of the receiving party or information that is in the public domain and can be proven to be public.

DEFINE THE TERM OF THE NDA

The term of the NDA specifies how long the confidential information will be protected. Usually this ranges from one to three years, depending on the nature of the transaction and market conditions.

The term is often where a disconnect occurs between buyers and business owners. While business owners want to protect their information as long as possible, buyers don't want to be bound by an NDA for an indefinite amount of time.

Other important elements of NDAs include:

- **Purpose of disclosing confidential information:** States the specific purpose for which confidential information has been disclosed.
- **Returning or destroying confidential information:** Defines how information is to be returned or destroyed and under what circumstances.
- **Use of confidential information:** Clarifies that information is not to be used for any purpose other than what was set forth explicitly in the agreement
- **Enforceability of entire agreement:** If one section of the agreement were to be found void, the remainder of the agreement survives and is enforceable.
- **Ownership of confidential information:** States which party owns the confidential information.

The Confidential Information Memorandum (CIM)

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Also referred to as the offering memorandum or pitch book, the CIM explains in more detail the intricacies of the company being sold and the long-term value of the business.

Although most business owners realize the importance of investing hundreds of thousands of dollars annually in high-quality marketing materials to sell their products and services, many fail to appreciate the importance of having professionally prepared materials when it comes time to explore an M&A transaction.

Having a robust set of investment marketing materials will have a substantial impact on the success of the M&A process in two primary areas:

1. **Speed:** The more questions answered in your marketing materials, the fewer one-off questions you must answer from a potential buyer. This becomes particularly important the longer your business is on the market. It can be easy to lose momentum as the deal process drags on. By anticipating potential buyers' questions in advance, you make it easier for them to assess their level of interest more quickly — and avoid wasted time on both sides.
2. **Buyer perception:** Human beings are heavily influenced by the appearance of things, and potential buyers are no exception. Presenting your business as professionally as possible in marketing materials is worth the investment. You'll attract more serious buyers, who will likely (consciously or not) be willing to pay more for your business than they would one an equal organization with amateur materials.

WHY DO YOU NEED A CIM?

After a potential buyer signs your NDA, what do you do next? This is where the CIM comes in. The purpose of the CIM is to help a buyer understand your business and the unique strategic investment opportunity it presents.

The components of a CIM vary depending on the company's industry and unique characteristics. Many CIMs contain the following components:

- Executive summary
- Company history
- Sales process and/or manufacturing capabilities
- Management team structure
- Growth opportunities
- Competitive landscape or industry outlook
- Intellectual property overview and/or company assets
- High-level financials (preferably five years of historical data and projections, if available)

Imagine you approach 20 carefully targeted potential buyers. Ten of the buyers express a preliminary level of interest, sign an NDA, and ask for more information. Without a CIM, the next step would be participating in 10 separate conference calls with each buyer, in which you would almost certainly answer some of the exact same questions over and over again. The conference call would lead to more one-off phone calls and emails.

With a CIM, you can accomplish the equivalent of these conference calls, phone calls, and emails with one document. Once a buyer has reviewed the CIM, they can quickly determine if they want to pass or move to the next stage in the deal process, typically a conference call with the business owner. This call will be a more in-depth conversation covering topics like the owner's personal goals, valuation, and desired deal structure.

Buyers will always want to speak with business owners and management over the phone, visit the company in-person, meet the team, and tour the facilities to get a clear picture of your business. But a CIM can and should set the tone for all discussions and set expectations in a transaction. Sharing a CIM is the most productive and efficient way to determine a qualified buyer's level of interest.

Don't make the mistake of thinking you can prepare a high-quality CIM for your company without some sort of help.

SHOULD I HAVE A CIM EVEN IF I'M NOT ACTIVELY SELLING?

Even if you are not actively selling your business, there are several reasons to have a prepared CIM on hand. Creating a CIM often helps business owners uncover issues in the company (e.g., large customer concentration, unscalable processes, or a lack of suitable management expertise in place) that can be corrected before selling the company. The CIM can help owners visualize their business from the perspective of a buyer and identify potential sticking points (e.g., large customer concentration or lack of management expertise) and opportunities for improvement. The CIM can also serve as a useful tool when approaching commercial banks for a loan. Lastly, a good CIM can be used in emergency situations (e.g., your plant burns down, you lose a key manager or owner to illness, major personal financial change of status, etc.).

DON'T GO IT ALONE

Just as you would not put together professional marketing materials for your business without the help of a marketing professional, don't make the mistake of thinking you can prepare a high-quality CIM for your company without some sort of help.

