

## Heads of Terms or Term Sheet Analysis

### A. Introduction

A key point which is often forgotten is that Term Sheets are at least in part an agreement to agree (discussed below in *Enforceability*). Under English law “Agreements to agree” [in good faith] are of questionable enforceability. Term Sheets are not supposed to be binding (with the exception of specific provisions discussed below) – they nevertheless affect the power dynamics of the negotiating parties (with agreed conceptual positions being difficult to change later on), may create representations difficult to rebut (subject to local law), affect regulation / law and have a significant tax impact on the treatment of the transaction. It goes without saying, but we shall say it anyway for the rebellious business folks out there, that appropriate legal and tax advice should be always be sought prior to entering into a new form of Term Sheet or Heads of Terms.

Terms Sheets should only cover important commercial points vital to the deal and should not focus on drafting points (which could derail these preliminary arrangements).

The first question to ask is what is the purpose of the transaction? Secondly, what is the best way to achieve this purpose from a documentation stand-point? In this note we shall focus on the two primary types of “business” acquisition method: i) asset sale/ purchase and ii) share purchase. There are pros and cons related to each acquisition type and, depending on the client’s needs and objectives, either of these methods (or alternative structures) may be most suitable. One should apply different risk mitigating conditions within either of the asset sale or share purchases forms of Terms Sheet. Within this note we adopt an English law centric approach, however note that local or international legal issues (relevant to the governing law of the agreement and local of assets/ shares) will affect the interpretation of the relevant Term Sheet terms.

### B. Deal Structure – Asset Sale or Share Purchase

- i) Asset sales give the purchaser the opportunity to specify exactly within the Term Sheet which assets and which liabilities of the business shall be taken on by the purchaser. The Term Sheet should specify exactly which assets and liabilities (will be and) will not be taken on by the purchaser. These retained liabilities should be met by the Seller, for example from the proceeds of sale or from other resources excluded from the sale). Due diligence is key to the purchase – but at the Term Sheet stage this diligence has not been completed (or may not even be initiated), reservation of additional elements and aspects that affect “price” shall be made. Asset sales often raise questions as to employee rights. The Terms Sheet should make an indication of which employees shall automatically transfer with the going concern (from a UK regulatory perspective). As the Seller shall have effectively removed core value from the business pursuant to the sale, it is common under an asset sale for the Seller’s Term Sheet obligations (or even transaction obligations) to be guaranteed (by a deep pocketed entity that, it is envisaged shall continue in operation); and
- ii) Share sales – transfer control of the “going concern” at the companies “top co.” level. The operating entity and related entities maybe acquired entirety through a majority stake in the “top co.” Depending on the status of the company shares (public) this may trigger a mandatory take-over bid. Again – the Buyers rationale for the purchase and the focused view on the value proposition of the transaction or the “to be” purchased

enterprise is key to ensure that value is retained. Tax implications and management of these issues are significant value factors affecting the mechanics of the sale.

Management and key personnel are important “soft retention requirements”, which shall automatically remain controlled by the sold entity now controlled pursuant to the share purchase. [Can we add a little more here about Share Purchases - what about seller guarantees in this context]

### **C. Deal Structure – Social Impact Conditionality**

Traditional Term Sheet legal analysis has primarily focused on price determinant conditions and operational requirements which have to be completed prior to a binding agreement being reached (condition precedents) and entered into. Social Finance requires that the goals of fostering positive environmental, social (people) or governance change are key transaction requirements. These transaction requirements are measured and deliverable requirements. The creation and agreement of the basic Social criteria, measurement and deliverables are essential to the “social” transaction and acquisition of the “going concern”. The creation of bespoke, simple social impact goals and target milestones are the foundation of the social transaction. The Heads of Terms/ Term Sheet can specify these core Social requirements as conditions to ensure that they are reflected in the final deal agreement (and applied by the “going concern”). Such conditions shall vary depending on the nature of the transaction and asset type. However – the Global Impact Investment Network (GIIN)’s criteria called IRIS, provides a number of core concepts which could be worked into any term sheet or agreement (we assume that the traditional financial performance milestones are also identified in the agreement, although we do not mention them here):

#### *Operational Impact*

- Governance and ownership
- Social Policies
- Environmental Policies
- Environmental Performance
- Employment make-up, wages and scale
- Training and Assessment

#### *Product Impact*

- Quality and Reach
  - Quality and Performance
  - Client Information
  - Supplier Information
  - Distribution Information
- (reference: GIIN.)

