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Term Sheets, Letters of Intent and Other "Non-Binding" Pre-Deal Documents

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Agenda

- Overview of Pre-deal Documents
- Pre-deal Documents - Advantages
- Pre-deal Documents - Risks
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- Other Unintentionally Binding Agreements
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Overview of Pre-deal Documents

- Pre-deal documents:
  - Set out certain key terms of a transaction agreed in principle between parties (usually the business principals).
  - Are typically negotiated and signed (but not always signed) at the beginning of a transaction, before drafting definitive documentation.

Overview of Pre-deal Documents

- Typical pre-deal documents include:
  - **Term Sheet.** Generally formatted as an abbreviated list of key points.
  - **Letter of Intent.** Generally prepared in letter format and may include more detail on key terms than a term sheet.
  - **Memorandum of Understanding.** Generally more comprehensive than both term sheets and letters of intent.
- The content and form of a pre-deal document varies based on industry, type of transaction and intent of the parties. For example:
  - Parties to M&A transactions typically utilize Letters of Intent in responding to bids.
  - Non-U.S. parties will typically utilize a Memorandum of Understanding.
  - Bank deals typically employ term sheets.

Overview of Pre-deal Documents

- Used in a variety of transactions, including commercial negotiations, mergers and acquisitions, lending arrangements, joint ventures, and real estate.
  - — Outside of the M&A context, internal and external legal counsel may not always be involved at the outset of the process
- Generally not intended to be legally binding, with key exceptions.
  - — Can be used to bind a counterparty to legally enforceable obligations during negotiation of the final agreement (i.e., confidentiality, exclusivity and expense reimbursement).
  - — Ambiguously drafted pre-deal documents may be interpreted by courts to create other binding obligations (as discussed in further detail in subsequent slides).

Pre-deal Documents - Advantages

- Set out basic expectations and understandings regarding material terms (e.g., price, term and termination) at the outset of negotiations.
  - This can focus the drafting and negotiation of definitive documents if key terms are resolved early in the process.
- Identify major issues or "deal-breakers" before committing time and money to conduct due diligence or draft transaction documents.

Pre-deal Documents - Advantages

- Increase deal certainty.
  - Even if terms are not legally binding, parties may feel a “moral commitment” to those terms.
  - Binding obligations to negotiate in good faith or other binding provisions increase commitment to consummate a transaction.
- Outline the timetables and general obligations of the parties.
- Set out certain legally binding clauses (e.g., exclusivity, confidentiality and expense reimbursement).
- May be used to submit applications to relevant regulatory authorities (e.g., HSR Act).

Pre-deal Documents - Advantages

- **Practice Tips**:
  - Educate business teams to get legal involved early in the process.
  - Ensure pre-deal documentation sets out key terms in sufficient detail to avoid subsequent disagreement (e.g., “customary” and “typical” standards leave many details to be negotiated later).
  - Negotiate potentially contentious terms at the pre-deal phase to save time and expense at the definitive documentation stage and to identify if there are any deal-breakers.
  - Expressly specify any key terms that should be legally binding on either party (as further discussed below) to increase transaction certainty.

Pre-Deal Documents – Risk Overview

- Letters of intent, memoranda of understanding or term sheets can introduce significant risk if not drafted properly.
  - **Binding Effect**. Risks include creating an unexpected binding obligation to perform a contract or produce payment, or conversely, the inability to enforce terms expected to be enforceable.
  - Whether pre-deal documents are binding or non-binding depends on the language. Courts look at multiple factors in finding whether the language in a pre-deal document is binding or non-binding.
  - **Ambiguity**. Typically, parties mean letters of intent and term sheets to evidence their intent to do something in the future. While intended to show good faith rather than "final" contract documents, ambiguity and differing intentions can result in a dispute. Insufficiently detailed letters of intent can result in subsequent disputes.
  - **Difficulty of Renegotiation**. Although most term sheet provisions are legally non-binding, it is very difficult – and can be politically and economically expensive – to attempt to renegotiate an executed term sheet.

