

TERMSHEETS

When an inventor builds a machine, he makes sure that he knows how each of the parts work and how they fit together. The more planning and preparation he puts into the machine, the more smoothly it operates when he switches it on. If the same kind of detailed planning and preparation is put into the legal administration of a company, then selling that company should be a much smoother process. The intention of this series of articles is to assist with that planning by looking at some of the cogs in the machine and providing some insight into what each one does.

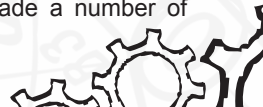
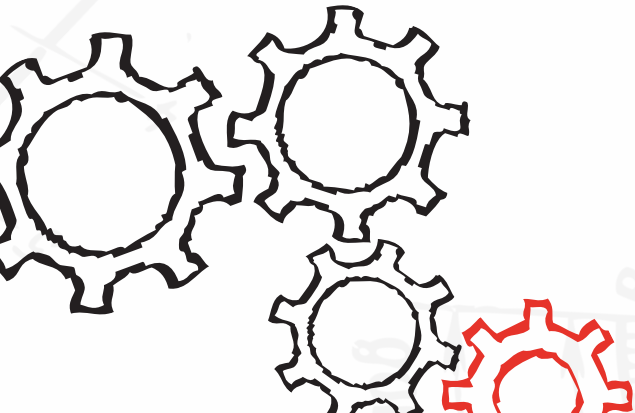
Over the course of this series of articles we first considered cogs that are put in place earlier in a company's life and, later, those that are put in last – the planning and preparation that management put into the major transactions in the life of their company. From the first to the last, each of the cogs in a gear chain has an effect on the others and on the overall efficiency of the machine. In the same way, the success of a company's eventual sale or fundraising round depends on each of the decisions that management has taken during the company's life.

This article deals with the last cog to fall into place – the document that sets out the main terms for a major, transformative transaction. That might be a substantive commercial contract, or more usually an investment in or sale of the company. I will use the word 'termsheet' for the sake of simplicity – in practice the document may be referred to as any one of a number of things, from a letter of intent through a heads of agreement to a memorandum of understanding.

Whatever its title or format, the main purpose of a termsheet is to set out the key commercial terms of the proposed transaction – the proverbial '30,000 feet' view. Both parties will have certain issues which dictate whether or not they will be willing to proceed with the deal, and the termsheet gives both parties the ability to raise their 'deal breaker' issues at an early stage. In theory agreement on these points should be easier at an earlier stage in the process but, if no compromise can be reached, both parties can at least cut their losses before they have invested significant time, management attention or money into the deal.

100,000 FEET LTD.

When the directors of 100,000 Feet Ltd. went out to raise funding, they quickly established a good rapport with the principals from a particular venture capital house. The VC was a good fit for the business, having made a number of



investments in a similar sector. They understood 100,000 Feet's technology and the two teams got along well. After the initial meeting, it was clear to all concerned that there was a deal to be done. The headline terms of the deal were agreed over dinner the following week, and a termsheet was signed by both sides soon afterwards.

The VC duly dispatched its lawyers and specialists to perform diligence on 100,000 Feet's books and records, and with management spending significant time and advisers fees arranging those records, answering questions and moving the transaction along. Everything was progressing smoothly until the VC's lawyers delivered a first draft of the investment agreement. The terms, while not in themselves particularly harsh, were just not acceptable. A series of meetings ensued but although there was still goodwill on both sides, the parties could not come to agreement and the deal fell through.

While the momentum created by the initial meeting between 100,000 Feet and the VC had been helpful in moving towards a deal, it had also pushed the directors through termsheet stage too quickly. By failing to give the termsheet proper consideration, management had not identified and dealt with their dealbreaker issues at the appropriate time. Whether or not the issues could have been resolved with the VC at termsheet stage is open to question, but having the deal broken at that stage would have

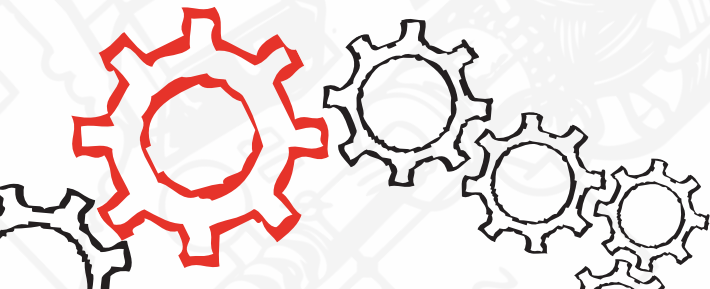
allowed 100,000 Feet to go back to other interested investors while they were still warm – and with their reserves of time, effort and cash still intact.

WORMSEYE LTD.

The management of WormsEye Ltd. identified a partner for a potential joint venture which, if completed, would be the transaction that would define their business. WormsEye's management was conscious of the need to get the deal terms correct – they had a limited number of possible JV partners. Sensibly, their dealbreakers were all covered in early discussions with their JV partner and the draft termsheet that Wormseye then received from their partner accurately reflected the agreed positions on the dealbreakers.

