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M&A in Russia under English law: Are we bound by this term sheet?

A high proportion of M&A transactions involving (directly or indirectly) Russian assets are carried out under English law. Parties to a transaction will often execute a term sheet in the early stages of a deal, long before transaction documents are drafted, agreed and executed, which will generally set out the basic agreed commercial framework between the parties in anticipation of the long-form transaction documents. Are such term sheets binding? Does a party retain the ability to walk away? Can one party hold the other to the bargain? This note seeks to address these questions in the context of providing a broader insight into the use of term sheets.

Key issues

- Why use a term sheet?
- When is a term sheet binding?
- What about exclusivity provisions?
- Are pre-agreed damages payments and break fees enforceable?

Summary

A term sheet, sometimes referred to as a 'memorandum of understanding' or a 'heads of agreement', is an effective mechanism for parties to agree on the principal commercial aspects of a deal whilst minimising costs, including legal costs. In particular, a term sheet can help to focus the negotiations, advance a transaction process and, by highlighting major issues at an early stage, prevent the parties wasting time and resources if those issues cannot be resolved.

When considering a term sheet, there are certain issues that parties should be aware of:

When is a term sheet binding/non-binding?

The general position under English law is that parties to a term sheet will not be bound unless:

- the agreement is sufficiently certain (that is, it is clear what the parties are bound to do);
- there is an intention to be bound; and
- "consideration" is exchanged. The exchange of consideration under an agreement involves a reciprocal exchange between the parties, e.g. in its simplest form, by way of payment (by one party) in exchange for delivery (by the other party). In a commercial context, the exchange of consideration is unlikely to be an issue - a party is generally not willing to agree to do something for nothing.

Generally speaking, term sheets tend not to be binding (at least as regards the key commercial terms of a transaction), although certain aspects (e.g. confidentiality or exclusivity) may be binding. In selecting English law as the governing law of the term sheet, parties agree (and such agreement would be binding), that English law rules will be applied to determine whether or not contractual obligations have been created in the term sheet, and if so, the nature of those obligations.

Where the term sheet includes provisions which are intended to be binding, these must be clearly identified and the legal requirements for creation of a valid contract referred to above must be satisfied.

Are exclusivity provisions enforceable?

Exclusivity provisions are generally enforceable provided they are not structured as lock-in agreements. However, there are practical difficulties with such provisions, as it may be difficult to obtain an effective remedy in the instance of a breach.

Are pre-agreed damages payments and break fees enforceable?

Damages payments and break fees are fundamentally different obligations, although in practice there can be considerable confusion in the use of the terms. Looking at each:

- *Damages payments*: The parties may agree that a 'breach' by one party will require that party to pay an amount to the other party. However, it is important to consider whether the term being 'breached' was enforceable at all. For example, an "agreement to agree" under English law would be unenforceable for lack of certainty; consequently, no damages can arise. Conversely, if there was a breach of a binding exclusivity provision, damages do have the potential to arise. If a fixed sum is expressed to be payable by parties on default, i.e. "liquidated damages", such an amount would be enforceable to the extent that the figure is a reasonable pre-estimate of the party's loss at the time the contract was entered into.
- *Break fees*: Where Party A has a right to elect whether to continue with a transaction or where Party A accepts the risk of certain events either occurring or not occurring, the parties may agree that Party A will be obliged to pay Party B an amount if it elects not to proceed or if such events occur/do not occur. The allowable quantum for such a fee is often regulated in respect of public companies, whereas private companies have more discretion to choose an appropriate quantum. However, while the term 'break fee' is commonly used in term sheets, it is rarely appropriate: simply, in the absence of a binding agreement, there is nothing to break.

Why use a term sheet?