Your options include:

- **Hiring a professional investment bank.** Qualified investment banks have extensive experience building these materials. Ask them for samples so you can get familiar with their work; some banks might be a better fit for your business and style than others.
- **Hire an M&A consultant.** This can be a more economical solution, and allows you to get outside assistance without the expectation that you are planning to sell your business immediately. Before engaging a consultant, ask to speak to references, see specific deals or projects they've worked on, and look at samples of past prepared materials.
- **Work with your CFO.** This is the least expensive option, but can be risky if your CFO doesn't have materials preparation skills. For many small businesses, this is a good place to start. Begin aggregating the key materials, then consider handing them over to a consultant or bank for the final compilation and review.

Committing the necessary resources is key to producing a successful, professional CIM. Buyers will be turned off by incomplete or amateur documentation, and in turn think poorly of your business, low-ball the valuation, or simply ignore you. If you're serious about selling (either now or in the future), your investment in the CIM will pay off.

The Indication of Interest (IOI) : 16

As the M&A process progresses down the funnel and the potential buyer pool narrows, some buyers will provide you with an indication of interest (IOI).

But, what exactly is an IOI? An IOI is a non-binding formal letter written by a buyer and addressed to the seller, with the purpose of expressing a genuine interest in purchasing the company. An IOI should approximate the target company valuation and outline the general conditions for getting a deal done, among other information.

Elements of a typical IOI include:

- **Approximate price range.** This can be expressed in a dollar value range (e.g., \$10-15 million) or stated as a multiple of EBITDA (e.g., 3-5x EBITDA).
- **Buyer's general availability of funds,** including sources of financing
- **Necessary due diligence items** and a rough estimate of the due diligence timeline
- **Potential proposed elements of the transaction structure,** e.g., asset vs. equity, leveraged transaction, cash vs. equity, etc.
- **Management retention plan** and role of the equity owner(s) post-transaction
- **Time frame** to close the transaction

Think of an IOI as the very first written offer for your company. It's usually based on the fairly limited information; the buyer probably hasn't visited your company or conducted any serious due diligence at this point.

As the seller, use the IOI to help weed out tire-kickers, and ensure that you dedicate time and resources only to serious buyers. Look to see that a buyer values your company within your target range and has adequate industry experience to understand the inherent risks and opportunities of your business. If many buyers are expressing interest in your business, the IOI can help you determine the most credible ones.

Often, business owners new to the M&A process confuse an IOI with a Letter of Intent (LOI). These documents, while similar in purpose, are quite different. Read the next section for more information on the LOI.

The Letter of Intent (LOI)

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The letter of intent is a more formal document than the IOI, and outlines a final price and deal structure for your company. Unlike the IOI, which offers a general price range, the LOI provides a final bid for the company in absolute dollar value or as a firm multiple of EBITDA.

The LOI indicates that the buyers would like to engage your company for an exclusive period, during which time the buyer can conduct a full due diligence process. If you accept and execute the LOI, it also prohibits you as the seller from speaking with other buyers. (An IOI does not require exclusivity.)

A buyer doesn't necessarily need to issue an IOI before an LOI. There are many ways of getting a deal done. Some deals obtain IOIs first where other ones go straight to the LOI stage.

Normally, a LOI comes after one to three meetings with a prospective buyer. If you are running a structured sale process soliciting multiple buyers, it's likely that you will have spoken with several suitors and narrowed the prospects to one to four prospective buyers for these more in-depth discussions.

If both the business owner and the prospective buyer(s) are interested in continuing the M&A process, the buyer(s) should submit a letter of intent (LOI) outlining the buyer's proposed deal structure and terms. Receipt of an LOI from a potential buyer is a clear signal that they are serious in their intentions; however, it is not a given that they are fully committed yet. Some buyers try to lock up as many deals as possible, but only close the top three to four.

The LOI should include a summary description of all of the material deal terms that will later appear in the purchase agreement. There are differing schools of thought on how detailed an LOI should be; the document can range from two to over ten pages in length. Some argue shorter LOIs speed up the negotiating process since the parties focus their conversations on the primary terms: price, consideration, and timing. If the parties can't agree on these fundamentals, the logic goes, there's no need to even get into other deal terms. Those in favor of longer LOIs prefer to have all issues addressed upfront and prevent any future surprises (e.g., reps and warranties or treatment of unvested options).