Risks - Binding Effect

- A key disadvantage of pre-deal documents is that imprecise drafting can lead to uncertainty as to whether there is a deal until a definitive agreement is reached.
  - Creates significant potential for disputes and the risk that a court will regard the arrangement as more (or less) binding than a party may have intended.
- Parties expecting the substantive terms of a term sheet or letter of intent to be binding on a counterparty in subsequent negotiations may be unable to enforce such terms.
- Conversely, parties expecting to walk away from negotiations following execution of a term sheet without ongoing obligations may have unintentionally bound themselves by certain terms, or in some instances, an obligation to negotiate in good faith.

Risks - Binding Effect

- **Practice Tips:**
  - Include specific language explicitly stating the binding or non-binding nature of each section of the pre-deal document.
  - Carefully consider and review which provisions are specified as legally binding, including any key business terms.
- **Example**:
  - "*This Letter of Intent does not constitute a legally binding agreement, except that Section 3 (Exclusivity), Section 4 (Confidentiality), Section 5 (Binding Provisions), Section 6 (Expenses), and Section 7 (Governing Law) of this Letter of Intent shall constitute legally binding and enforceable obligations of Counterparty and the Company*"

Risks - Binding Effect

- Binding provisions are usually limited to those that are necessary during the negotiation period. For example:
  - **Exclusivity.** A party may require a binding exclusivity commitment before it expends any time and money on negotiations of the deal:
    - *"The Company agrees to negotiate exclusively with Counterparty with respect to a Transaction and agrees not to directly or indirectly solicit any inquiries, proposals or offers, participate in any discussions or enter into any agreement or arrangement regarding a proposed Transaction, until December 31, 2020."*
  - **Confidentiality**. A party may want a binding confidentiality provision before it provides the other party with any information for its due diligence review, if not already included in a separate agreement:
    - "*Prior to the execution and delivery of a definitive agreement, neither the Company nor the Counterparty shall disclose to any third party (other than its counsel, financial advisors, accountants, equity holders or other agents or representatives) the fact that negotiations relating to the Transaction are taking place or any of the proposed terms or conditions of the proposed Transaction, without the prior consent of the other party, unless required by applicable law or regulation in the opinion of counsel.*"

Risks - Binding Effect

- **Expenses**. The parties may want to include a binding provision allocating fees and expenses incurred for the transaction:
  - "*Except as provided in a definitive agreement, each party hereto will bear its own costs and expenses (including without limitation legal, consulting, accounting and other professional fees and expenses) incurred in connection with this Letter of Intent, any definitive agreement and the transactions contemplated hereby and thereby, whether or not definitive agreement has been executed.*"
- **Dispute Resolution and Governing Law**. Parties may want to specify dispute resolution mechanics and governing law in the event of a dispute:
  - *"This Letter of Intent shall be governed by, and construed in accordance with, the laws of the State of Delaware, without regard to conflict of laws provisions. In any dispute between the parties arising out of or relating to this Letter of Intent each of the parties irrevocably and unconditionally consents and submits to the exclusive jurisdiction and venue of the state and Federal courts located in the State of Delaware."*
- **Termination Fees**. Standstills and termination fees are frequently intended to be binding:
  - *"Company and Counterparty intend to be, and acknowledge that they hereby are, bound to complete the Transaction by no later than the Outside Date on the terms and conditions set forth in this Binding Letter of Intent. Buyer shall pay to Seller a termination fee of [$______] if the closing of the Transaction does not occur prior to the Outside Date."*

Risks - Unintentional Binding Effect

- If a pre-deal document does not contain explicit language specifying the binding or non-binding nature of each provision, a court may nonetheless determine that some or all of a pre-deal document creates legally binding obligations.
- When determining whether an obligation is binding, courts generally look to the parties' intent by examining the following factors:
  - Language used in the term sheet.
  - Context of the agreement and the surrounding negotiations.
  - Whether the terms are sufficiently definite to be enforceable or there are material terms still left to be negotiated.
  - Partial performance of the obligations by one of the parties.
  - Whether the subject matter of the discussions concern complex issues which are normally addressed in a formal contract.
  - The most significant factor is the language used in the document.