The directors, however, considered that some of the language in the termsheet was too vague – for a deal of this significance they wanted to know what they were getting into before they signed. Clarifying these points to everyone's satisfaction took a couple more weeks of discussions, but eventually the directors pronounced the termsheet language sufficiently detailed on these points.

Having covered their own issues, Wormseye's directors decided it would be sensible to give other people within the business who would be heavily involved with the joint venture a chance to comment on the terms. The chief technical officer and the head of the project team, among others, weighed in and added some new areas to the termsheet. Again, WormsEye were careful to ensure that there was no ambiguity in the language – and as a result the termsheet took several more weeks to agree among all the stakeholders on both sides.



At the end of the process, Wormseye had an agreed 18-page termsheet that covered a substantial proportion of the subject matter of the joint venture. Unfortunately they had taken so long to get there that several external deadlines to have the joint venture implemented were fast approaching. Both sides had run up considerable costs with their advisers, and although the negotiations on the termsheet had not been particularly difficult the partners' management teams did not have the appetite to get back around the table and negotiate definitive documents. In fact, Wormseye and their JV partner ended up agreeing not to use definitive agreements at all – they had their lawyers amend the termsheet to reflect that it was now intended to be binding. Of course a year or so later when a dispute arose, the lack of any definitive agreements became a significant issue for both parties.

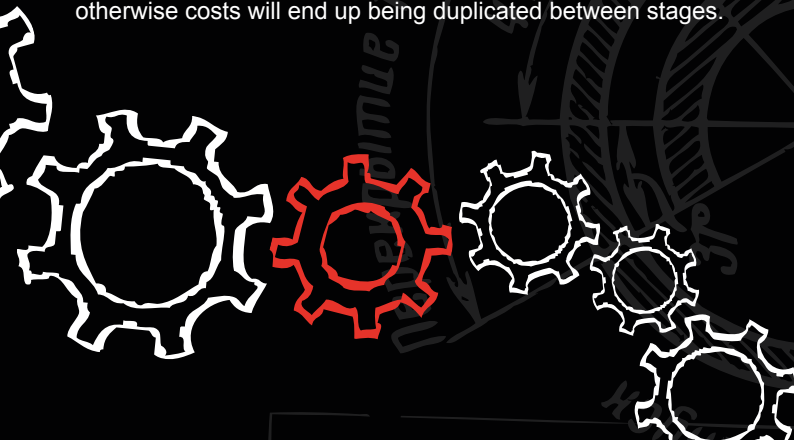
This example is an extreme one – but it is all too often the case that parties find themselves stuck in the mud at termsheet stage. Time and money spent here does not equate directly to time and money saved when the definitive documents are agreed – certainly some issues will be resolved, but detailed points should be left to be discussed when definitive documents are agreed, otherwise costs will end up being duplicated between stages.

NOTSUBJECT LTD

Notsubject Ltd. entered into negotiations with a software company to provide outsourced training services to that company's licensees. The principals conducted the detailed negotiations, and six weeks later all key terms had been agreed with the aim of proceeding "by the end of this month" and a termsheet to that effect was signed. Notsubject's in-house team was busy on other matters and as a result, no definitive agreements were produced by the start date that had been contemplated. Following that start date, the software company had now decided that it did not want to outsource its training services to notsubject or, indeed, at all.

Fortunately for notsubject, the termsheet was silent on the point of whether or not it was intended to be legally binding. There is a body of law on this topic but as a broad rule, a document that appears to be setting out a commercial agreement between two parties (both of whom have signed it) will generally be held to be binding. The software company was in fact stuck with a binding arrangement it did not want. It is usual in termsheets to insert specific language such as 'this termsheet is not intended to be legally binding', and then specifically to highlight any terms (such as confidentiality or exclusivity) that the parties do intend to have legal effect.

Phrases such as 'subject to contract' or 'subject to further documentation' are often used to try and achieve the same effect, but these are less clear and can depend on context. A termsheet being expressed to be 'subject to contract' may create a presumption that the parties anticipate further definitive documents, but it does not necessarily mean that the terms in the termsheet are not binding. It would be open to a court to decide that some or all of the terms were intended to have contractual force. In short, there is no substitute for clarity at the outset.





CONCLUSION

Used correctly, a termsheet can be extremely useful in the process of doing a deal. Both sides should look to have their dealbreakers brought up and agreed at this stage, and ensure that the termsheet covers all of them. Though termsheets are an indication of serious intent or moral commitment, they will typically not require the parties to deal on its terms, if at all. However, a well-drafted termsheet that addresses the correct areas will reduce the risk of both parties getting some way down the line and then discovering that there is no deal to be done, and by eliminating certain issues from the negotiation of the definitive documents it can save both sides considerable time and expense.

The traps for the unwary, with this particular cog, lie at both ends of the scale – a termsheet that is too high-level will not save any effort at all, whereas one that is too detailed will inevitably lead to cost and delay. Entrepreneurs should consider before the process begins what they wish to see covered in the termsheet, and during discussions with their counterparty and their advisers should bear in mind that an agreement in principle is what counts at this stage – the detail should come later, and it should be clear from the language of that termsheet that other points may arise subsequently provided that they do not counter any of the key terms agreed on the termsheet.