

Heads of Agreement

... what they mean and when to use them

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Note: This publication has not been updated since it was last published. Some of the hyperlinks may have changed and may need updating. In addition, some of the information in this publication may be out of date.

Introduction

In many business deals, the signing of a document called the Heads of Agreement (“Heads”) marks a milestone in any transaction. No doubt there will be a tendency to pop a few champagne corks to celebrate.

Be wary though - the Heads is only the start and there's still a lot of work to be done before completion.

If the Heads have been properly prepared, it should help to ensure that both parties work towards a common goal of achieving a successful completion.

Heads of Agreement

Heads represent exactly what you'd expect the term to cover - the key issues and principal terms of agreement that have been reached and which, when fully drafted by the lawyers, represent the basis of the deal that's been struck.

Heads of agreement are also known as a memorandum of understanding or letter of intent. They are particularly useful when negotiating high-value or complex agreements and as such almost always feature when buying or selling companies. They have two main purposes:

- The first is to record the commercial agreement between the parties and avoid subsequent misunderstanding. They should form a core source when the legal advisers start to prepare legal documentation;
- Secondly, they provide a route map through to completion setting out the agreed timetable and the issues that must be satisfied for the deal to complete. It is an important document and well worth investing time and effort to get right.

Individual circumstances will dictate what should be included. However a suggested checklist is provided on the next page.

Whilst Heads are generally not legally binding they are sufficiently formal so as not to be entered into lightly. By signing the Heads both parties evidence a clear agreement to the key elements of the deal and a serious intention to proceed. Both parties may, however, consider it appropriate at this stage to include additional clauses that are legally binding about matters relating to the negotiations.

Therefore, Heads may also include, for example:

- A “lock-out” agreement, preventing the vendor from negotiating with other parties for a defined period;
- Agreements to protect the confidentiality of the information disclosed and of the negotiations themselves (this may have been covered by separate confidentiality signed at an earlier stage); and
- An agreement that one party will bear some of the other's costs if the deal does not proceed

Obviously addressing all of these issues in the Heads could lead to a lengthy and complex document. However, the more key issues that can be addressed up front the cleaner the run in to completion. Conversely, if the Heads include excessive and unnecessary detail then this will delay completion and may even break the deal.

Both parties and their advisors must have a clear idea of what they wish to achieve with the Heads, which issues should be settled at the outset and which more sensibly should be left for the detailed documents.

In order to preserve the commercial intentions of both parties, the best people to draft the Heads are probably the lead advisors and the parties themselves. However, as some clauses may be legally binding and where there are particularly complex legal issues relating to the structure or operation of the business, it is usually appropriate to give lawyers sight of draft Heads before signing – after all, they have to turn the Heads into a workable legal document.

If the appropriate level of work is put into drafting the Heads, they not only form an excellent briefing paper for the legal contracts but, in a sales process, will help to ensure that the price stays firm through to completion.

When “Heads” are useful

Often, negotiations take place between parties where the agreement will be non-standard. It is not possible for the parties to use a standard form of agreement, and eventually what has been agreed will need to be tidied up and formalised by lawyers. In the meantime some way has to be found of recording the discussions, without binding the parties.

A typical solution is to draw up a document called a 'Heads of Agreement'. This is an agreement with two main characteristics. It is not formal in style, and it is not (usually) binding. It is vital however that the parties be clear as to whether and precisely how far they intend that the discussions should be binding.

Source:
www.swarb.co.uk

Heads of Agreement Checklist

<p>Key substantive terms</p> <ul style="list-style-type: none"> - parties involved; - what is being bought/sold; and - price <p>Principal conditions to exchange of contracts</p> <ul style="list-style-type: none"> - due diligence requirements; - updated financial information; - basic nature of warranties and indemnities; - purchaser's financing; - third party consents/agreements; - regulatory approval/tax clearances; and - board approval <p>Principal conditions to completion (for example, shareholder or regulatory approval)</p>	<p>Timetable to completion</p> <p>Confidentiality (or refer to separate agreement)</p> <ul style="list-style-type: none"> - of information, negotiations <p>Costs failing completion</p> <p>"Lock-out" agreement</p> <ul style="list-style-type: none"> - consideration; and - duration <p>Status of Heads</p> <ul style="list-style-type: none"> - transaction terms not binding (position in Europe may be different); - specify provisions intended to be binding; and - governing law
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Further Information

This guide is for general interest - it is always essential to take advice on specific issues. We believe that the facts are correct as at the date of publication, but there may be certain errors and omissions for which we cannot be responsible.

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