Risks - Unintentional Binding Effect

- Second Circuit has established a framework for determining binding effect of pre-deal documents. Other courts have adopted this framework.
  - Categorized as Type I and Type II Agreements (see *Vacold LLC v. Cerami*, 545 F.3d 114, 124 n. 2 (2d Cir. 2008))
  - Type I Agreements
    - Formed when parties reach complete agreement on all issues requiring negotiation.
    - Binding on parties and fully enforceable even if parties never execute a subsequent definitive document.
  - Type II Agreements
    - Formed when parties agree upon the major terms while acknowledging open terms requiring further negotiation.
    - Parties not contractually bound, but are required to negotiate open terms in good faith.

Risks - Unintentional Binding Effect

- Courts apply the following test for identifying Type I agreements:
  - Whether the agreement contains a reservation not to be bound in the absence of a later writing;
    - The precise language of the agreement is most critical.
  - Whether there has been partial performance of the agreement;
    - Partial performance under the agreement, accepted by the other party, evidences a binding agreement.
  - Whether all of the agreement's terms have been agreed upon; and
    - Courts will employ a flexible analysis to determine whether the parties agreed upon the necessary aspects of their agreement, assessing the significance of open terms and the subject matter, complexity, and purpose of the agreement.
  - Whether the agreement at issue is the kind that is usually committed to writing.
- Context of negotiations are considered in addition to the foregoing factors in identifying Type II agreements.

Risks - Unintentional Binding Effect

- **Practice Tips**
  - To avoid unintentional binding effect:
    - Pre-deal documents should clearly and plainly state nonbinding or binding effect.
    - Title the document according to the parties' intentions (e.g., "binding" or "non-binding"). Titles or footers to this effect may not be sufficient.
    - If intended to be non-binding, consider utilizing an unsigned list outlining key terms.
    - If certain provisions are intended to be binding, clearly and unambiguously identify which provisions are binding **and** which provisions are non-binding.
    - If parties desire binding obligations to be subject to certain pre-conditions, include provisions clearly stating such pre-conditions.
      - E.g., obtaining financing, completion of due diligence, board approval, contractual consents, etc.

Risks - Unintentional Obligation to Negotiate in Good Faith

- Even if the terms of a pre-deal document are not legally binding, parties may nonetheless be obligated to negotiate in good faith.
  - Some courts have found an obligation to negotiate in good faith even though it was not expressly stated in the term sheet but circumstances supported a finding that the parties intended to be bound by an agreement to negotiate in good faith (see *In Channel Home Centers, Div. of Grace Retail Corp. v. Grossman*, 795 F.2d 291 (3d Cir. 1986)).
  - Other courts have held that no duty existed where, even though there was an express provision to do so, that provision was not clearly identified as one of the binding provisions of the term sheet (see *Schwanbeck v. Federal-Mogul Corp*., 412 Mass. 703 (Mass. 1992)).

Risks - Unintentional Obligation to Negotiate in Good Faith

– As with cases involving the issue of binding or non-binding provisions, courts look to the intent of the parties by examining several different factors, including the language contained in the term sheet. Parties, therefore, must pay particular attention to how the term sheet is drafted.

- **Practice Tip**:
- Explicitly state whether there is an obligation to negotiate in good faith.
  - **Example 1**: "*This Letter of Intent creates no legal obligations, including the obligation to negotiate, with respect to the Transaction on the part of any party hereto.*"
  - **Example 2**: "*The Company agrees to work with the Counterparty expeditiously and in good faith to complete the definitive agreement, together with all other legal documents required to consummate the Transaction*"
- If an obligation to negotiate in good faith is desired, ensure the document explicitly states that such provision is legally binding.

Risks - Unintentional Obligation to Negotiate in Good Faith

- ***SIGA Technologies, Inc. v. Pharmathene, Inc.*, 67 A.3d 330 (Del. 2013)**
  - Delaware Supreme Court adopted the Type I/Type II framework.
  - SIGA and PharmAthene entered into a bridge loan and merger agreement when SIGA was in financial distress and the value of SIGA's drug for the treatment of smallpox was uncertain. The bridge loan and the merger agreement provided that, if SIGA at any time exercised any of its rights to terminate the merger agreement, the parties would negotiate in good faith an agreement granting PharmAthene a license on SIGA's drug, consistent with the terms set forth on a term sheet attached to the merger agreement.
  - SIGA subsequently exercised its right to terminate the merger agreement and refused to negotiate the license agreement on terms consistent with the term sheet, insisting instead on "drastically different" terms.