The advantage of using a term sheet (instead of embarking at an early stage on drafting full transaction documents) is that it allows the parties to focus on agreeing the key commercial issues in isolation. In this sense, the parties are not hindered or distracted by negotiation of the finer legal or drafting points that inevitably accompany full transaction documents. This streamlines the process and, if the term sheet is adequately drafted to reflect the agreed commercial points, can reduce the time and cost associated with drafting the detailed agreements.

When is a term sheet binding?

A term sheet should be analysed in the same manner as an ordinary contract. Are the obligations certain? Is there an intention to be bound? Is there an exchange of consideration? All elements must be satisfied before a term sheet is enforceable.

A. The obligations must be certain

Firstly, for a contract to be binding, there must be certainty as to what the parties are agreeing to do.

The subject matter is 'certain' if it is clear what the parties are actually required to do. Take the following two examples, assuming there is no other evidence: [1]

- Scenario A: Party A agrees to sell to Party B 25% of the shares in XYZ Company Limited at a price of US$100m; or
- Scenario B: Party A agrees to sell to Party B a number of shares (such number to be agreed between the parties) in XYZ Company Limited at a price that shall be agreed between A and B during negotiations in good faith,

in each case in accordance with specified or implied terms setting out the remainder of the agreement.

Scenario A is an agreement which would, in all likelihood, be enforceable - it is agreed what is being sold, to whom, and for how much. In Scenario B, the parties have merely *agreed to agree* on what is being sold and for how much. Such an agreement would not, *prima facie*, be enforceable, even if the parties described it as an enforceable obligation, because the court could not say with certainty what the agreement actually encompasses. Scenario B is commonly witnessed in term sheets; fundamental aspects of the agreement will be omitted and expressed to be subject to negotiation between the parties in the full transaction documents. In the absence of those terms, a court would be reluctant to step in and 'fill in the gaps'.

In an attempt to remedy this, many term sheets will express an obligation on the parties to negotiate and agree terms - that is an "agreement to negotiate in good faith". The overarching position is that there is no

[1] To the extent there is additional evidence, the court may use that evidence to ascertain the parties' intentions.

generalised legal principle of good faith having application under English law, although this view may be shifting following a recent High Court decision.[2]

Furthermore, such an undertaking is generally nothing more than an "agreement to agree" and therefore normally unenforceable on the grounds that it is too uncertain and fundamentally incompatible with the principle that each party must be free to advance its own interests in negotiations. The parties could agree to any number of various outcomes, and if the parties failed to agree on any outcome, it could not be determined which of the parties failed in its 'obligation to agree/negotiate' or what would have ordinarily been agreed. Therefore, a claim for damages for breach of such an obligation could not succeed in the ordinary course, and the courts are very unlikely to infer an agreement on the parties in the absence of any formal agreement. For this reason, even where a term sheet states that the obligation is intended to be binding, it is unlikely that either party will in fact be able to effectively enforce an obligation to agree. However, this does not preclude such an undertaking being found enforceable in certain contexts[3]. As such, while a party should not rely on being able to enforce an obligation to negotiate, equally it may be unwise to agree to such a provision on the assumption it will be held to be unenforceable.

B. There must be an intention to be bound

Secondly, the parties must have the intention to be bound by the terms. This is relevant for term sheets in at least two ways:

- Where a term sheet is lacking fundamental terms ordinarily included in an agreement, a court may take this as evidence that the parties did not intend to be bound by the term sheet. So for instance, in respect of a sale of shares, if fundamental provisions (for example, the mechanical terms governing the sale of the shares themselves) are expressed imprecisely or incompletely or as-to-be-agreed, the court may infer from this that the parties did not intend the term sheet to be binding.
- In other cases, term sheets will expressly disavow an intention to be binding, for instance by expressly stating that the term sheet is non-binding or noting that it remains "subject to contract". The English courts are extremely unlikely to look behind such a statement. That being said, "subject to contract" is not a recognised term of art in many jurisdictions outside the UK, so it should not be relied on where one (or more) of the parties is based elsewhere in continental Europe. In some jurisdictions, including Russia, certain descriptive provisions, such as "pre-contract" or "preliminary contract" can risk creating contractual obligations.

