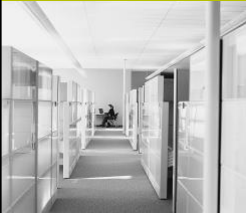




THE NUTS AND BOLTS OF EXECUTING SUCCESSFUL EXITS



AN ACA, ACEF & FOLEY HOAG WEBINAR ON EXECUTING SUCCESSFUL EXITS

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Two Basic Rules For Sellers



- **THE GOAL:** Money in your pocket at the end of the process after taxes and payment of deal liabilities.
- **THE DEAL MINIMUM:** Always walk away from the closing with the minimum amount you would accept for the entire company.

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Phases Of The Deal: A Brief Overview

- Starting Out
 - The decision to exit
 - Selecting the deal team
 - Process choices
- Finding a prospective buyer/buyers
- Due diligence concerning prospective buyers
- Interactions with prospective buyers: Their information gathering and due diligence
- Reaching agreement on price and terms with a buyer and memorializing the agreement:
 - Leads to further activity/exclusive arrangements.
 - Indications of interest and letters of intent
- Negotiating the purchase/merger agreement
 - Drafting and language
 - Preparation of disclosure schedules
 - Further due diligence by the prospective buyer

Phases Of The Deal: A Brief Overview (continued)

- How long does this take?
 - Highly variable
 - Due diligence and negotiation of definitive documents can require considerable time
 - Most buyers request at least 30-45 days of exclusivity after letter of intent
 - This may only be time period to negotiate definitive agreement: subsequent period to close.
 - Auction process will require more time if pursued.
 - Rushed sellers usual receive suboptimal terms.
 - Private deals can be more complex than big public deals: they have more variability and moving parts.

- The decision to exit
- What is an “exit”?
- How is the decision reached?
 - Is there only one decision?
- Who makes the decision?
 - Initially and thereafter
 - What is a “special committee”? Do you need one?
- What happens if there is a disagreement about exiting?
 - The reluctant founder

- Who speaks for the Company?
 - Another key rule: Always speak with one voice. Multiple voices cause losses in negotiations.
 - Can management do it?
 - Alignment of interest
 - What must you do to align the interests?
 - Should/can a Board representative do it?
 - Should/can an investment banker do it?
- Who else is on the team?
 - Other members of management: There is a lot to do.
 - Lawyers
 - Accountants
- Investment bankers
 - A BIG question: Do we need one?
 - Selecting one in a segmented investment banking market
 - Size
 - Industry specialty
 - What do they add?
 - What do they cost?
- Shareholder representative for post-closing claims

How Do You Find A Buyer?

- Sometimes the buyer is “obvious.”
 - Is that true?
- Unsolicited offers.
 - What should you do with them?
- Running “a process”.
 - What is “a process”?
 - Do you need an offering memorandum?
 - Can you run the process yourself?
 - What does this mean?
 - Again: should you use an investment banker?
- Auctions
 - Are they a good thing?
 - Maximizing price
 - How does management feel about them?
 - When is management’s “deal” determined?
 - What effect will an auction have on the business being sold?
 - Confidentiality and leaks

Buyers

- Types of buyers.
 - Strategic
 - Experienced/occasional
 - Large/small
 - From the industry/conglomerates
 - Financial
 - Style
 - Others/hybrids
 - Roll ups and platform companies
- Do sellers care who is the buyer?
 - Management sellers certainly do.
 - But others should as well.
 - Re-trading
 - A desire to “win points”

Buyers (continued)

- Likelihood/ease of closing
 - Remember the exclusive
 - Do they "write checks"?
 - Are they "just fishing"?
 - Information gathering
 - Recruiting
- Due diligence as to prospective buyers
 - Track record
 - True precedent transactions
 - Reports from prior target managements
 - How did other targets fare after acquisition?

