

Corporate Department

Heads of Agreement

Good Heads and Good Planning

What are heads of agreement?

Heads of agreement have many different labels, the most common of which are 'heads of terms', 'letters of intent', 'memoranda of understanding', 'term sheets' or 'letters of potential interest' (**Heads**).

Heads outline the main terms of a commercial transaction agreed in principle between the parties to the Heads.

There is no standard form (Heads can vary from a simple letter form to a carefully drafted document prepared by professional advisers) and the content of Heads will often depend on their purpose.

Heads are commonly entered into at the start of a transaction once preliminary terms have been agreed and before due diligence and the drafting of definitive agreements.

The legal effects of Heads

Heads will usually contain provisions that the parties intend to be legally binding and others that are not intended to be legally binding.

Heads are often said to be "non-binding" as parties to the Heads, at the time of entering into the Heads, invariably do not want the terms of their commercial transaction to be legally binding. Provisions are usually included covering confidentiality, exclusivity, costs and governing law and the parties will want those provisions to have legal effect.

Great care must be taken when drafting Heads so that the intentions of the parties are achieved. For example, Heads can give rise to liability for misrepresentation or negligent misstatement, whether or not the Heads are contractually binding.

There are advantages and disadvantages to Heads

Advantages include:

- Heads are usually considered to confirm a moral commitment of the parties to the Heads to observe the terms agreed (which can be an advantage or disadvantage)
- Heads can help focus negotiations and "flush out" any misunderstandings and, by identifying problems at an early stage, prevent parties wasting money and time if those issues cannot be resolved
- Heads can help parties to instruct their advisers, can help advisers to ask the right questions and perhaps highlight issues the parties had not previously considered
- Heads can be useful to help "sell" a deal to people not directly involved in the negotiations such as a board of directors or lenders
- Heads allow an opportunity to introduce binding commitments such as confidentiality obligations or exclusivity undertakings and outline the timetable and obligations of the parties during negotiations

Disadvantages include:

- The time taken to agree Heads can be disproportionate to any benefit – care should be taken to ensure that a main transaction agreement is not effectively negotiated twice
- The fact that Heads confirm a moral commitment on both sides can sometimes limit flexibility in subsequent negotiations – a party’s negotiating position may be weakened if it seeks to depart from agreed terms
- Heads can expire before a final agreement is executed and if this is not catered for, a contractual vacuum may arise whereby parties are not covered for the work they are carrying out
- Heads can create a legally binding agreement between the parties even if this isn’t intended by the parties. In international transactions, it is important to ensure that signing Heads will not create any unintended obligations (for example, in some European jurisdictions, there is a duty to negotiate in good faith)
- Care must be taken to ensure that Heads do not fall foul of competition law rules and that there are no adverse tax consequences

Binding and non-binding

Heads should always make clear which terms are to be legally binding.

Any provisions that are intended to be legally binding must satisfy the legal requirements relating to the creation of a valid contract – indeed, to create Heads that are binding as a whole, all features of a valid contract must be present.

Examples of common binding and non-binding terms in “non-binding” Heads include:-

Binding terms	Non-binding terms
Confidentiality	The nature of the deal/transaction
Costs	Price or payment or form of consideration
Exclusivity	The timetable
Governing law and jurisdiction	Details of any conditions and due diligence provisions

Conclusion

Good planning and good heads of agreement can prove to be crucial to the success of any transaction.

Heads are much more than an informal road map; anyone considering entering into Heads should consult professional advisers at the earliest possible opportunity.

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