

UNDERSTANDING TERM SHEETS AND LETTERS OF INTENT

Whether a transaction involves a purchase, sale, joint venture, vendor agreement, or a strategic alliance, many of the legal issues confronted will be similar. At the top of the list for transactions involving technology or technology companies will be considerations regarding confidentiality and the protection of proprietary information and products. Close on the heels of confidentiality and nondisclosure concerns, however, comes a host of equally important issues. What are the parties' expectations? What is the purpose of the transaction and what are its parameters? Each of these issues and more are often addressed, at least initially, in a term sheet or letter of intent.

Overview of Term Sheets

Definition and Purpose

A term sheet is usually a non-binding written outline setting forth some or all of the key points of understanding between parties with respect to the most significant components of a proposed transaction. Term sheets are almost always presented in an outline or "bullet" format and rarely exceed a few pages. Term sheets are the means of determining at an early stage whether the parties are generally in agreement on some of the most significant elements of the proposed transaction. Term sheets tend to speak more to the key economic, financial and strategic elements of a proposed transaction, and rarely to any of the legal details. At their most rudimentary level, term sheets help the parties of the proposed transaction to ensure that they have some fundamental level of mutual vision and understanding at a very early stage of discussions.

When to Use a Term Sheet

Term sheets are viewed as either very useful tools or a waste of time and energy. In fact, both views can be correct, depending upon the particulars and circumstances of a given transaction. In relatively simple transactions in which the issues related to structure, consideration, covenants and the like are rather straightforward, term sheets may well be unnecessary. However, if the transaction is particularly complicated or involves equity or debt securities, term sheets can prove very useful and efficient.

Overview of Letters of Intent

Definition and Purpose

A letter of intent is a written agreement setting forth the preliminary understandings of parties who intend in the future to enter into a more definitive, comprehensive and complete contract. It can be binding, non-binding, or binding-in-part and non-binding-in-part. Like term sheets, letters of intent ensure that there is some fundamental meeting of minds between the principals before further due diligence, negotiation, drafting and expense are undertaken. Letters of intent can serve a number of important functions. At their most basic level, they help the parties to focus on those points with respect to which they are in accord and also on any key issues that must be resolved in order to proceed. In so doing, letters of intent can help prevent misunderstandings and promote clear understanding between the parties with respect to matters of economic, strategic or institutional importance.

Advantages of Letters of Intent

One of the principal benefits of a letter of intent is that it clarifies each party's position before an extensive and expensive negotiating, documenting and due diligence process is undertaken. A second advantage associated with letters of intent is that they clarify areas that are still to be addressed or resolved. This allows the parties to focus their negotiations more clearly on those points that require clarification or are in contention, leaving the lawyers to draft definitive agreement provisions that embody the points already settled. Third, letters of intent add substance and stability to the overall process. Parties are less likely to abandon a transaction if they have gone to the trouble and expense of negotiating and signing a letter of intent. The signing of an agreement, even one that is non-binding or non-binding in part, often gives rise to an intangible but quite important sense of moral obligation. A fourth, and particularly practical, benefit of letters of intent is that they may facilitate obtaining certain types of regulatory approval and any required acquisition financing.

Potential Disadvantages of Letters of Intent

Letters of intent may delay the real work of crafting a definitive agreement and therefore forestall the closing of the relevant transactions. Whether this expenditure of time is ultimately recouped as the process continues is a matter on which reasonable people can differ. In relatively straightforward transactions, many would argue that it is often more efficient to proceed with the ultimate agreement rather than dedicate time to the letter of intent. A second potential disadvantage of letters of intent is the risk associated with premature public disclosure of the transactions contemplated thereby. This risk is especially relevant when the purchase and sale of a public company, or one whose principal assets are proprietary and confidential, is involved. Public knowledge of a proposed transaction may, for example, attract other competing bids for the same or alternative transactions. From the buyer's perspective, such a development is not particularly attractive, since it may drive up the price or even put the transaction itself at risk. From the seller's perspective, premature disclosure may be equally unattractive or problematic. For example, once a possible transaction is announced, a failure to proceed to closing may create the impression of "damaged goods," thereby diminishing the value or likelihood of an alternative transaction. Whether deserved or undeserved, this perception can make it difficult for a seller to find a new buyer. Finally, letters of intent actually may promote inflexibility. Signatories to a letter of intent may feel bound or constrained by the terms of the letter and may be unwilling to deviate from them. Such a posture can, these practitioners argue, lead to grid locked negotiations or collapsed transactions.

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