### **D. Term Sheets – Core Provisions**

Please refer to Prime Advocates to ensure that the Term Sheet as drafted reflects the specific transactional details and requirements. However, we address certain core Term Sheet provisions of note below:

i) Enforceability: Binding or non-binding provisions

Non-binding Term-Sheets: *Term Sheets are based on the premise that they are generally non-binding:*

- *the provisions of a Term Sheet shall be supplanted by the parties' entry into the full comprehensive contract (in this case either a full Asset Purchase Agreement or Share Purchase Agreement);*
- *under English law – "Agreements to agree" (like Term Sheets) are of questionable enforceability anyway;*
- *the Term Sheet should rebut any presumption that the terms of the Term Sheet are binding by expressly stating that they are non – binding, with the exception of specified "binding provisions"; and*
- *"Subject to Contract" – is the common legal phrase applied to the provisions of Term Sheets to limit their binding effect. This construction makes the provision non-binding from an English Law perspective and avoids the risk related to misrepresentation of provisions (made and relied upon in contemplation of a contract) and negligent mis-statement. The "subject to contract" phrase is not universally recognised throughout Europe and the best way of avoiding Term Sheets or Heads of Terms provisions from being deemed as binding is to describe that the terms of the agreement are not binding and no reliance should be made upon them (describing the intention of the parties). Please seek local law advice as appropriate.*

Binding Term Sheet Provisions: The Term Sheet is an agreement and subject to contract law requirements (offer, acceptance and transfer of consideration [see below for details]) may be binding and enforceable. Terms Sheets should specify which provisions purport to be binding. Traditionally the binding Term Sheet provisions are those provisions protecting the parties investment of time, due diligence and other resources and the allocation of risk (including reputational) between the Buyer and Seller in this interim period (of exclusivity) so as to facilitate the transaction or agreement being reached. The prescribed "binding provisions" may include:

- *Top & Tails of the Term Sheet* - including the parties names, specified governing law or provisions identifying the exclusivity or not or a jurisdiction in which a dispute is brought;
- *Indemnity provisions* – granted by the Seller to the Buyer for liabilities related to transaction (i.e. that they have the right to sell etc.);
- *Seller's Guarantor* (discussed above) who is guaranteeing the obligations of the, soon to be sold, Seller. Indemnity provisions and the Guarantor's obligations may survive the end of the Term Sheet contract;
- *Exclusivity Provisions* – the specified exclusivity of tender period in which the Buyer may work without fear of be usurped – Exclusivity Period (defined below). This is required to merit the investment of resources and reputation need to progress a transaction from Heads of Terms to completion;
- *Non-compete (and non-solicitation) provisions* - this applies to both Buyer and Seller and is often used to protect business processes/ arrangement contemplated under the Term Sheet

or key employees. This protects against loss of business value as both sides open up their businesses and information to each other.

- *Confidentiality – the transaction itself, disclosed information pursuant to the Term Sheet and diligence processes remain high sensitive. Disclosures by either party of such information may have a material impact on either parties’ business value or reputation. Confidentiality provision protect against such disclosure and may exist until the Agreement is signed (being replaced by confidentiality terms therein) or for a period year post execution of the Term Sheet;*
- *Fees - coverage of legal, consulting or other intermediaries fee and who bears these costs and other costs during the period of exclusivity as the parties negotiate towards a full agreement under the terms of the Term Sheet. The parties may agree a “break-fee” payable upon conditions arising from one party ending or walking away from the transaction.*
- *Furthermore, note that the indemnity provisions and the Guarantor’s obligations may survive the end of the contract.*

