No-Shop Term Sheet Provisions

As an entrepreneur, the way to get the best deal for a round of financing is to have multiple options. However, there comes a point in time where you have to choose your investor and shift from "search for an investor" mode to "close the deal" mode. Part of this involves choosing a lead investor and negotiating a term sheet with him. A "No-Shop agreement" is almost always part of a venture capital final term sheet.

A typical No-Shop agreement is as follows:

"***No-Shop****: The Company shall work in good faith expeditiously towards a closing. The Company and The Investor agrees to work in good faith expeditiously towards a closing. The Company and the Founders agree that they will not, for a period of six weeks from the date these terms are accepted, take any action to solicit, initiate, encourage or assist the submission of any proposal, negotiation or offer from any person or entity other than the Investors relating to the sale or issuance, of any of the capital stock of the Company [or the acquisition, sale, lease, license or other disposition of the Company or any material part of the stock or assets of the Company] and shall notify the Investors promptly of any inquiries by any third parties in regards to the foregoing. [In the event that the Company breaches this No-Shop obligation and, prior to six weeks from the date hereof, closes any of the above-referenced transactions, without providing the Investors the opportunity to invest on the same terms as the other parties to such transaction, then the Company shall pay to the Investors $500,000 upon the closing of any such transaction as liquidated damages. The Company will not disclose the terms of this Term Sheet to any person other than officers, members of the Board of Directors and the Company's accountants and attorneys and other potential Investors without the written consent of the Investors.*"

The No-Shop provision reinforces the "handshake agreement" that which according to which the company and the investor said to each other "Ok, we want to do this. No more looking around for a better transaction. Let's close this deal!"

The No-Shop obligation requires the company not to solicit any other investment offer for a certain period of time. During the No-Shop period, the company is expected to work and cooperate in good faith towards closing the investment transaction. The No-Shop language is intended to prevent the company from stalling out the deal if it comes to believe a better opportunity might be available after it has entered into the term sheet. Often, the company is required to promptly notify the investor of any third-party inquiries, including offers the company did not solicit or encourage.

The National Venture Capital Association (NVCA) model term sheet offers a liquidated damages provision requiring the company to pay a specified “break-up fee” if it breaches the No-Shop clause closes an investment with another party. The language might provide that the break-up fee only applies if the investor is not given the opportunity to participate in the transaction on the same terms as the other party.

Reducing the Risk

Once it is a *fait accompli* that a term sheet will contain a No-Shop provision, what can the company do to reduce its risks?

- Bind the No-Shop by a time period. It should try to negotiate the No-Shop term down as much as possible, two-to-four weeks rather than six weeks or longer.

- Make the No-Shop commitment mutual. The company agrees not to shop the deal while the investor agrees to close within a reasonable time frame.

- Have the No-Shop period start after the investor has started legal and accounting due diligence by hiring a law firm and/or accounting firm. An investor with skin in the game is less likely to waste the company's time and resources.

- Have a clause that says the No-Shop period will end if the investor stops negotiating or conducting due diligence for a specified period. You don’t want to be off the market if the investor isn’t moving the deal forward.

- Only agree to pay the investor’s legal fees if the deal actually goes through.

- The company should do its own due diligence on the investor before signing the term sheet. Make sure the investor actually has readily available funds for the investment and doesn't have a history of walking away from deals.

A seemingly innocuous "No-Shop" provision in a term sheet is a binding legal agreement and, if deemed to have been breached, can entail damages. Whether those damages will be significant or simply equate to out-of-pocket costs is an open point. Most venture capital investors do not sue in such circumstances, aware that other attractive deals will not come their way if they are deemed to be litigious soreheads.

In addition, if the provisions of the full investment documents deviate significantly from the term sheet, then the company should have the ability to decide not to proceed forward with closing the investment. Thus, in most instances, it would be in the company's interest to have a detailed and comprehensive term sheet when a No-Shop is in the picture, in order to minimize the risk of unpleasant surprises in the final investment transaction documentation. From the company's point of view, investments at the Seed or Series A stage entail partnership between the company and investor if the company is to be successful at all. It is unlikely that a successful partnership will develop between an angry investor, compelled to wedge its way into the deal through a court order, and the company.

Even if the "No-Shop" provision entails an explicitly expressed concept of specific performance, that remedy does not appear to be realistic. A forced investment between two antagonists is not likely to be productive of the kind of relationship that will yield value for the parties involved. the best deals materialize not because of contractual obligations, but rather because of the worthy alignment of business interests and fair terms that benefit both sides.

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