

TERM SHEETS: DON'T SCREW IT UP!

A term sheet is a document that summarizes the key terms of a major transaction that is being negotiated. Term sheets can be used in many situations – sales of companies or major assets, equity investments, secured and unsecured loans, and joint ventures, to name just a few. Term sheets are often misused and under-utilized, which are mistakes that can be costly to both sides to the transaction. We regularly see businesses run into trouble that could have been avoided if the parties followed these simple guidelines:

- 1. Document Basic Terms.** Probably the most frequent mistake we see is businesses that skip ahead to drafting definitive documents and not “bother” with a term sheet. They may do this in an effort to be efficient, but this effort at streamlining can cause major problems at a later stage. Parties on opposite sides of the table often walk away from a negotiating session with different impressions regarding what (if anything!) was agreed to. A term sheet is a vital way to ensure that the parties in fact have a meeting of the minds. When the parties jump into the drafting of complex legal documents without carefully agreeing in some detail on key aspects of the deal, there may be angry accusations (or worse) when someone discovers details in the documents that are contrary to what he or she thought had been agreed upon. Even where there is no such breakdown, the term sheet often expedites drafting of final documents.
- 2. Understand and State What Is Binding.** Most aspects of a term sheet such as the amount of investment or the purchase price are typically non-binding. However, a term sheet usually also includes provisions that are binding such as confidentiality, no-shop restrictions, jurisdiction, and governing law. Term sheets that are drafted without the assistance of outside professionals often fail to differentiate clearly between what is binding and what is not. This failure can have disastrous consequences. As one example, potential buyers of a company that walk away from a transaction are often later sued – sometimes successfully! – by the selling company, which claims that the term sheet was a binding commitment.
- 3. Involve Outside Experts.** The failure to distinguish between binding and nonbinding provisions is one of the many results of not involving outside professionals in the term sheet process. A good business attorney will draw clear distinctions between what is and what is not binding and include “magic language” to reinforce the non-binding nature of the majority of the terms. Equally importantly, an attorney will be instrumental in identifying all of the key terms that need to be in the term sheet. For example, we have seen M&A transactions fall apart at the last minute because the parties did not agree at an early stage regarding the duration of the non-compete that the buyers required from the selling shareholders. There are numerous other situations where transactions are cancelled or significantly delayed because of disagreement over items that should have been included in the term sheet.

As mentioned above, equity investments and M&A transactions are two situations in which term sheets are highly advisable. Below are samples of the elements usually found in term sheets for these types of transactions.

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Venture Capital Term Sheets. When companies negotiate for equity investment by angel investors or venture capital funds, items that should be included in the term sheet will vary depending on the details of each situation. However, at a minimum the term sheet will specify: (a) amount of investment; (b) timing of investment (single investment versus tranches); (c) exact equity ownership that the investor will receive (e.g., the number of shares of common stock or preferred stock); (d) details of minimum raise and escrow, if applicable; (e) terms of any preferred stock such as the dividend rate, liquidation preference, conversion terms, cumulative versus noncumulative, participating versus non-participating; (f) information rights of the preferred shareholders; (g) board seat provisions for the investors, if applicable; and (h) rights of the preferred shareholders to approve specified major transactions.

Mergers and Acquisitions Term Sheets. Again, the exact items will vary depending on the specifics of the transaction. However, the term sheet at a minimum will specify: (a) the purchase price; (b) whether assets or equity of the target company are being acquired or there is to be a merger; (c) whether the purchase price will be paid in cash, equity, debt securities, or some combination of thereof; (d) any excluded assets; (e) liabilities to be assumed; (f) key terms of the employment agreements for executives remaining after the acquisition; (g) earn-out provisions if any; (h) timing of closing; (i) any special indemnification terms and (j) conditions to closing – e.g. financing or third party approvals.

There are many other nuances to term sheets beyond what is discussed here, and each term sheet will have its own unique considerations. An experienced attorney can help you decide if a term sheet is needed, and if so provide extremely valuable input into the term sheet process. We would be happy to discuss whether a term sheet is appropriate in your situation and to assist in the preparation and negotiation of the term sheet.

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