



Contracts from the Beginning: Term Sheet



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1 Introduction

For parties entering a business arrangement, an ideal starting point is the Term Sheet, a document that outlines initial key terms and understandings.

Although that document may come under different names — Term Sheet, Letter of Intent (LOI), Memorandum of Understanding (MOU), Letter of Agreement — its function is essentially the same. For ease of reference, this e-book collectively refers to such documents as Term Sheets.

Although not every transaction necessitates it, a Term Sheet can be of great benefit in a wide range of transactions, including commercial negotiations, mergers and acquisitions (M&A), lending arrangements, joint ventures, and real estate transactions. For some contractual situations, however, a Term Sheet might put one or both parties at significant disadvantage. Worse, it could inadvertently obligate a party to a bad deal. Term Sheets are unique to each transaction and should be tailored to their particular arrangement.

Well-developed Term Sheets facilitate a mutual understanding among parties and expedite drafting a final contract. It can also help identify any irreconcilable differences at an early stage. That can save the parties money, time, and a lot of headaches. Conversely, a signed and overly-specific statement of terms could be treated as binding. Inadvertently creating a binding Term Sheet can be no different from a contract enforceable by courts.

Term Sheets are invaluable tools and should be drafted with care. Parties should select and include only necessary, agreed upon terms. This e-book will explore drafting tips and suggestions, explanations of the advantages and disadvantages for using Term Sheets, how to identify nuances that each drafter should consider, and a framework for creating a well-drawn Term Sheet.



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2 What is a Term Sheet All About?



Although Terms Sheets are generally non-binding, at least some of the provisions in them can be enforceable in court. For best results, the drafters themselves should openly decide which terms, if any, should be enforceable. Drafters should remember the precise, underlying reason for the document, as well as the goal of the signing parties. In rare cases, the parties may choose to make the entire document binding.

Industry-specific Terms Sheets can have different goals. For example, non-binding Term Sheets in commercial transactions typically provide a roadmap for proceeding or completing a transaction. When the bargaining power of the parties is roughly equal, Term Sheets are drawn up after at least some negotiation. In such scenarios, binding Term Sheets typically lock-in specific terms of an initial transaction or create a safety net, like a confidentiality provision. In investment transactions, Term Sheets are typically offered at the inception of the parties' relationship, oftentimes to simply demonstrate an interest in or intention to invest in the company.

There is no standard form for Term Sheets. It is up to the drafter what shape and form the document will take. However, certain characteristics tied to the intent of the Term Sheet may be common. For instance, binding Terms Sheets will resemble the form of a short agreement, and non-binding ones might not (and often should not) have a signature block at all.



3 Who Prepares the Term Sheet?

It depends on the transaction.

For example, in financing transactions, the more dominant party (i.e., lender or investor) usually prepares this document. In business dealings, when the parties have relatively equal bargaining power, either side can choose to prepare the draft.



4 Benefits of Term Sheets

Term Sheets offer many benefits in the early stages of negotiations. Here are some advantages to using Term Sheets.



- ✓ **Reveal Parties' Essential Terms.** Partly due to their length, the parties must determine and communicate the most important initial criteria for closing the deal. This allows both parties to evaluate each other's needs and wants and identify non-negotiable issues that could halt the deal. Presenting the key requirements in a simple, bulleted or numbered list can help clarify both parties' understandings of the transaction. If some terms seem unacceptable to either party, they can opt out early and save a lot of valuable time and money.
- ✓ **Establish a Clear Roadmap.** Provided that no deal-breaking terms are found, the parties then have a written confirmation of the terms agreed upon. This serves as a clear roadmap for creating a final, definitive contract.
- ✓ **Clarify the Terms.** Complex transactions with multiple parties and compound agreements are improved by clarifying key elements of the arrangement. This can prevent costly misunderstandings and afford a smoother course for the transaction. A clear understanding of the terms also allows the parties to focus on each point in future negotiation.
- ✓ **Lock-In Important Terms.** In some transactions, locking-in principal terms early in the deal (such as price, expenses, and exclusivity) may benefit one or both parties. For example, including a binding Exclusivity Provision allows the purchasing party to complete thorough due diligence and obtain the most favorable financing without the pressure of competing against other buyers.
- ✓ **Establish Duty to Negotiate in Good Faith.** Only binding Term Sheets, or those that are held binding, are enforceable in court. However, this does not mean that the party to a non-binding Term Sheet may easily withdraw from the transaction at any time. Some courts have held that, even with a non-binding Term Sheet, the parties are obligated to negotiate in good faith (Channel Home Centers, Div. of Grace Retail Corp. v. Grossman, 795 F.2d 291 (3d Cir. 1986) states that a duty to negotiate in good faith existed even without an express clause but only when circumstances suggested that the parties intended to be bound by the agreement to negotiate in good faith). However, other courts have held that no such obligation is imposed without a clear and express provision requiring it. Nonetheless, the process of negotiating a Term Sheet can organically suggest some moral and social obligation to complete the transaction, thus strengthening the relationship and promoting trust between parties.
- ✓ **Follow Customary Practice.** Term Sheets are common practice for some types of transactions. For example, they are customary in a startup world. Entrepreneurs often receive such documents from venture capitalists interested in investing in their companies. Showing Term Sheets may be helpful or even required for a party to obtain funding from a third-party or approval from a regulatory body.

