Setting the Wheels in Motion

Why a Letter of Intent is Necessary in a Business Transaction

At VR, a letter of intent is drafted between the buyer and the seller before a definitive agreement can be made in a business transaction. Many people don't understand the purpose of what a letter of intent does, nor do they understand its importance. Any serious buyer of a business not only should be using representation of a VR business intermediary, but should have a letter of intent drafted; no matter what size business is involved.

A letter of intent is a pre-contractual written agreement that defines both the buyer and seller's preliminary understandings of what is about to be engaged in contractual negotiations. It is not a binding agreement, but crystallizes the basic terms of the transaction. It is drafted after the terms have been the subject of only oral negotiations between the parties that the VR business intermediary has facilitated.

The letter of intent sets forth:

- The proposed structure of the transaction;
- The price and how it will be paid;
- The terms of notes or stock to be conveyed as part of the price;
- Special accounting or tax considerations, etc.

More importantly, the letter of intent establishes the pre-conditions for completing the transaction between the buyer and seller, which includes the conclusion of due diligence and execution of the purchase agreement.

Letters of intent are usually executed after the buyer has completed its basic financial due diligence but before it embarks on its major legal due diligence. This timing reduces the likelihood of incurring substantial expenses before the parties have reached an agreement in principle about basic business terms.

Every VR business intermediary will have both parties use a letter of intent for three reasons:

Binding Provisions Give a Clearer Understanding
Experienced buyers do not want to waste time while the seller considers other potential buyers. Therefore, the letter of intent should include a no-shop agreement, which requires that the seller refrain from negotiating with others for a specified period of time.

Saves Time and Money Prior to Due Diligence
Both parties will spend a substantial amount of time and effort to not only complete due diligence but draft a purchase agreement. The buyer and seller must have a clear understanding of the basic terms of the business sale before going forward. Either side has a lot to lose financially if a letter of intent is not drafted. This ensures what the foundation of the deal will center around, and gives the parties peace of mind in moving forward with negotiations.

Creates a Good-Faith Commitment
Although the letter of intent is not a binding agreement, it creates a moral commitment to consummate the transaction in accordance with the terms that are outlined. Once the letter of intent is executed, there is motivation to proceed forward in making the deal work.

If you are looking to sell your business or become an owner, click here to speak to a VR business intermediary in your area.