NEXT CHAPTER WEALTH

Reading the LOI

Seven traps hidden in the standard Letter of Intent, and how to defuse each one before signing exclusivity.

A practitioner guide for owners reviewing a Letter of Intent

nextchapterwealthadvisors.com

The LOI is where seller leverage ends

> *The Letter of Intent is the cliff edge. Before you sign, you are negotiating with a market of buyers. After you sign, you are negotiating with one buyer who knows the rest of the market just went home. Every dollar and every favorable term you want from the transaction has to be captured before the LOI is signed, because the structural terms in the LOI become the floor and the ceiling of what gets to the wire.*

This guide walks the seven most expensive traps that show up in standard mid-market LOIs, what each one quietly costs, and the specific defuse language that protects the seller.

TRAP 1

The working capital target with no methodology

The LOI states a working capital target without defining how the target was calculated, which months go into the trailing average, what counts toward working capital, and what is excluded. The buyer-side calculation at closing will surface a deficit, and the price will be reduced by the deficit dollar for dollar. Most undisciplined LOIs hide a $400K to $1.2M haircut here.

HOW TO DEFUSE

Insist that the LOI specify: the methodology (trailing 12 months or trailing 3 months average), the exact line items that count and the line items that are excluded (deferred revenue, accrued bonuses, capital leases), and the convention (debt-free / cash-free or otherwise). If the buyer resists committing the methodology at the LOI, the actual peg is a moving target.

TRAP 2

Exclusivity with no diligence deadline

"Exclusivity for 90 days" with no specific milestones for what the buyer must accomplish. The buyer's incentive becomes to drag diligence and renegotiate as the seller's patience erodes and the other buyers move on. Re-trades become possible because the seller has no credible threat of returning to the market.

> **HOW TO DEFUSE**
>
> Set exclusivity at 60 days with a 30-day extension only if the buyer is acting in good faith and has hit specific milestones (signed engagement letter with QoE firm, financing letters delivered, definitive draft circulated by day 45). If the buyer misses a milestone, exclusivity terminates and the seller can re-engage the market.

TRAP 3

Earn-out tied to vague metrics

The LOI proposes an earn-out tied to "post-close EBITDA" without defining how post-close EBITDA will be measured, what add-backs are permitted, what corporate overhead the buyer can allocate, and what governance the seller has over operating decisions that drive the metric.

> **HOW TO DEFUSE**
>
> Demand that the LOI specify: the EBITDA definition (matching the pre-sale CIM definition), a cap on corporate allocations, governance rights for the seller during the earn-out period (board observer, veto over discretionary capex), and a true-up mechanism if buyer actions materially shift the metric. Then risk-adjust the headline earn-out by 30 to 60 percent in your own thinking. Earn-outs achieve roughly 50 percent of stated value on average.

TRAP 4

Indemnification cap with no rep and warranty insurance

The LOI proposes an indemnification cap of 15 to 25 percent of purchase price and no rep and warranty insurance. The seller's exposure runs for 18 to 36 months post-close on a meaningful slice of the proceeds, with the practical risk that one indemnity claim wipes out the escrow and reaches into the seller's pocket.

HOW TO DEFUSE

Push for the deal to be insured with a rep and warranty insurance policy, with seller-side liability capped at 0.5 percent to 1 percent of purchase price for general reps. The insurance premium (1 to 3 percent of policy limit) is typically split or paid by the buyer. Insured deals are now the market standard above $40M of enterprise value.

TRAP 5

Rollover equity at the buyer's stated value with no governance

The LOI requires the seller to roll 20 percent of proceeds into the buyer's holding company at the buyer's stated valuation. The seller has no liquidity rights, no minority protections, no information rights, and no clear path to a second exit. The "20 percent of headline value" becomes locked-up paper at risk.

HOW TO DEFUSE

Negotiate liquidity through tag-along rights at the next exit, anti-dilution protection, quarterly financial reporting, and a put option after a defined period at fair market value. If those are off the table, treat the rollover as a 100 percent at-risk investment in a single private company and discount your perceived value accordingly.

TRAP 6

Debt-like items defined later

The LOI is "debt-free, cash-free" but never defines what debt-like items will reduce the purchase price at closing. Buyers will later argue that capital lease obligations, accrued bonuses, deferred revenue, severance accruals, and contingent tax liabilities are all debt-like. Each item shaves the wire by hundreds of thousands.

> **HOW TO DEFUSE**
>
> Insist that the LOI list every category of debt-like item that will reduce the purchase price, and explicitly state that no item not listed will be added later. Get tax counsel and M&A counsel reviewing the list together. The owner who skips this step is the owner who is surprised at closing.

TRAP 7

Seller note with no priority and a long tail

The LOI proposes a seller note for 10 to 20 percent of purchase price. The note is subordinated to senior debt, carries below-market interest, and has a five to seven year term. If the business hits trouble post-close, the note becomes a residual claim against an over-leveraged platform.

> **HOW TO DEFUSE**
>
> Negotiate market-rate interest (or higher to compensate for subordination), a personal guarantee from the buyer's principals where possible, acceleration on change of control, and security interests in specific assets. Discount your perceived value of the seller note by 25 to 40 percent given subordination and credit risk.

The pre-LOI principle

The LOI is the wrong place to negotiate. By the time it is on the table, the seller has already given up the best leverage of the entire transaction by going exclusive. The right place to handle these seven traps is in the IOI rung and the management meeting rung, by:

- Asking each IOI submitter how they propose to address each trap before they advance to management meetings.

- Pushing finalists to commit to seller-friendly term structures as a condition of getting to the LOI rung.
- Drafting a seller-side preferred LOI template in advance, with M&A counsel, that you push at the buyer rather than receive from them.

The owner who reads this guide for the first time the day the buyer's LOI arrives in their email is already too late. The owner who has internalized these seven traps before the IOI rung is the owner who walks away with the structure they wanted.

The free tools that prepare you for the LOI

The Valuation Calculator gives you a defensible range to compare incoming IOIs against. The Business Readiness Scorecard surfaces the structural issues that buyers will turn into LOI levers. Both are 5-minute reads at **nextchapterwealthadvisors.com**.