5 Drawbacks of Using Term Sheets



Despite their tremendous value, Term Sheets are not suitable for every transaction. Sometimes the parties are better off negotiating and drafting their final contract without a Term Sheet. Below are a few examples of some disadvantages to using Term Sheets.



Increase Costs and Time. Obviously, preparing an additional document requires more negotiations, time, and financial costs. The more complex the transaction, the more time it will take for a lawyer to talk through the main terms and draw up a document. For simpler, low-stakes arrangements, it may not be worth going through the additional step of preparing this preliminary document.

May Inadvertently Create Obligations.

This may be the most important factor in deciding whether to prepare a Term Sheet for a deal. Especially in transactions that don't involve legal professionals, inadvertently creating a liability is easier than one might think. When courts decide whether the provisions of the Terms are binding or non-binding, they consider the language of the document, the intentions of the parties, and the circumstances surrounding the negotiations. The court will also assess the complexity of the transaction as a whole and consider any partial performance of the terms. Thus, even if the document itself does not explicitly state that its provisions were binding, there is a risk that the court may rule otherwise.

Reduce Negotiation Power.

Term Sheets may diminish some leverage for one or both parties. As mentioned above, the No-shop provision limits the seller's ability to seek other potential buyers. The seller likely will not be able to negotiate on the principle of "take it or leave it."

Break the Flow of Negotiations.

Each transaction usually has an organic flow of events leading to successful completion. If the parties pause to create a Term Sheet, it may interrupt this natural flow. This can slow down the deal, introduce doubts in one or both of the parties or possibly even lead to the cancellation of the deal.

May Force the Deal.

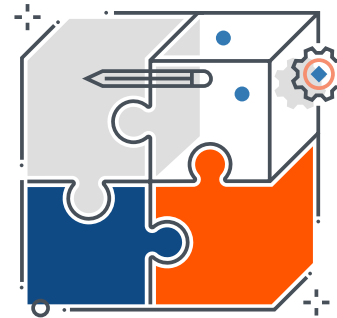
Remedies for breach of a binding list of conditions include specific performance. This means the party undertaking the obligation must perform the obligation in accordance with the promise; otherwise, they might face monetary damages. Either option may result in material detriment under certain circumstances.

6 What Terms to Include?

Binding or non-binding. Typically, Term Sheets explicitly state whether the parties intend for the document to be binding, partially binding, or non-binding.

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- ✓ **Description of the transaction.** This section describes the essence of the transaction and the parties involved and provides relevant background information, if necessary.
- ✓ **Key dates.** Key dates typically include the timeframe for each milestone event to happen. Examples might include the proposed closing date, expiration of the due diligence period, and expiration of the exclusivity period.
- ✓ **Allocation of responsibilities.** Here the drafter may include the key responsibilities of the parties, as determined and agreed upon by the parties. For example, they may specify who is responsible for obtaining certain documents or approvals from third parties and who will draft the definitive agreement.
- ✓ **Price and payments.** This section defines amounts payable, raised, or received and how those amounts would change hands.
- ✓ **Material Procedures.** Key procedures may also be mentioned in the condition sheets, when the parties consider them important and worthy of negotiation. For example, scope and procedures of due diligence could be briefly added to the list.
- ✓ **Conditions.** Here, the drafter may include significant conditions for the transaction to proceed. These might include successfully obtaining financing or similar requirements.
- ✓ **Limitations.** These provisions may address limitations such as clauses for exclusivity, confidentiality, no public announcement, non-disclosure, limitation on indemnification obligations, restriction of remedies, and other restrictions.
- ✓ **Termination.** This part of the Term Sheet may include exit strategies, define default conditions and procedures, and address termination.
- ✓ **Miscellaneous.** Miscellaneous provisions such as governing law and venue may also be included, if necessary, although this is less typical.





7 Dos and Don'ts of Term Sheets



Do Include All Essential Deal Terms.

The terms included should identify the key positions agreed upon by the parties, such as identifying which party is responsible for each task, descriptions of assets, and key parties involved.