Risks - Unintentional Obligation to Negotiate in Good Faith

- Delaware Supreme Court held that an agreement to negotiate a definitive agreement in good faith is enforceable, and that expectation damages were an appropriate remedy for such a breach if they can be proven with reasonable certainty and the court determines that the parties would have reached an agreement but for the bad faith conduct of the defendants.
- Other courts have been hesitant to grant expectation damages for a failure to negotiate in good faith.
- In *SIGA*, the fact that the footer in the licensing term sheet stated "Non-binding terms" was not enough to override the obligation in the merger agreement to negotiate in good faith based on the terms in the term sheet.

Risks - Unintentional Obligation to Negotiate in Good Faith

- Holding may have differed in the case of breach of a preliminary agreement to negotiate a merger agreement that includes a fiduciary out and/or stockholder approval requirement, given uncertainty as to whether a definitive agreement would ultimately be consummated.
- **Practice Tips**:
  - Consider negotiating the type of damages that would apply in the case of a breach (e.g., expressly excluding expectation or reliance damages).
  - Definitive documentation can be conditioned on satisfaction of certain factors (e.g., board or committee approval), which can impede a finding by a court that a deal was not reached because of a failure to negotiate in good faith.

Risks - Unintentional Obligation to Negotiate in Good Faith

- Satisfaction of an obligation to negotiate in good faith:
  - Parties need not consummate a transaction to fulfill their duty to negotiate in good faith. Parties can fail to come to an agreement if they can prove that they did not act in bad faith.
    - Question of fact and depends on the circumstances surrounding the negotiations.
  - However, a party cannot renounce the obligation to negotiate, abandon negotiations without good faith efforts to reach agreement, or insist on conditions or terms that are materially inconsistent with the term sheet or letter of intent.
  - In *SIGA*, the merger agreement and bridge loan explicitly provided that, if the merger agreement were terminated, the parties had an obligation to negotiate an agreement reflecting the licensing term sheet. That explicit obligation, together with a term sheet that included many of the material terms relating to the contemplated license agreement, together with SIGA's clear refusal to negotiate an agreement consistent with the terms set forth on the term sheet, resulted in the court's finding that SIGA had breached an obligation to negotiate the license agreement in good faith.
- **Practice Tip**:
  - Consider specifying what constitutes bad faith (for example, violating the exclusivity clause, lack of cooperation with due diligence, or failure to use reasonable efforts to obtain financing).

Risks - Unintentional Obligation to Negotiate in Good Faith

- A change in economic circumstances generally does not provide an opportunity to renegotiate terms.
- A party's internal and external communications will be considered in determining its "willfulness" in breaching an obligation to negotiate in good faith.
  - In *SIGA*, SIGA's internal communications made clear that SIGA regretted having entered into the merger agreement and preferred not to enter into the related license agreement. A party's communications to its counterparty, as well as internal emails and board presentations, will be relevant in a court's determining (i) whether a party's refusal to negotiate is based on a contractual or other legally justifiable excuse for its not being bound, or (ii) a willful breach of its obligation in bad faith.

Other Binding Agreements – Email and Other Pre-deal Communications

- E-mail or unsigned pre-deal communications may result in fully binding obligations even when the parties anticipate executing a subsequent definitive agreement.
- A court will first look to the language of the document, which is considered to be the best objective indicator of the intent of the parties.
- ***Shinhan Bank v. Lehman Brothers Holdings Inc. (In re Lehman Brothers Holdings Inc.)*, 17-2700 (2d Cir. July 17, 2018)**
  - Second Circuit upheld the bankruptcy court's and district court's ruling that an email by defendant's counsel to the opposing side stating that the defendant will sign a settlement agreement creates a binding contract even if the defendant later chooses not to sign the settlement agreement.
  - Parties intended to be bound by the settlement agreement despite not having an executed document because (i) the parties had not expressly reserved their right not to be bound absent a writing and (ii) there existed no disagreement on any material issue.