A statement that some terms are binding, whilst others are not, is of course valid and, provided that the expressly binding obligations are otherwise certain and assumed in exchange for consideration, these terms will normally be enforceable.

C. There must be an exchange of consideration

To the extent a term sheet is intended to be binding as a contract, it is a requirement of English law that consideration passes between the parties. For a term sheet it is unusual for consideration to be in the form of cash. More often, it is the exchange of mutual undertakings: for example, Party A (seller) undertakes to make information available for Party B's (buyer) due diligence, and Party B undertakes to keep the information confidential. Alternatively, executing an agreement as a deed would avoid the need for consideration altogether.

Why sign a non-binding term sheet?

Notwithstanding that term sheets often are not binding, they do provide tangible commercial value by ensuring that challenging commercial discussions occur at an early stage and allow the parties to formally record their agreement, prior to the more nuanced details of such agreement having been fully developed. This can and often does place a 'moral' obligation upon the parties to proceed with the deal on the terms described (except perhaps where there is a change in assumptions). It is likely to be harder for one party to renege on earlier commitments if they are recorded in a formal term sheet, particularly as the party is aware that it will risk damaging its reputation and credibility by doing so. This effect is amplified where the term sheet (or certain clauses of a term sheet) is described as binding; the intention here is of course to fix negotiating positions of the respective parties, although in reality it may not be enforceable for the reasons mentioned above.

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[2] In Yam Seng Pte Ltd v International Trade Corporation Ltd [2013] EWHC 111 (QB) the High Court held that the duty to perform a contract in good faith could be implied based on the presumed intentions of the parties.

[3] See, for example, the decision of the High Court in Barbudev v Eurocom Cable Management Bulgaria [2011] EWHC 1560 (Comm). The Court there noted that an agreement to negotiate in good faith may be enforceable if the parties have set out objective criteria, or machinery for resolving any disagreement.

Clauses that are frequently expressed to be binding include confidentiality undertakings, exclusivity (if included), payment of costs and/or liquidated damages/break fees (as referred below) and other boilerplate provisions.

What about exclusivity provisions?

An exclusivity provision (also known as a lock-out provision) requires Party A to agree not to negotiate with any party except Party B in respect of the proposed transaction (or any similar transaction). Exclusivity clauses are often expressed to be binding, including where the provision is part of an otherwise non-binding agreement, and are ordinarily sufficiently certain so as to be enforceable.

Exclusivity provisions amount to a restraint on one or both sides. Restraint provisions are interpreted narrowly by the English courts, and are permitted only to the extent that the provision amounts to a reasonable limitation. In any event, it is important to consider the duration and scope of the exclusivity clause. Common exclusivity clauses provide for exclusivity that extends until the earlier of: (a) execution of the transaction documents; and (b) expiry of a fixed period of time. The time periods typically range from one to six months and, although the period is subject to ordinary commercial negotiation, in each instance the period should be considered in the context of the particular transaction to ensure that it is not unreasonable.

Although exclusivity provisions might be enforceable in a strict sense, in reality, they often provide limited practical comfort because: (a) Party A may not know or may find it difficult to prove that Party B is negotiating with a third party; and (b) even if Party A finds out that Party B is negotiating with a third party, Party A will generally not be able to prevent Party B from negotiating (this is because the court will be reluctant to grant an injunction), but will only be able to seek a damages award from an arbitral tribunal or the courts.

Damages are unlikely to be an effective remedy, because at most, damages would compensate Party A for its costs. Beyond this, damages would be difficult to quantify, and the claimed loss could not be based on the loss of the expected profits from the transaction - this is because Party A had no right to the transaction (the parties had not yet reached agreement). Damages for lost costs only are thus likely to provide only limited satisfaction to the aggrieved party.