Do Include Mutually Accepted Terms.

Term Sheets should be viewed as establishing pillars for the definitive agreement to be refined later. Those added features may be negotiated, edited, or amended, but the pillars themselves should not change.

Do Choose a Simple Layout.

A bullet pointed catalog or list format is ideal for Term Sheets. For a non-binding Term Sheet, it adds an additional layer of protection if the format signals that it's not a contract.

Do Include Examples.

Include an illustration of how a certain principal would be implemented if it is useful. As a rule of thumb, use terms, formulas and calculations, examples, and definitions that will help establish a clear understanding between the parties.

Do State Whether the Term Sheet is Binding or Non-binding.

A definitive statement at the beginning of this document is ideal. Similarly, a statement in bold or all capitals at the end can be used with the same effect.

Do Include a Signature Block for Binding Term Sheets.

When parties decide to make their agreement binding, drafters should include a signature block. Note that other basic elements that make a contract enforceable must be present.



(7) DOS AND DON'TS OF TERM SHEETS (CONTINUED)

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Don't Include Details for Each Term.

The level of specificity must be sufficient to identify the underlying principle behind each term but should not address the minute nuances of each term. For example, implementation procedures for a certain term should not be included, unless, of course, they are essential to the transaction and have been discussed and agreed on by all parties.

Don't State Terms as Placeholders.

If a particular term has not been discussed, it is best not to include it at this early stage. Even with non-binding lists, the drafter should not leave an opportunity for the other party to claim that placeholder terms were conceded in principle.

Don't Define the Final Document.

Avoid specifying the form or content of the final agreement. Besides the fact that it may be premature to discuss or design the form of the final document, any resemblance to a definitive agreement could backfire, if the question of enforcement arises.

Do Not Omit Conditions or Assumptions for Terms Included.

In other words, leave some room for parties to back out or make major changes to any terms with portions either unknown or needing verification. For example, even if the price has been negotiated and agreed upon by the parties, it may be subject to change if certain conditions are not met. For this type of term, be sure to include the condition(s) that must occur and any assumption(s) upon which a term is based.

Do Not Include Vague Statements.

Clear and unambiguous drafting is one of the basic principles of contract drafting. Not surprisingly, the same principle applies to Terms Sheets as it is essentially a basic dictionary for a future contract, albeit written in general terms. Concision and precision are vital for Term Sheets, because the goal is to avoid uncertainty and eliminate misunderstandings among the parties.

Do Not Include a Signature Block for Non-Binding Term Sheets.

Most of the time, Term Sheets are non-binding and, as such, should not include a signature block. If specific provisions are intended to be binding, this should be clearly noted.

8 Should a Confidentiality Provision Be Included?

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A confidentiality provision may be included as the situation demands; however, for transactions with high stakes or sensitive information, it may make sense to sign a separate stand-alone confidentiality agreement.

In that case, Term Sheets should explicitly reference the separate confidentiality agreement to ensure that protection. Alternatively, if the parties have signed a confidentiality agreement prior to a Term Sheet's creation, the Term Sheet should then reference that agreement by name and date.

9 Tips for Term Sheets by Specific Industry

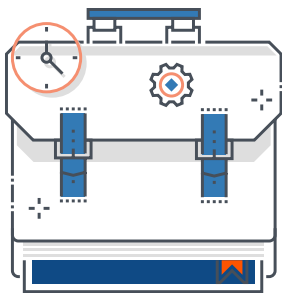
Below are some highlights for typical provisions included in Term Sheets according to their specific industry.

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Mergers and Acquisitions (M&A)

Public companies may have additional disclosure requirements under Federal Securities Law. This requirement may even apply to non-binding Term Sheets. For example, public companies must file Form 8-K to disclose information when entering “into a material definitive agreement not made in the ordinary course of business.” Among others, this includes agreements for merger, sale or purchase of assets, and issuance or sale of securities. It follows that a binding Term Sheet for M&A will be considered a material definitive agreement that must be disclosed.

Another essential factor to keep in mind when drafting Term Sheets for M&A is exclusivity. This may be an exclusivity clause or stand-alone agreement (sometimes referred to as “no-shop” provision or agreement) which is designed to limit the seller’s ability to solicit additional offers. Including an exclusivity provision in the Term Sheet at the outset of negotiations mostly protects the buyer. Bear in mind that an exclusivity provision is usually limited by a defined period of time with an explicit expiration date and time.



