Setting the Stage: Exploring the Role of Term Sheets in M&A Transactions

Term sheets in M&A transactions (also known as letters of intent, memoranda of understanding, heads of terms or heads of agreement) generally take the form of a relatively short document outlining the main terms of the transaction that the parties have agreed prior to commencing preparation and negotiation of the definitive sale and purchase agreement.

This note briefly explains:

- The purpose of a term sheet.
- Term sheets' form and legal effect.
- The key reasons why parties may choose to put in place a term sheet.
- The key reasons why a term sheet may not always be appropriate.

Term sheets are used in a variety of other transactions, including public mergers and acquisitions, joint ventures, project financing and private equity investments. However, this note focuses on their use in the context of private M&A transactions.

Purpose of term sheets

Term sheets are used for a number of purposes:

- As written confirmation of the main terms of a transaction agreed in principle.
- To outline the transaction timetable and obligations of the parties during the negotiations.
- As a framework for certain preliminary legally binding clauses, such as an exclusivity (or lock-out) agreement.

It should not always be assumed that term sheets will be useful in the context of negotiating a transaction, and they may be of more use to one party than the other, but they can help to avoid misunderstandings and provide a useful roadmap of the steps to be taken on the way to signing the formal agreement. If, however, negotiation of the term sheet stalls over points of unnecessary detail (which in reality should properly be addressed at a later stage in the process) this can delay preparation of the definitive documents and increase the length and cost of the negotiations.

Term sheets' form and legal effect

There is no standard form for a term sheet in the M&A context. They can vary from a simple letter to a more comprehensive agreement drafted by lawyers. There is no convention as to who prepares the term sheet for an acquisition, although it is more common for this to be initiated by the buyer on a typical bilateral sale.

A term sheet is commonly entered into at the beginning of a transaction, once preliminary terms have been agreed and before commencement of detailed due diligence and the drafting of definitive agreements (which is where the parties will begin to incur more significant costs). The parties may sign separate letters or enter into a series of heads of agreement throughout the negotiations, particularly when negotiations are prolonged.

A term sheet evidences serious intent, and may have moral force, but is not automatically legally binding. This will depend on:

- The matters addressed in the term sheet.
- The parties' intention (as evidenced by that document).
- Whether the key elements required to evidence formation of a contract are present.

It follows that term sheets may be fully binding, partly binding or not binding at all.

Reasons for using term sheets

Whether or not the parties put in place a term sheet is purely a matter of choice: there are both advantages and disadvantages. The perceived advantages of using a term sheet are:

- **Moral commitment.** Term sheets are usually considered to impose a moral commitment on both parties to observe the terms agreed (although this can be an advantage or disadvantage depending on the circumstances). It is psychologically harder for one party to renege on earlier commitments (and therefore each party can proceed with more confidence) if they are recorded in formal term sheets.
- **Complex transactions.** Where a transaction is complex, term sheets can help focus the negotiations, draw out and clarify any misunderstandings and highlight any major issues or dealbreakers at an early stage, helping the parties to avoid wasting further time and money if those issues cannot be resolved at this early stage.
- **Framework for binding commitments.** Term sheets frequently contain a binding:
- exclusivity agreement;
- confidentiality agreement; and
- (in some cases) provision for payment of costs and break fees in the event of negotiations breaking down.
- These commitments may be important at the negotiating stage, even where there is no agreement on the main commercial deal. Obtaining exclusivity for a limited period, and some protection against wasted costs, should enable the buyer to proceed with more confidence.
- **Summary of transaction for third parties.** Where a deal has to be explained and sold in advance to persons not directly involved in the negotiations, the term sheets can provide a useful statement of the key terms of the proposed deal. These people might include:
- the main board of directors of the parent company within a wider group where negotiations are being handled at a lower level;
- prospective underwriters or lenders; or
- non-management shareholders in the context of a private company share purchase.
- **Basis for clearance submissions.** Term sheets can provide the basis of a joint submission for clearance or guidance from the relevant competition authorities and might assist in the preparation of tax clearance applications.
- **Basis for instructing advisers.** Draft term sheets can sometimes be a helpful tool for the parties to instruct their respective advisers. In particular, they can serve as a starting point for the advisers to ask further questions about the basis for the deal and perhaps highlight issues that have not previously been considered.
- **Tactical advantage for seller.** Because term sheets are normally prepared early in the transaction process before the buyer has commenced detailed due diligence, the seller will know considerably more about the business being sold than the buyer. The seller may therefore be in a stronger position to incorporate transaction terms into the term sheets that the buyer may not accept at a later stage once due diligence has begun.

Reasons against using a term sheet

Term sheets may equally have certain disadvantages which a party and its legal advisers will need to balance against any advantages there may be to putting them in place:

- **Limit room for manoeuvre.** Term sheets carry moral force, and can therefore limit room for manoeuvre in the subsequent negotiations. They should therefore be approached with caution, especially on the part of a buyer, who at this stage of negotiations normally has much less information than the seller. If the buyer is required to sign a term sheet, then consideration should be given to inserting into the document the key assumptions on which the buyer is relying.
- **Create legal relations inadvertently.** In some jurisdictions, term sheets can create a legally binding agreement between the parties unless an express term is included to the effect that there is no intent to create legal relations. In international transactions, particular care must be taken to ensure that signing formal heads will not inadvertently create obligations which the parties are not yet ready to undertake. In many jurisdictions there is a duty to negotiate in good faith which can give rise to liability should one party withdraw from the negotiations.
- **Accelerate need for public announcement of deal.** Where either party is a listed company or otherwise has financial instruments that bring the company within the scope of the Russian Central Bank regulations or an analogous foreign regulator, it will need to consider whether negotiating and signing a term sheet of terms may precipitate an early announcement of the deal.
- **Competition law.** Term sheets (binding or not) may fall foul of competition law rules. If they contain binding provisions which restrict, distort or prevent competition within specific jurisdiction, they may be prohibited by the relevant antimonopoly regulations.
- **Increase in workload.** The time taken to agree a term sheet may be disproportionate to the benefit. Care needs to be taken to avoid effectively negotiating the main agreement twice.

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