

Typical Red Flags in Letters of Intent (LOIs) During Mergers and Acquisitions



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When navigating the complex world of mergers and acquisitions (**M&A**), the **Letter of Intent (LOI)** is often the first significant document exchanged between the buyer and seller. While typically **non-binding**, an LOI sets the tone for negotiations and reflects the seriousness and intentions of both parties. For sellers, identifying red flags in an LOI can help avoid pitfalls later in the process, while buyers must ensure clarity and fairness to build trust.

In this article, we outline the **most common red flags in LOIs**, offering essential insights for both buyers and sellers to navigate M&A negotiations effectively.

1. Overly Vague Terms and Ambiguities

Red Flag: Unclear language or undefined key terms.

An LOI should balance **detail** and **flexibility**. However, overly vague terms—such as “*reasonable*,” “*industry standard*,” or “*subject to further discussion*”—can lead to misunderstandings and disputes. Ambiguity allows one party to reinterpret the LOI to their advantage during negotiations.

Example:

If an LOI states, “*The purchase price will be determined based on standard industry metrics*,” without specifying the metrics or methods, it leaves room for conflicting interpretations. The seller may expect a **revenue multiple valuation**, while the buyer might lean toward an **EBITDA-based valuation**.

What to Do:

Ensure key terms like **purchase price**, **payment structure**, and **timelines** are clearly defined. Both parties should agree on **valuation methods**, **metrics**, and any **contingencies** upfront.

2. Excessive Exclusivity Periods

Red Flag: Long or open-ended exclusivity clauses without clear deadlines.

Most LOIs include an **exclusivity period** (also known as a “*no-shop*” clause), during which the seller agrees not to negotiate with other potential buyers. While some exclusivity is standard, excessively long periods can tie up the seller unnecessarily, reducing leverage and delaying alternatives if the deal falls through.

Example:

An LOI stipulating a **6-month exclusivity period** without progress checkpoints can hinder the seller, especially if the buyer slows down **due diligence**.

What to Do:

Negotiate a **reasonable exclusivity period** (typically **30-60 days**) with built-in **milestones** for progress. For example, exclusivity can be conditional upon the buyer completing due diligence within a set timeframe.

3. One-Sided Binding Provisions

Red Flag: Overly restrictive obligations imposed on one party with no reciprocal commitments.

While LOIs are typically **non-binding** regarding deal completion, certain provisions—like **confidentiality, exclusivity, and breakup fees**—are often binding. Red flags appear when these terms are heavily one-sided, favoring one party over the other.

Example:

An LOI may state that the **seller must cover all legal fees** if the deal falls through, regardless of cause, while the buyer faces no penalties for walking away.

What to Do:

Ensure that **binding provisions** are **fair** and **mutual**. If the LOI includes **penalties** or **breakup fees**, they should apply equally to both parties if either fails to uphold their commitments.

4. Unclear or Unfavorable Payment Terms

Red Flag: Vague payment structures or heavy reliance on earn-outs or long seller note periods.

The **payment structure**—whether it's **all-cash, stock, or a mix**—should be clearly defined in the LOI. Red flags include vague language around **deferred payments, earn-outs** (where part of the payment depends on future performance), or excessive contingencies that reduce the seller's certainty of getting paid.

Example:

An LOI outlining a **\$10 million deal** but specifying that **\$6 million** is contingent on future

revenue milestones over three years exposes the seller to unnecessary risk if the metrics aren't well-defined or attainable.

What to Do:

Clarify the **amount**, **timing**, and **conditions** of payments. If earn-outs are involved, ensure **performance targets** are **realistic**, **specific**, and **measurable** to avoid disputes post-closing.

5. Lack of Clarity on Due Diligence Scope

Red Flag: Vague or overly broad due diligence requirements.

Due diligence is a critical phase in any M&A deal, where the buyer reviews the seller's **financials**, **operations**, and **legal matters**. However, an LOI with undefined or overly broad due diligence clauses can lead to endless requests, delays, or even **fishing expeditions**.

