Guide to: Heads of Terms

Heads of Terms are a set of (usually non-binding) principles that both parties sign to confirm their agreement to the key points of the proposed deal. Neither side is strictly held to them but it can be awkward (from a tactical negotiation perspective) to try to move the other side too far away from them once they've been signed.

If the seller and the buyer were to try and negotiate a detailed legal agreement, without first getting key points agreed in principle, they might find that negotiations stall or, even worse, halt completely.

Because Heads of Terms focus on the key commercial (rather than legal) points, it's generally quicker, easier and cheaper to negotiate them than it is to agree the binding legal agreement. If you can't reach a consensus on the Heads of Terms, then you certainly won't be able to negotiate a binding agreement and there's little point in continuing.

Heads of Terms therefore serve two main purposes. First of all, they make sure you really have got a deal agreed, and secondly, they should be the foundation on which the binding agreement is based.

Some of the key points that should be included in the Heads of Terms are: -

Deal structure

Is the buyer buying shares in the company (a "share sale"), or is the seller selling its business and assets (an "asset deal")? These are very different in respect of both tax treatment for the seller and risk for the buyer. It's important to make sure you're all agreed on the structure right from the start.

Price calculation

Does the buyer expect the price to be reduced to take account of debt? Does the seller expect it to be increased to take account of cash or debtors? Is the buyer expecting the seller to leave behind a level of working capital in the bank when they sell? These points should all be clearly set out in the Heads of Terms.

Payment structure

It's no good agreeing a price of £1 million, if the seller subsequently discovers that the buyer wants to pay only £100,000 up front with the rest delayed for 12 months or even longer. They need to both agree what is being paid when.

Also, the buyer might want part of the price to be dependent on the performance of the business after sale (often known as an "earn-out"). If the seller is prepared to agree to an earn-out, then they need to ensure that both parties agree how this is going to work commercially. They will need to know whether it will be based on profits or turnover, if a particular formula will be used and how will the seller be sure the buyer doesn't do anything to skew the figures.

Security

If the seller is accepting a significant amount of the payment in 12 months' time (or even later) then they will need to think about security. Considerations would be what happens if the buyer becomes insolvent, who will you they will need to chase, whether they will get a personal guarantee from a principal shareholder, or a corporate guarantee from another company in the buyer's group, or if they can get a legal charge (i.e. mortgage) over property or some other form of security for the deferred payments.

Property matters

If the property is leased by the seller (or your pension scheme) back to the company, then the buyer might want to renegotiate the terms of the lease. Lease duration, rent, break notices and repairing obligations are all points that may need to be discussed.

Transition

Does the buyer want the seller or other sellers to stay on for a period after the sale, to help with the transition? If you've agreed to an earn-out, then you're very likely to insist that you stay on, to ensure that turnover/profits are maximised. In either case the seller will need to consider if they are to be an employee or a consultant, how long they will stay and how much they will be paid.

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