GODFREY & KAHN S.C.

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THE MORE THINGS CHANGE, THE MORE...

Combining the tailwinds of readily available capital and a deep bench of privately-held sellers looking to exit businesses with the uncertain impacts of coronavirus, the upcoming U.S. elections and other macro trends, we expect middle market deal flow to continue at a relatively robust pace in 2020. If this trajectory holds, 2020 would continue the longest cycle of uninterrupted M&A activity in our firm's 60+ year history (as we write this, a "knocking on wood" sound can be heard through our offices...). Comparing the current cycle to its predecessors, certain constants emerge. Among these are the seemingly humble letters of intent—one of the most useful, and too frequently neglected, tools in the dealmaker's toolkit.

Letters of intent, term sheets and memoranda of understanding (LOIs) are preliminary documents entered into during the early stages of a transaction, outlining the economic terms for the deal and any non-economic terms that the parties feel warrant a (non-binding) meeting of the minds early on. LOIs are typically executed prior to the parties undertaking the bulk of their due diligence efforts (at a minimum, the buyer has probably reviewed high-level financial information as a basis to formulate its offer) or exchanging drafts of definitive transaction documents, each of which quickly drives up transaction costs.

THE DEAL LAWYER'S VIEW OF LOIs

1. ***Solidifying the buyer's valuation***. While LOIs are generally non-binding, it is in the seller's best interest that the valuation included in the LOI be as precise and fully-informed as is practicable under the circumstances.

    - *Precision*: Most businesses are bought and sold "cash free, debt free," and subject to the assumption that the business will be delivered to the buyer at the closing with a historically supportable level of non-cash working capital. The intent of the working capital requirement is that the buyer can step into ownership of the business and operate in the ordinary course, without the requirement of a near-term capital infusion above and beyond the purchase price. Within these broad parameters, there is significant room for interpretation. For example: (1) Is the buyer's valuation fixed, or variable based on how the seller's financial metrics (likely EBITDA) track between the LOI signing and closing? (2) What is included within "debt" (all parties would concede this includes bank debt, more disagree as to certain capitalized leases or "debt-like" items)? (3) Most frequently, what are the parties' respective views of the requisite level of non-cash working capital – in particular, where the seller's business is in the midst of significant growth (or retraction) or has cyclicality (seasonal or other) issues?

    - *Fully-Informed*: At its simplest, the more diligence the seller is willing to permit the buyer to undertake before the LOI is signed, the less "wiggle-room" the buyer will have to renegotiate the transaction terms later in the process. Timing of customer calls and environmental diligence are commonly the most contentious issues at this stage.

2. ***What is paid, when, by whom, and how?*** If the buyer is paying all cash at the closing, this is a non-issue. But short of that – which is more the rule than the exception – the buyer and the seller will move forward post-LOI with more certainty if the terms of payment are spelled out in detail. For example:

    - Will a portion of the purchase price be escrowed or subject to a buyer holdback? Many sellers view these choices as relatively interchangeable at the LOI stage and often overlook the exposure they have to the buyer's creditworthiness post-closing if a holdback is used.

    - If an earnout is proposed, a host of planning considerations are raised, including: (1) Is the trigger for achieving the earnout revenue or earnings-based? (2) Is the earnout target capped or uncapped, and what impact will this have on the seller's tax result? (3) What title and authority, if any, will carryover management have in the business's operations post-closing in furtherance of achieving the earnout, and will their incentives run in favor of the prior or new owner?

    - If post-closing payments are proposed – whether by means of a note, earnout or other – will the buyer's obligation be guaranteed or collateralized in some fashion? Many sellers overlook or defer undertaking diligence of the buyer's ability to finance the transaction at the LOI stage of negotiations.

3. ***Anticipate multi-party negotiations***. Sometimes the seller is so focused on negotiating the terms of the transaction, it can lose sight of a potential roadblock that needs to be addressed – the post-closing salary, bonus, equity incentives and other terms for key management. If the seller elects to defer the negotiation of these terms until after the LOI is signed, it does so at the risk of uncovering a material gap between the buyer's and management's expectations. Just as relative leverage shifts from seller to buyer after the LOI is signed, the same can be said of the leverage held by key management (regardless of whether they realize it and/or would be willing to exert it). Sellers concerned with this multi-party dynamic might choose to have management term sheets negotiated in a parallel track to the seller's LOI. Similar planning could be considered if the seller's business has key suppliers or customers whose consent is legally (or practically) required for the business to transfer to a new owner.

4. ***Confidential negotiations and process***. Given the potential consequences to the seller if news of a potential transaction is leaked prior to signing and/or closing, the seller should negotiate a free-standing non-disclosure agreement with potential buyers and give careful consideration to how those in the buyer group (e.g., affiliates and advisors) are bound by the direct signing party's NDA. In a non-disclosure agreement, sellers can delineate in detail which parties the buyer may inform of the transaction, what remedies are available to the seller in the event of a breach, and the duration of the buyer's confidentiality obligations (which may, under appropriate circumstances, "reset" as of the LOI signing if the NDA was signed at a time months, or in some cases years, earlier). Sellers should take care to avoid an interpretation that the LOI has somehow superseded previously executed NDAs between the parties (see so-called "merger" or "integration" clauses). Sellers should also review whether the parties who signed prior NDAs are different from the proposed buyer in the LOI (i.e., whether an affiliate or new subsidiary entered the picture as the proposed buyer who was not contemplated by the non-disclosure agreement signed earlier).

5. ***Exclusivity opt-outs***. Exclusive negotiation periods tend to range from 30 to 90 days from the LOI signing date, depending on relative leverage. Sellers who have alternatives to the contemplated transaction (or who want to maintain the perception they do) should attempt to negotiate for early termination of exclusivity if the buyer proposes a material adverse change to the LOI terms, such as a reduction in valuation or change in payment terms (e.g., substituting a seller note or earnout for cash) that is unsupported by new, material facts discovered during the buyer's due diligence after the LOI is signed.

6. ***Who are we dealing with?*** The dialogue that occurs during LOI negotiations is crucial to aligning key terms and the tenor of the negotiation to the parties' objectives. How do the parties view the valuation and other key terms, and who has ability to walk away from the deal? For a variety of reasons, sellers often overstate their desire to continue operating their business after closing, even to their advisors. If the buyer is proposing off-market terms at the LOI stage, is the buyer doing so because it perceives that it has leverage, or is it inexperienced? If the latter, how might that behavior affect the balance of the negotiations?

(THOUGHTFUL) LOIs SAVE TIME AND $$$

If used properly, LOIs are an effective means to filter deals that close from those that drain time, money and other critical resources. In our experience, parties who skip the LOI stage, or rush through and fail to give it the necessary attention, do so at their own peril.

For more information on LOIs, or to learn how Godfrey & Kahn can help with your next transaction, contact our Corporate Law Practice Group.

ADDENDA

Timeless client service has always been at the core of our culture.

There are several tales around Godfrey & Kahn about how, prior to iPhones, laptops and remote access, our attorneys would go to great lengths to get into the office to answer our clients' calls. One such tale involved Dudley Godfrey hitchhiking to the firm with a snowplow driver during a blizzard in the 1960s. Chuck Vogel, a senior shareholder on our Corporate team, tells the story of a time he tried unsuccessfully to get his 1973 Camaro (sweet!) through the snowy streets of Milwaukee, so he too hitched a ride to work, in hopes of impressing his colleagues with his dedication. When Chuck walked through the door, he realized that not only was he the last attorney to arrive that day, but a colleague whose leg was in a full cast was already at his desk grinding away on the day's work.

UPCOMING EVENTS

Labor & Employment Law Seminar

March 10, 2020
Discovery World | Milwaukee
7:30 a.m. – 12:00 p.m.

For more information on our events, visit www.gklaw.com/events.

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To date, our deals have spanned across all 50 U.S. states and 34 countries:

Through our TERRALEX network, clients benefit from our long-standing relations with other law firms around the globe.