Example:

An LOI stating the buyer has the right to conduct "*comprehensive due diligence on all aspects of the business*" without time limits or defined scope can overwhelm the seller and slow down the process.

What to Do:

Outline a **specific due diligence timeline** (e.g., **30-45 days**) and define the **scope**—such as **financial records for the past three years**, **legal contracts**, and **key operational data**—to keep the process efficient and focused.

6. Absence of a Clear Timeline

Red Flag: No deadlines for key milestones like due diligence, contract negotiation, or closing.

Without a **defined timeline**, deals can drag on indefinitely, causing frustration, resource drain, and potential loss of alternative opportunities.

Example:

An LOI stating, "*The parties will work towards closing the transaction in due course,*" provides no concrete timeline, allowing either party to stall without repercussions.

What to Do:

Include **specific deadlines** for major milestones, such as:

- **Due diligence completion:** 30 days from LOI signing
- **Drafting of the purchase agreement:** Within 15 days after due diligence
- **Target closing date:** No later than 90 days post-LOI

7. Overly Broad Non-Compete or Restrictive Covenants

Red Flag: Non-compete clauses that are too broad in scope, geography, or duration.

While **non-compete** or **non-solicitation** clauses are common, they should be **reasonable** and **specific**. Overly broad restrictions can unfairly limit the seller's future business opportunities, even if the deal doesn't close.

Example:

An LOI that prohibits the seller from engaging in **any related business worldwide** for **five years**, even if the deal falls through, is excessive.

What to Do:

Negotiate **reasonable limitations** on **scope** (specific industries), **geography** (regions where the buyer operates), and **duration** (typically **1-2 years**).

8. Missing or Weak Confidentiality Clauses

Red Flag: Lack of strong confidentiality provisions protecting sensitive information.

M&A discussions often involve **sensitive financial**, **operational**, and **proprietary information**. If the LOI lacks strong **confidentiality clauses**—or worse, omits them entirely—it opens the door for misuse or unauthorized sharing of information.

Example:

An LOI without a **confidentiality clause** could allow the buyer to share **sensitive financial data** with competitors or use it as leverage in future negotiations.

What to Do:

Include **robust confidentiality provisions** ensuring all shared information remains **private**, regardless of whether the deal closes.

9. Inflexible or Unreasonable Conditions Precedent

Red Flag: Excessive or unrealistic conditions that must be met before closing.

Conditions precedent are events or actions that must occur before a deal can be finalized. When these conditions are too numerous or unrealistic, it signals a **lack of commitment** or an attempt to **renegotiate terms** later.

Example:

An LOI requiring the seller to secure **multiple third-party approvals** or meet **unrealistic financial performance targets** before closing gives the buyer an easy exit if desired.

What to Do:

Ensure that conditions are **reasonable, achievable, and clearly defined**. Both parties should agree on essential closing conditions and avoid unnecessary hurdles.

10. Ignoring Working Capital Considerations

Red Flag: Failure to address working capital in the LOI.

Working capital is a key component in M&A transactions, representing the operational liquidity available to run the business. If working capital expectations are not clearly outlined in the LOI, it can lead to disputes during the final negotiations or at closing.

Example:

An LOI that specifies the purchase price but omits any mention of **working capital adjustments** can create confusion. The buyer may expect a certain level of working capital to be included in the purchase price, while the seller might assume any excess working capital is theirs to retain.

What to Do:

Clearly define **working capital targets** and **adjustment mechanisms** in the LOI. Both parties should agree on the **baseline working capital level** and how any deviations will affect the final purchase price.

Conclusion

A well-crafted LOI serves as a **blueprint for successful M&A negotiations**, but identifying red flags early can save both buyers and sellers from costly mistakes. By focusing on **clear terms, balanced payment structures, fair exclusivity clauses, and defined due diligence scopes**, parties can foster **transparency** and **trust** for smoother transactions.

In the high-stakes world of M&A, **details matter**. Working with a knowledgeable, professional team of experts in the field is vital to avoid costly mistakes and guarantee a smooth transaction.

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