



The importance of Heads of Terms in commercial transactions

In this article, Sarah Hemmings and Kyrran Dearnley-Porter in our Corporate and Commercial department explain what Heads of Terms (“HOT”) are and consider the benefits of both sides to a commercial transaction agreeing and executing Heads of Terms as a preliminary step.

A HOT document, sometimes known as a Letter of Intent or Memorandum of Understanding, serves as a mostly legally non-binding, preliminary agreement that sets out the essential commercial terms of a transaction. HOT typically outline the parties involved, the nature of the deal, the purchase price, what is being purchased, payment terms and other key rights and obligations. The HOT lay the foundation for later negotiations of a final document, such as a sale and purchase agreement, and aim to ensure that all parties are on the same page before proceeding with the transaction.

When clients believe that they have already agreed or have an understanding with the party as to the terms of the deal, understandably they may not see the commercial point or significance of a HOT document. Sometimes clients feel that this will simply prolong the process or add to legal costs. Clients sometimes say that the other party may feel that in insisting on HOT, there is a lack of trust between the parties in terms of what has been agreed.

Our commercial advice to clients is always that HOT are absolutely worth putting in place at the start of the transaction, with both sides considering that document and executing to confirm their agreement to its contents. So why is this? Why should parties bother?

- HOT provide very simply clarity going forward, outlining key agreed terms of the deal. This prevents future misunderstandings or misinterpretations meaning that disputes can be avoided or mitigated.
- Both parties’ legal and tax representatives should have input to the HOT. In doing this, clients have comfort that all key issues have been considered. Frequently clients will omit in their direct discussions, consideration of certain aspects of the deal. An experienced solicitor or accountant should be able to identify where a matter has not been considered or which needs further thought. A non-exhaustive list of things which should be reflected in any HOT (dependent upon the nature of the transaction) are;
 - (e) purchase price, how this is to be calculated, how this is to be paid and when;
 - (f) the nature of the acquisition – entire issued share capital, assets, certain assets only and so on;
 - (g) whether there is any mechanism to adjust the purchase price and what that mechanism looks like;
 - (h) if any element of the purchase price is to be deferred, how this will work and whether any security is being offered for the deferred element (e.g. by personal guarantee or a charge);
 - (i) any other specific provisions around purchase price – such as an anti-embarrassment clause, or restrictions on the business until the purchase price has been paid in full;
 - (j) if there are any restrictive covenants to be imposed on the seller;

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- (a) seller promises (in the form of warranties and a tax covenant) that will be given to the buyer and limitations on the seller's exposure to claims under those provisions;
 - (b) whether exchange and completion will happen simultaneously or is split. Is the transaction conditional upon any matter occurring first (e.g. obtaining certain third-party consents)?
 - (c) expectations of the seller going forward – is it intended that they will continue to work within the business and if so, on what terms? Is this to be subject to a consultancy, service or other agreement?
 - (d) any ancillary matters – for example, around property occupation.
- HOT should make reference to the legal formalities that the parties understand and agree will follow. These include the due diligence process (legal and accounting/tax) and preparation of a share (or asset) purchase agreement and other legal documents.
 - HOT will also set out the assumptions and expectations of a buyer about the target company which will be flushed out in due diligence enquiries.
 - Whilst as said above HOT are usually largely legally non-binding, certain clauses are expressed to be legally binding and these contain key clauses upon which a party may want to rely. Typically, the following are examples of legally binding clauses in HOT;
 - (a) provisions around exclusivity – that the buyer has exclusive rights to acquire the intended assets/shares up and until a certain date and the seller will enter no other negotiations with a third party during this time;
 - (b) confidentiality;
 - (c) specific cost provisions, for example that each party shall bear their own costs, or one party will compensate the other in the event that the transaction aborts as regards their costs incurred;
 - (d) jurisdiction provisions to be included in the sale agreement.

HOT will never contain the “full picture” – they will always be subject to subsequent negotiations and fleshing out, but if they are properly and comprehensively drafted, they should include provision for all key matters associated with that particular transaction and will focus everyone's minds on the relevant and agreed fundamental aspects of the deal.

The use of HOT is common in a number of commercial transactions, most commonly mergers and acquisitions and as solicitors acting for either side of the deal, we would recommend that they are produced in all cases. Taking the time to produce an agreed document at the outset can be invaluable in avoiding confusion, uncertainty and wasted legal costs at a later date.

If you are in need of any advice or assistance with regard to Heads of Terms, including drafting or reviewing, please contact our expert team of lawyers at NewEnquiries-Coco@chadlaw.co.uk.

For more information about how we can help you please contact:

