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Why Exclusivity Periods Are Scary and How Sellers Can Minimize Risk

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If you're selling a private company, there will almost inevitably come a time in the deal process when the potential buyer demands an exclusivity phase. "Virtually every deal goes into a no-shop phase," says Michael Shaw, the chairman of the business and finance group at Chicago-based law firm Much Shelist, where he focuses on M&A and private equity.

We talked to Michael about what can go wrong during no-shop periods, how sellers can mitigate risk, and more.

MMR: Are there any exceptions when it comes to no-shop phases?

Michael: The more competitive the deal, the more the buyer wants to have exclusivity. The only exceptions we see are where the seller has enough leverage that he or she can refuse the demand for exclusivity.

We see this sometimes in an auctioned deal with a lot of interested buyers. A seller may say, "No, I won't give you exclusivity," or "I'm going to run a couple of processes simultaneously and the first to the finish line wins." That does scare off a lot of buyers, especially of lower middle market and middle market companies — most buyers aren't willing to spend the time and resources for those type of deal sizes and take the risk that the seller will sign up with someone else. So it's pretty uncommon, but there are cases where the seller has enough leverage to make it happen.

The other exception is if the deal is so proprietary that none of the parties are really worried about the seller shopping it around elsewhere.

MMR: What's the typical length of time of a no-shop period?

Michael: Buyers want exclusivity periods to be long, and sellers want them to be short. The typical period of time we see is usually 45 to 75 days.

It has to be long enough that the buyer is comfortable that it can run its process — do due diligence, negotiate a purchase agreement. From the seller's standpoint, it has to be short enough that a buyer can't tie them up forever. I've certainly seen shorter and I've seen longer, but 45-75 days is the sweet spot.

MMR: When does the exclusivity period typically begin?

Michael: Typically it's a binding part of the letter of intent. It makes sense because both sides want to have enough information to know there's a good likelihood that they're going to do a deal. I have seen it done prior to a letter of intent. But it's a trickier situation, because a seller doesn't like to give the exclusivity if they don't know all the material deal terms and don't know how likely it is that a deal will happen.

MMR: What's the biggest risk for sellers of no-shops?

Michael: The biggest risk to the sellers is that the buyer is not moving things forward in good faith. It may be clear the deal likely will not be consummated, but the seller is still stuck with the exclusivity and has to wait out the period. The seller is not getting the deal done, and it can't renew shopping itself around until the end of that period. In those circumstances, any buyer that's worried about their reputation will generally let the seller out of the exclusivity, but that doesn't always happen.

MMR: How can sellers minimize risk?

Michael: Probably the best way I have found to protect the seller is to create milestones within the exclusivity period. If the buyer doesn't hit those milestones, the seller has the right to get out of the exclusivity. For example, the buyer must complete their due diligence by a particular date or deliver a draft purchase agreement by a particular date. That way if the deal doesn't stay on track the seller has the right to get out of exclusivity.

The other way is through breakup fees, which are often mutual breakup fees. But I think those were more popular years ago — I don't see nearly as many now. Breakup fees allow the seller to at least recoup the fees and expenses that it's been paying as well as the opportunity costs of not shopping around the company in the case the buyer calls off the deal. But they're hard to enforce, and you can spend so much time negotiating the nuances of the breakup fee that you may as well be negotiating the definitive documents instead. I think that's why we're not seeing them as much anymore. Buyers and sellers would rather spend the time on more productive uses, like negotiating the agreement.

MMR: What else should sellers keep in mind during the exclusivity phase?

Michael: On the buyer's end the difficulty is that deals always seem to take longer than anticipated. If the exclusivity period is running to an end, but the buyer is still working in good faith on the transaction and asks for an extension, it gives the seller some leverage. Before agreeing, the seller might trade items in the purchase agreement to get things done faster, or make a monetary request. Really whatever the seller thinks of. It shifts some leverage, because buyers will want the extension of the exclusivity to keep working toward a closing.

MMR: Do you see a lot of litigation around no-shop clauses in the middle market?

Michael: Not a lot. Because the dollar amounts are usually not worth litigation. I have seen it though — in fact my firm's involved in one right now. That one involves a no-shop provision that was extremely poorly drafted. I'm happy to say we didn't draft it. But there was enough ambiguity around the duration of the period that the parties could argue over what it meant and whether it has expired.

The other aspect you sometimes see litigation on is provisions that call for the termination of exclusivity if certain milestones happen, and then the parties argue on whether that event occurred or not. That's where careful drafting is important.

MMR: Anything else sellers should know?

Michael: A lot of clients tend to do letters of intent on their own and come to their lawyers after they've seen signed. There are a lot of nuances here and it's important to get your attorney involved early to make sure the no-shop is properly drafted and all the potential issues have been thought through. The earlier a lawyer gets involved, the easier the process.