COMMON TERMS IN AN LOI

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1. **Deal Structure.** Defines the transaction as a stock or asset purchase. Generally, the seller prefers a stock transaction from a tax and legal perspective. Asset transactions are preferred by the buyer to protect against prior liabilities and provides a stepped-up tax basis.
2. **Consideration.** Outlines the form(s) of payment — including cash, stock, seller notes, earn-outs, rollover equity, and contingent pricing.
3. **Closing Date.** The projected date for completing the transaction. This date is an estimation and often changes based on due diligence or the purchase agreement.
4. **Closing Conditions.** Lists the tasks, approvals, and consents that must be obtained prior to or on the Closing Date.
5. **Exclusivity Period (Binding).** It is common practice for a buyer to request an exclusive negotiating period to ensure the seller is not shopping their deal to a higher bidder while appearing to negotiate in good faith. Expect to see requested periods of 30 to 120 days. The duration may be negotiable, but the presence of the exclusivity term rarely is.
6. **Break-up Fee (Binding).** A fee to be paid to the buyer if the business owner decides to cancel the deal. Break-up fees are relatively common in larger deals (above \$500 million). The fee can either be a percentage (typically 3%) or a fixed amount.
7. **Management Compensation.** Outlines plan for senior-management post-sale. This term describes who in the management will be provided employment, equity plans, and employment agreement. This term is often vaguely worded to provide the buyer with latitude since they may not be prepared to make commitments to senior management.
8. **Due Diligence.** Describes the buyer's due diligence requirements, including time frame and access.
9. **Confidentiality (Binding).** Although both parties have probably signed a confidentiality agreement at this point, this additional term ensures all discussions regarding the transaction are confidential.
10. **Approvals.** Lists any approvals needed by the buyer (e.g., board of directors) or seller (e.g., regulatory agencies, customers) to complete the transaction.
11. **Escrow.** Provides the summary terms of the buyer's expected escrow terms for holding back some percentage of the purchase price to cover future payments for past liabilities. The escrow is typically highly negotiable and often excluded from the LOI and presented for the first time in the purchase agreement.
12. **Representations and Warranties.** This clause will include indemnifications in the purchase agreement. It is best practice to include any terms that may be contentious or non-standard.

OTHER TERMS THAT MIGHT APPEAR IN AN LOI

1. **Employment Agreements.** This clause typically relates to management compensation, but may also include agreements with favored or long-time employees. (Note that requiring the buyer to provide employees with employment agreements, maintain current compensation structure, etc., may fall outside the buyer's standard post-deal integration practices. The buyer may simply refuse or require the seller to compensate accordingly.)
2. **Retention Bonuses and One-Time Payments.** Like employee agreements, buyers may not want the additional administrative or financial responsibility.
3. **Option Pools.** Treatment of unvested options, vested but underwater options, etc., are not standardized practices in an LOI. Buyers may opt to honor current option plans by converting them into their plan or a similar structure.
4. **Fees.** Generally, the party that incurred the charges pays the fees — but there are circumstances where ambiguity is possible. For example, if the buyer requires reviewed or audited financial statements from the seller and the deal does not close, then the seller may want the buyer to pay the audit fee.

While the LOI is not binding and the transaction terms will be finalized only in the purchase agreement, it is a best practice to include all critical terms in the LOI. Inserting terms into the purchase agreement that were not included in the signed LOI is not uncommon, but it can come at a price.

For example, if you have employees who do not hold equity but you want them to receive a payment at closing or an extended employment contract, that should be in the signed LOI. If you have issues that may impact valuation or a buyer's decision to close the transaction (e.g., unresolved equity disputes or litigation), it is best to disclose these issues prior to signing the LOI. It's better to get in front of these issues in the LOI stage than to have them discovered in due diligence.

The LOI is an important milestone in the successful sale of a company. If you have not engaged an M&A attorney yet, now is the time to add one to your deal team. Similarly, you should consult with your tax accountant and wealth manager regarding the ideal deal structure before signing the agreement. Professional investment bankers can also help make sure you receive the best deal.

The Purchase Agreement

Once the LOI is signed, the next major legal document is the purchase agreement. This document incorporates terms agreed upon in the LOI as well as new terms and conditions (e.g., indemnification provisions) and will be the reference point post-transaction.

While an attorney should be involved in the interpretation and navigation of this document, the seller is bound by the purchase agreement's terms and therefore must not delegate it out entirely. This commitment will involve a lot of time and help from your M&A advisor and your M&A attorney, but it is crucial to a successful outcome.

The following sections represent most of the common material terms found in a standard purchase agreement. Since each transaction is unique, yours may include other provisions that are equally important to those outlined below. The sections are ordered as they are generally found, but it varies by legal counsel and the other authors of the agreement.

DEFINITIONS

This section may seem basic, but it is perhaps one of the most important aspects of any purchase agreement. Every term or word found in the purchase agreement that is capitalized is considered a defined term and should be found in the Definitions section. Material terms such as Adjusted EBITDA and Net Working Capital that are especially subject to multiple and highly varied interpretations should be clearly and concisely defined.

Any person reading the purchase agreement, whether involved in the process or not, should be able to read a given definition and have no doubt as to its meaning. Poorly written or vague definitions can become a problem should buyers and sellers disagree on the amount of a post-closing working capital adjustment, earn-out calculation, or purchase price adjustment. For example, does Net Working Capital include only trade receivables? Does Adjusted EBITDA include or exclude "market" adjustments to retained seller's salaries? If you don't nail these issues down, and the transaction is subject to post-closing adjustments, there may be major disagreements down the road.