ii) Enforceability: Requirement for Consideration

- **Consideration:** For the Term Sheet to be binding as applicable, the contract needs to reflect the passing of consideration or benefit from each party to the other. For example: “[In consideration of the Buyer undertaking to pay the Sellers the sum of £1, receipt of which is hereby acknowledged, and the Buyer undertaking, and incurring fees and expenses and other costs in connection with, the due diligence investigations in relation to the Company and the Subsidiaries, the Sellers grant the Buyer a period of exclusivity on and from the date of these heads of terms to and including [DATE] (**Exclusivity Period**)”].

iii) Enforceability: Operational burden

- The Term Sheet provides for a transaction deliverable time table and allocates the main transactional procedural responsibilities. For example who will draft the main transactional documents (and bear that cost – this is usually the Seller’s responsibility) or which parties on each side shall be responsible for co-ordinating due diligence and the disclosures. By being clear in the Term Sheet who has drafting responsibility this ensures that there is little confusion or dispute and increase the efficiency of the transaction flow.

**E. Term Sheets – Boilerplate provisions or conditions precedent**

We list a number of important provisions which may be a condition precedent (a condition to be met prior to the agreement being reached) to the parties entering into the agreement and as such are listed (we shall be happy to provide further detail upon request):

- **Time limits - parties negotiate in good faith and prior to a certain time-limits being met. The parties hope to enter into a full agreement by the specified time?**
- **Tax (Term Sheets set out the commercial reasons for the transaction, which shall affect any “tax avoidance position” or “any tax challenge”) – this will be useful in ensuring the final transaction obtains the desired tax treatment**
- **Resolutions passed by the Buyer’s Board – this is a condition precedent to the final agreement being entered into [noted at the Term Sheet level]. The Buyer’s and/ or the Seller’s board need to approve the deal and price.**

- **The deal is not referred to the Competition Commission for investigation re: part 3 of Enterprise Act or EC (Chapter 1 of Competition Act 1998) or Article 81(1) EC Treaty – this is again a condition to the final agreement, as competition matters may undermine the ability for the deal to legally move forward.**
- **An understanding of the basis by which Competition and other clearance submissions shall be obtained. The Term Sheet can specify the role of the parties in these important submissions.**
- **No government or person threatens commercial or regulatory proceeding against the entity to be sold – condition precedent to the final deal.**
- **Quoted and public companies – the Buyer and Seller need to comply with the requirements of relevant regulatory bodies. For example, US securities regulation (if applicable) may require the disclosure of a proposed transaction by a US listed company prior to the signing of a definitive agreement. If the company in question is publically listed the parties may need to comply with the Listing Rule of the FSA (in the UK). Term Sheets can address these obligations confidentially without accelerating them (i.e. without bringing them to the markets attention).**
- **Assumptions (deal specific) can be flagged at the Term Sheet stage (i.e. pre- reps and warranties may be noted, which shall more specifically be addressed in the final binding agreement between the parties).**
- **Listed warranties accurate on completion.**

Other Boiler-plate conditions to consider:

- **Agreement on a high-light of the Social goals/mission of the “going concern” to be acquired or the Social purpose of the transaction. Social Mile-stones, method and frequency of measurement and deliverable. What are the consequences to the parties of failure to meet those deliverables?**
- **Business termination – MAC (material adverse condition) clause.**
- **Requirements that the Company Accounts provided are satisfactory to the Buyer.**
- **Legal opinion – if necessary for the completion of the deal.**
- **Consultation with Trade Unions.**
- **Is there a due diligence review as a condition precedent to be carried out.**
- **Will there be special exercises such as environmental audit or accountants long form reports.**
- **Does either party need to arrange credit, underwriting, loans or bridging finance to finance the deal? If these elements are a requirement, what are the consequences to the parties on their obligations if these requirements are not obtained?**

**F. Conclusion**

Please refer to you legal, tax and business advisers as necessary when entering into a new transaction reflected through a Term Sheet.