Are pre-agreed damages payments and break fees enforceable?

In order to protect their perceived preliminary agreement, parties will often consider including a mandatory payment obligation into a term sheet. Mandatory payments under term sheets normally come in one of three forms: liquidated damages, break fees and deposits. These are fundamentally different obligations.

A. Liquidated Damages

A liquidated damages obligation is a requirement to pay a fixed amount upon a breach of an enforceable obligation, allowing the loss-sufferer to recover a pre-estimated amount of damages under the contract.

Liquidated damages are recoverable to the extent that the fixed amount is a genuine pre-estimate of the loss, as assessed by reference to the time the contract was entered into. An amount that exceeds a genuine pre-estimate is considered a "penalty" and is not recoverable.[4] Therefore, any liquidated damages amount must be justifiable by reference to the losses expected to be suffered. It must not be extravagant or unconscionable in comparison with the greatest loss that could conceivably be proved to have followed from the breach.

In order to assist the court in finding that the estimate of the loss is reasonable, the parties can record in the contract their mutual acknowledgement to this effect and (though less frequently seen) also record the components of their calculations showing why the estimate was reasonable. Costs that might make up the amount of the potential loss could include professional fees, management time, costs of capital for funds set aside and out of pocket costs.

B. Break fees

The second form of pre-agreed payment commonly used is a break fee. A break fee is best thought of as a 'walk-away' price, payable by a party where it elects to 'walk-away' from a deal. A break fee allows the entitled party to demand the fee as a debt under the contract. Most commonly, a break fee is used where a party has a right to cancel an otherwise enforceable contract or for example, where a party may fail to fulfil a condition precedent under its control (e.g. obtaining its own board

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[4] Penalties are generally unrecoverable under English law because the purpose of an award of damages is to compensate the claimant rather than to punish the breaching party, and thus as a matter of policy, English law does not allow a claim which is in excess of the actual loss.

approval), and agrees to pay an amount to the other party if it exercises that right or fails to satisfy such condition precedent.

C. Deposits

The third form of pre-agreed payment occasionally used is a deposit. Typically a deposit is paid in advance (contrast with a break fee, which becomes payable when a potential transaction falls away) as an up-front measure of good faith to evidence a party's seriousness and to give the transaction process more credibility.

The primary consideration for a party giving a deposit should be to expressly set out whether the deposit is (or is not) refundable (together with any conditions).

If the deposit is expressed to be non-refundable, there is certainty as to both quantum and when such sum is due and there is no other conditionality involved, it is likely that the English courts will enforce this as a non-refundable deposit. If, however, the term sheet is silent as to whether the deposit shall be refunded if the transaction does not go ahead, courts routinely hold that in such instances where there is failure to agree on the final contract and there is nothing more than an agreement to agree, any deposit is impliedly refundable. If there is an unambiguous intention for any deposit to be refunded if the transaction fails to progress, this should be expressly stated in the term sheet.

Conclusion

Term sheets which facilitate the progression of a transaction by establishing preliminary agreement on key terms can be a useful product evidencing the parties' serious intent. The term sheet should aim to strike a balance between recording these key terms and not becoming too detailed, with recognition needed that full transaction documentation will follow in due course.

Parties should consider to what extent they wish to create any binding provisions - e.g. in respect of confidentiality, exclusivity, break fees, etc. - whilst understanding that the test for ascertaining whether such provisions are in fact binding is the same as that for contract (certainty of obligations, an intention to be bound and exchange of consideration).

Alternatively, the parties may decide on drafting a term sheet which neither party will be legally bound by. This will still be useful in setting out the key commercial elements of a deal, but will be limited to having 'moral' force only.

Authors

Nicholas Rees
Partner

T: +7 495 258 5090
E: nicholas.rees@cliffordchance.com

Gurbir Sethi
Associate

T: +7 495 725 6425
E: gurbir.sethi@cliffordchance.com

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