

Term Sheets: Binding & Non-Binding

Guest post by [Teresa Daggett](#)

First, let's get terminology out of the way. Whether the document that outlines your deal is called a "term sheet," a "memorandum of understanding" or a "letter of intent," these terms mean essentially the same thing. We will use "term sheet" in this article, but the other terms could easily be substituted. The differences between these three are merely stylistic.

Why a term sheet?

The decision makers for a business have decided to do a deal. The deal may be for one company to buy another company, or the sale of stock or promissory notes to investors, or for some other reason. For purposes of this article, we will assume that the term sheet is for the purchase of one business by another business. Once the parties have determined the major points of the deal, they ask their attorneys to draft a term sheet containing the key provisions that they have agreed on. Invariably, the attorneys will also raise questions about other provisions that the parties may want to add to the term sheet.

By drafting a term sheet, the parties can identify their major issues before committing time and money to due diligence and the far more extensive drafting involved in the definitive agreements. In addition to the provisions in the term sheet, the parties can identify "deal-breakers" and create momentum to move the deal along. Some or all of the provisions in the term sheet can be specified as "binding" or the entire term sheet can be "non-binding and for discussion purposes only."

What are often "binding" terms in a substantially non-binding term sheet?

Exclusivity period. Our hypothetical buyer wants an exclusivity period during which the seller cannot entertain any other offers for its business. Our hypothetical seller thinks the buyer may not have the financial resources it claims in order to buy seller's extremely (in its mind) valuable business, and therefore the seller does not want an exclusivity period. If our buyer is successful in its bid for an exclusivity period, this will typically be binding on the parties, and the seller will need to stop courting other potential buyers during the exclusivity period.

Confidentiality. Another term that is typically binding if included is the confidentiality of the term sheet, its terms, and the negotiations between the parties. We all know that a promise to keep something a secret is easily broken. However, the statement that the confidentiality provision is binding will put the parties on notice to keep this deal secret until the parties are ready to announce it. At a minimum, this provision sets up a moral obligation to keep the deal secret.

Fees and expenses. Often a term sheet will include the binding term that each party is responsible for its own fees and expenses prior to closing. Costs can include legal, accounting and investment

banking fees and out-of-pocket expenses.

Conduct of the business. The business that is being purchased is not going to be worth much if the seller decides to sleep in every day and not conduct the business as usual. A commonly used binding provision is that “seller will conduct its business in the normal and ordinary course, consistent with prior practices.”

Bifurcate! If your term sheet has binding and non-binding provisions, be sure to be clear which are binding and which are not. Bifurcate the two types of provisions, or set out a provision that states that the term sheet is not binding except for Sections X, Y and Z.

What other provisions may be in a term sheet?

Type of transaction. Going back to our hypothetical seller and buyer, is the stock or partnership interest being sold? Alternatively, are only the assets being sold? If this is an asset sale, what assets are included and what are excluded? Be sure the term sheet clearly states what is being sold.

Price and payment terms. Price is one thing that is usually agreed on before the lawyers get involved. However, the payment terms may not have been decided yet. Will the seller get partial payment at closing and then carry a note? If so, what will the terms of the note be? If there is a note, will the buyer provide a personal guaranty? Will there be a holdback for certain contingencies? Or an escrow? How much of the deal consideration will be risk to secure the representations and warranties? How long will the representations and warranties last? Is there a minimum claim size (a basket), and does it tip? (A tipping basket is a minimum claim threshold that allows the buyer to recover from dollar zero of damages once the minimum has been surpassed; as opposed to a deductible.)

Treatment of outstanding stock options, warrants and convertible notes. If a corporation is being sold and the company has any of these types of securities outstanding, the parties should address how to treat these for the least disruption to the business.

Key employees. If there are one or more key employees, the buyer will want to be sure that they will stay with the company after the closing. The arrangement may include employment agreements, board seats, or stock options. Similarly, if there is a key employee who will not remain, will a severance payment and a noncompetition/nonsolicitation agreement be part of the deal?

Due diligence. The buyer needs to know what the seller’s business actually consists of. Likewise, the seller needs to know that the buyer has the financial wherewithal to pay. The due diligence provision of a term sheet will typically state that the parties will sign a mutual confidentiality agreement and then disclose “such documents and information as reasonably requested, so that each party can perform a full investigation of the other’s business and legal conditions.”

Noncompetition. The buyer may ask the seller to not compete with the buyer after the closing. If the seller is sailing off into retirement, this may not be a point of negotiation. On the other hand, if the seller wants to start a business that is similar – but not directly competing with its current business – the parties may be able to reach agreement on a somewhat narrow definition of noncompetition, either in terms of geography, length of time, or type of business.

How elaborate should the term sheet be

Can the term sheet be deemed to be binding – even if it does not say that it is?

This may be a tough call if either party has partially performed or the term sheet was so heavily negotiated and reads so much like a definitive agreement that the definitive agreement would be a mere formality. We generally recommend that the term sheet be more of an outline of the terms of the deal and not contain sentences such as “All warranties, representations, covenants and agreements, including indemnities and releases hereunder, made by Seller and Buyer shall be deemed and construed to be continuing warranties, representations, covenants and agreements which shall survive the Closing.”

The problem with a term sheet appearing too much like a definitive agreement is that, if challenged by one of the parties, a court may impose its own interpretation of commercially reasonable terms.

Aside from the terms that should be binding, to ensure that the remainder of your term sheet is non-binding, consider:

- The parties contemplate a later, formal agreement
- Use the term “prospective buyer”
- Make closing subject to financing and satisfactory due diligence
- Avoid the terms “will” and “shall”
- Avoid performance requirements before closing, as performance may give rise to a promissory estoppel claim

This article is not intended to be an exhaustive discourse on the subject of binding and non-binding provisions in a term sheet. Rather, we just want to highlight some things to consider when drafting your term sheets.