Walk Before You Run: Using Term Sheets to Improve a Contract Negotiation

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Negotiating a term sheet is a common first step in a contract negotiation process. An effective term sheet can help streamline a negotiation and increase the odds that the final deal will include terms favorable to you, or help you avoid expending significant resources pursuing a deal that is doomed from the start.

Viewing a Term Sheet as a Mini-Contract

Many firms require finalizing a term sheet or letter of intent with a counterparty before initiating the process of negotiating a transaction in earnest. In a term sheet, parties typically "agree" to the major deal points, which then serve as guideposts for negotiating the definitive agreement. I put quotation marks around "agree" as most term sheets are intended and stated to be non-binding, meaning that either party is free to change their mind and propose changes or abandon the negotiation entirely.

Despite their typical non-binding nature, term sheets can be effective at reducing the risk that a party will abruptly change course deep into negotiations. This article describes a few suggestions for crafting term sheets to help improve their effectiveness. As always, it's recommended that a party engage legal counsel to advise on crafting a term sheet.

Headline Items

The term sheet should set forth the key business terms of the deal. Although establishing key terms in a non-binding term sheet generally does not prevent the other party from changing its mind, it may make proposing changes to those terms harder from a practical negotiating perspective. If one party proposes changes to terms already "agreed to" in the term sheet, the other party can use the term sheet as leverage to push back or negotiate accommodations elsewhere in exchange for agreeing to the change.

Firms should also consider including terms that may not be "headline" items but are important to them in determining whether to do the deal. For example, if you're a seller in an M&A deal, consider including terms regarding limitations on indemnity and liability, and if you're receiving equity of the buyer in the deal, considering including an expectation that you'll receive diligence information on the buyer. If the other party does not agree to those points in the term sheet, that may be a sign that the negotiation will not succeed and you should focus your efforts elsewhere.

Conditions to Closing

The buyer often prefers to list conditions that must be satisfied before the deal can be closed. This may include requiring the seller to obtain specified third-party consents and noting that the buyer must obtain the consent of its board or other body before it can close. If diligence is involved, the buyer may state that the seller must cooperate with and respond promptly to all reasonable information requests of the buyer.

Exclusivity and Timelines

The acquirer in the M&A context often wants the target to negotiate exclusively with the acquirer and terminate any discussions with other potential bidders to reduce the likelihood that the acquirer will expend significant resources vetting a deal only for the seller to use the acquirer's bid as leverage to get a better offer elsewhere. If the seller is willing to agree to exclusivity, the seller should keep the exclusivity period short and perhaps provide that exclusivity automatically ends if the buyer proposes terms that conflict with terms "agreed to" in the term sheet.

Non-Binding

Many term sheets state that they are non-binding. If a party desires for the term sheet to be non-binding and not enforceable in court, it should discuss with legal counsel the provisions to include to reduce the risk that a court will treat the term sheet as binding. If a party wishes for certain terms – such as exclusivity and access to information – to be binding and enforceable, then the term sheet should exclude those terms from any "non-binding" statements and note that they are enforceable. If a term sheet contains terms intended to be enforceable, then all parties generally sign the term sheet.

Takeaways

Of course, the above are just a few of the terms that parties consider when negotiating term sheets. Because term sheets are generally short, parties are often strategic in determining which terms to include and which terms to address only in the definitive agreement. By crafting an effective term sheet, firms can reduce the risk of spending time and energy on negotiations that are doomed from the start and streamline those negotiations where a beneficial deal is likely to be within reach.

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