- ✓ **No-shop Provision** – prevents the parties from negotiating with anyone not party to the Term Sheet
- ✓ **Escrow Requirements** – specifies the escrow company, if any, and the terms for releasing the funds
- ✓ **Material Closing Conditions** – significant conditions that must be met prior to closing



(9) TIPS FOR TERM SHEETS BY SPECIFIC INDUSTRY (CONTINUED)



Private Lending Arrangements



In finance transactions, Term Sheets should be attached to the commitment letter from the lender.

- ✓ Loan Summary and Purpose – this may describe the structure or type of the loan offered
- ✓ Guarantees or Guarantors – provides a safety net for the lender in case of borrower default
- ✓ Fees and Expenses – sets amounts for fees (typically a percentage of the loan) to be paid by the borrower, as well as any expenses that are or might be covered by the lender

Joint Ventures



When two or more parties set out to pursue a business venture, Term Sheets may state how the parties will collaborate, pool resources, and develop an enterprise or accomplish a specific goal of the joint venture.

Some of the terms that are specific to joint venture Term Sheets include the following.

- ✓ Initial contribution of the parties – states the amount of each party's contribution
- ✓ Rights and responsibilities of each party – provides the pertinent rights and obligations stipulated by the parties
- ✓ Sharing and distribution of profits and losses – defines the major profit/loss sharing schemes
- ✓ Management structure of the joint venture – describes how the venture ought to be managed
- ✓ Framework for obtaining financing – sets out ways to raise capital, if needed
- ✓ Management of employees – provides a framework for employee involvement in the joint venture
- ✓ Indemnification of the parties – provides guidelines for the compensation for any harm or loss of each party
- ✓ Termination of the coalition and exit strategy – outlines the major pathways to termination



(9) TIPS FOR TERM SHEETS BY SPECIFIC INDUSTRY (CONTINUED)



Venture Capitalists



Venture capitalist Term Sheets are often used between businesses and venture capitalist investors. They might include some of the following terms.

- ✓ Type of security to be purchased – for example, Series A Convertible Preferred Stock
- ✓ Pre- and post-financing valuations
- ✓ Anti-dilution protections
- ✓ Board of Directors (BOD) –the composition of the BOD, its representation rights, or other matters under its purview
- ✓ Redemption or repurchase price – if the type of securities under the agreement are subject to future redemption or repurchase, the Term Sheet should spell out the conditions under which such a redemption or repurchase may occur
- ✓ Representations and warranties –standard representations and warranties developed and established by the business
- ✓ Liquidation –the procedure and distribution of proceeds in the event of liquidation, dissolution, or the winding up of the business
- ✓ Dividends –the amount and other conditions for any dividend payments agreed upon
- ✓ Covenants – affirmative covenants (requires a party to take an action) and negative covenants (restrictions or prohibitions) may be included
- ✓ Confidentiality – may if not opted out of for a free-standing agreement



(9) TIPS FOR TERM SHEETS BY SPECIFIC INDUSTRY (CONTINUED)



Real Estate



Term Sheets are common (and extremely useful!) in commercial leasing. Aside from the expected provisions discussing the price, term, and lease commencement date, here are some other significant provisions to consider.

- ✓ **Fixturization Period** – a time period given to the tenant to build out the property and prepare it for opening
- ✓ **Permitted Use** – the scope of use allowed with restrictions and limitations
- ✓ **Parking** – allocation of specific parking space or limitation to the tenant
- ✓ **Assignment/Subletting** – rights and obligations of the parties regarding assignment and subletting
- ✓ **Default** – may specify the notice requirement and opportunity to cure
- ✓ **Parties' responsibility for repairs and maintenance** – allocates responsibilities among the parties for repair and maintenance of the leased property and common area if any
- ✓ **Alterations** – defines the scope and fee of allowed alterations by the tenant during the lease period

For properties with high demand, the tenant might want to include an exclusivity period to prevent the landlord from negotiating with other potential tenants during that time.



10 Conclusion



A Term Sheet is a brief document that summarizes a transaction and the key principles of the transaction that are subject to negotiation.

Term Sheets should be viewed as the foundational documents for the parties to build on throughout contract negotiation. The provisions included should be those that are significant for the business arrangement and necessary to proceed.

Included key provisions should not be changed when preparing the final agreement. This highlights the importance of the selection process for the terms. All included provisions must be discussed and agreed upon by the parties before the creation of the document.

As with many other business and legal documents, Term Sheets can be an invaluable tool, but if drafted poorly, they may become an unwelcome obligation or a waste of time and money. Drafted and tailored appropriately for specific types of deals, Term Sheets will provide invaluable insight, clarity, and organization for their transactions and allow the parties to smoothly achieve successful closings. Thus, Term Sheets must be drafted with caution and ideally by a legal professional familiar with the industry of the transaction. So remember, almost all well-drafted, complex contracts begin with a well-drafted Term Sheet.