Other Binding Agreements – Email and Other Pre-deal Communications

- Court focused on four factors, with no single factor being decisive:
  - whether there has been an express reservation of the right not to be bound in the absence of a writing;
  - whether there has been partial performance of the contract;
  - whether all of the terms of the alleged contract have been agreed upon; and
  - whether the agreement at issue is the type of contract that is usually committed to writing.
- While this case was a ruling by summary order and does not have precedential effect, it highlights circumstances in which a court might deem emails or other indications of intent to be binding, enforceable contracts.
- Courts may be more likely to deem an executed letter of intent or term sheet to be a binding, enforceable contract.

Reducing Risk – Practice Tips

- Pre-deal documents should clearly and plainly state nonbinding or binding effect.
- Title the document according to the parties' intentions (e.g., "binding" or "non-binding").
  - In *SIGA*, a footer stating "Non-binding Terms" was not sufficient.
- If intended to be non-binding, consider utilizing an unsigned list outlining key terms.
- If certain provisions are intended to be binding, clearly and unambiguously identify which provisions are binding **and** which provisions are non-binding.
- If parties desire binding obligations to be subject to certain pre-conditions, include provisions clearly stating such pre-conditions.
  - E.g., obtaining financing, completion of due diligence, board approval, etc.
- Consider negotiating the type of damages that would apply in the case of a breach (e.g., expressly excluding or including expectation or reliance damages)

COVID-19 Implications

- Generally, COVID-19 impact on business environment may cause a shift in negotiating power. Investors or more financially stable counterparties may be able to extract more favorable terms at the pre-deal documentation phase.
  - Financially unstable or distressed companies may be overeager to sign something imminently without appropriate focus on the formalities mentioned previously.
- Remote work environment leads to less formal communications which can enhance the risks already covered.
  - e.g., greater use of email and reduced instances of manually signed documents.
- COVID-19 will likely increase focus on provisions related to termination or obligations to negotiate or consummate transactions.

COVID-19 Implications

- May lead to more detailed or heavily negotiated provisions at the pre-deal documentation phase for healthy companies:
  - Parties may wish to negotiate force majeure clauses that explicitly include references to viruses or the COVID-19 pandemic.
  - Parties may wish to negotiate detailed material adverse change or event of default provisions at the term sheet phase to explicitly include or disclaim COVID-19 or other pandemic related effects.
  - Until the market coalesces around standard language, these additional terms may, in and of themselves, lead to disputes.

Speaker Biographies

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Justin Ochs represents both public and private companies on a variety of corporate finance and other matters. Borrowers, private equity sponsors and financial institutions rely on Mr. Ochs' experience and strategic business advice and turn to him for counsel on a wide range of debt financing transactions. Mr. Ochs successfully represents his clients in matters involving secured and unsecured financings, leveraged buyouts and acquisition financings, bridge loans, first- and second-lien, mezzanine and other subordinated debt, working capital facilities, commercial paper programs and letters of credit. He is also a trusted advisor to clients on mergers and acquisitions and other general corporate and securities matters. Mr. Ochs is a member of the American Bar Association (Business Law Section), the DC Bar Association and the New York State Bar Association. He also serves on the Advisory Board of the Georgetown Law Corporate Counsel Institute.

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Stephanie Evans advises domestic and international clients on a wide range of corporate transactions, with a particular focus on mergers and acquisitions, joint ventures, strategic alliances and financings. She regularly advises boards and special committees in connection with transactions and provides advice on governance and commercial transactions. Her clients include private and public companies in a variety of industries, including financial services, defense and technology. She is active with emerging growth companies throughout their development cycle (see more on Ms. Evans' emerging growth company practice on WilmerHaleLaunch.com). She was previously Vice Chair of the Corporate Practice Group. Ms. Evans also worked as an associate in the Global Investment Banking Group of Deutsche Banc.

Dan Kecman is Managing Director and Associate General Counsel for Corporate Transactions at Navient. In this role, he manages Navient's corporate transactions team and focuses his practice on a range of strategic and commercial transactions and related matters. Prior to joining Navient, he was a corporate attorney at Latham & Watkins where his practice focused primarily on mergers and acquisitions, general corporate matters and emerging companies matters. He received his B.S. in Finance from Virginia Tech and his J.D. from American University, Washington College of Law.

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