Vague or poorly-worded definitions can lead to major disagreements down the road.

ECONOMIC TERMS

This section of the purchase agreement details the purchase price, payment mechanics, earn-outs, escrows, and purchase price adjustments. Ideally, these terms will be introduced and agreed upon in the LOI — but it is not uncommon for one or more to appear post-LOI.

The purchase price is traditionally a combination of cash, buyer's stock, or seller financing. If the buyer is a public company, then this is where the mechanics of how the buyer's stock will be valued (e.g., average closing price on NYSE for the 10 days prior to the closing date).

Earn-out targets, escrows, and purchase price adjustments are typically the largest sources of negotiating friction. If earn-out targets were not included in the LOI, then discussions on how to calculate the target, the future result, and the amount of the earn-out can significantly delay closing or halt the process entirely.

Buyers request escrows to cover potential future claims against the seller post-closing. Related conflicts generally regard the amount (it is standard to express the amount as a percentage of total purchase price), the escrow period, the frequency of fund releases from escrow, or definitions related to materiality of claims and types of claims.

Purchase price adjustments may be tied to agreed net working capital delivered at closing, meeting future financial goals (e.g., “EBITDA did not decline more than 5% in first twelve months post-closing”), or other benchmarks.

REPRESENTATIONS, WARRANTIES, AND SCHEDULES

Sellers and buyers ask each other to state that certain conditions and facts are true at the time of sale; however, the seller's disclosures to the buyer far exceed the buyer's. It is in this section of the purchase agreement, and the following indemnification, that sellers will rely heavily on their counsel to protect their interests.

There are at least three material issues your attorney will be negotiating for you: who will make the representations on behalf of the seller, for what period(s), and definitions of the terms “materiality” and “knowledge.”

Sellers should try to cut the section back as much as possible as its language can open management or shareholders to personal liability post-closing. As might be expected, few non-management shareholders are willing to accept that risk. Your counsel and intermediary can also help to try to reduce the number of required disclosure schedules and level of detail provided.

While any section may require a supporting schedule, the representations and warranties sections generally require the majority of these schedules. Generally, a purchase agreement will include a “Schedules” list or table of one to two pages. To the uninitiated this may appear to be a rather benign request. However, such schedules can be the source of hours spent researching and compiling spreadsheets and materials to place into due diligence to support the schedules.

INDEMNIFICATIONS

Indemnifications define which actions caused by one party can damage the other, and are heavily weighted towards protecting the buyer. Generally speaking, the buyer is trying to protect against future liabilities that result from seller’s actions pre-closing and contractually require the seller to agree to compensate them for damages.

Friction points in negotiating indemnifications are found in issues like: the breadth of actions covered, who must provide the indemnification, how long the indemnification period lasts, caps on damages, relationship to escrow, and materiality of claims. Examples of indemnified actions include intellectual property, taxes, employment matters, and securities issues.

Buyers and sellers may negotiate a discrete indemnification period and damages cap for each of these items, though some areas (e.g., tax) are almost always uncapped. Buyers may ask that management and material be held accountable for paying indemnified damages. Sellers will generally work to limit who is making the indemnification, ask for a cap on damages of no more than the escrow amount, and limit the indemnification period to no more than the escrow period.

Lastly, indemnified items may be subject to a deductible and to a materiality standard. If the claims never exceed a certain amount, the buyer pays the claims. Disagreements over indemnification provisions are common, so it is critical to review this section early in the process.

INTERIM AND POST-CLOSING COVENANTS

Interim and post-closing covenants detail how the seller and buyer promise to conduct business before and after the transaction. Sellers are often surprised by the number and specificity of the interim covenants. Standard requirements include not hiring any new employees, not granting any bonuses or salary increases, and not making purchases greater than \$10,000. These covenants reflect the fact that the buyer has valued the seller’s business based on the operations and numbers as of the LOI date (or earlier), and expects to receive a business very little changed from that decision date.

Post-closing covenants may also include non-competes, transition services, and ongoing D&O insurance for former management and directors. Non-competes are highly negotiated and may vary greatly between individual sellers. They are also highly variable in allowable terms depending on the seller's state of residence.

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CLOSING CONDITIONS

The simplest description of closing conditions is a list of items or events that must be completed before each party signs on all of the deal documents. Closing conditions may include regulatory approvals (e.g., government-issued licenses or permits which are often non-transferrable or require long lead times to transfer), written consents from all seller landlords (even for stock sales), written consents from customers and vendors where the seller's agreement with them did not include a change-in-control provision or still requires written consent, etc. The seller's attorneys and intermediary help coordinate activities needed to meet closing conditions by the targeted closing date. It is possible to close without satisfying all conditions at the complying parties' discretion, but expect an associated fee.