Confidentiality

- The sale process and all of its stages must be confidential
 - Avoid unnecessary staff disruptions
 - Avoid disruption of customer relationships
 - Avoid advantages to competitors
- How do you maintain confidentiality in an active deal process?
 - Limit participants
 - Organize and plan interactions
 - Use offsite opportunities for negotiations/diligence
 - Obtain confidentiality agreements (a/k/a non-disclosure agreements) from all prospective buyers before engaging.
 - Even that activity can require some planning
- What do we do when word starts to leak out?
 - Damage control: internal/external
 - Some rumors are inevitable
 - "We do not comment on rumors."

- Aren't all confidentiality agreements alike? No. Like any other agreements they vary widely.
- The basics
 - Broad definition of confidential information: Do not limit it to marked documents
 - Agreement not to disclose
 - Disclosure may be made by prospective buyer to its representatives - - but only with limitations
 - Agreement not to use confidential information
 - Sometimes omitted: a mistake
 - Agreement not to solicit employees: essential in exit process.
 - Acknowledgement of no obligation to undertake transaction and no transfer of rights in information.
 - Obligation to return/destroy information.
- Beware the "residual rights" clause: a staple of some large buyers

- Who has a fiduciary duty in this situation?
 - Directors
 - Officers
 - Controlling Shareholders
- Laws differ from state to state. Duty is determined by state in which target corporation (or other entity) is organized (not state of principal place of business).
- Duties may be different if you have a limited liability company or limited partnership.
- The basic duty in Delaware under the Revlon case: once the corporation is "for sale", obtain the best price reasonably available.
- How do you handle conflicts of interest?
 - Recusal
 - Special committees
 - Isn't management always conflicted?

Written Indications Of Interest

- Do you need them?
 - Essential in an auction. That is how it proceeds. They are used to decide negotiating partner.
 - Useful in other contexts. Focuses the buyer and sorts out whether there might be a deal.
- What will the indication of interest say?
 - Outline of price, structure and other key terms.
 - Non-binding on either party
 - Often a precursor to letter of intent or in the form of a letter of intent

Letters Of Intent

- Basic: Consider the letter of intent to be the key document in the transaction. Spend the time and effort to negotiate it carefully.
 - Non-binding except as specifically stated
 - Describes terms of the transaction
 - More money made (or lost) here than at any other time in exit process. Focus on terms here and bring lawyers into negotiation process fully.
 - With “honorable buyer”, sellers can use it to prevent re-trading of terms.
- What is in a letter of intent?
 - Broad statement that it is non-binding on either party except as stated
 - Avoid binding requirement to negotiate in good faith. This is a trap for the unwary.
 - Deal description: price and structure
 - Basis on which there could be purchase price adjustments
 - Anticipated timing of deal

- Key “non-customary” conditions to closing
 - Management contracts
 - Specialized consents
- For sellers, the following terms are essential: limits on liability post-closing; description of escrows or holdbacks; baskets; deal “statutes of limitations”
 - Remember the first basic rule above and apply it.
 - This is the time to limit liability.
- Exclusivity/No Shop
 - Prospective buyer wants it as a binding term: do they get it? Need for preemptive bid.
 - Duration
 - Exceptions to exclusivity
- Break-up fees? Reverse break-up fees? Deposits?
 - Not customary at this stage

- What is due diligence?
 - What is the origin of the term?
 - Broad review of target company, its business and documents
 - Activity often follows a written diligence review list.
- When does due diligence take place?
 - Some must occur before indication of interest/letter of intent. Enough so that a prospective buyer can craft an offer.
 - After letter of intent/before definitive agreement there will be further diligence.
 - Should sellers permit diligence after execution of definitive agreement? Only bring down/confirmatory due diligence. Should sellers agree to a “diligence out” or “diligence condition” to closing?
 - Ordinarily, no. This is a trap for the unwary.
- Who participates in the due diligence process and what do sellers and target company do?
 - Diligence teams typically are led by CFO and chief scientific officer (if there is one).

Due Diligence And Related Activities (continued)

- Documentary diligence
 - Modern style involves posting to an electronic data room
 - Lawyers review documents before posting
- Interviews with key personnel
 - Need to manage carefully
- Intellectual property due diligence. Can be very extensive and expensive
- A specialized problem: Documents and information which are confidential, themselves. How to disclose them?
- The problem of sensitive information and a prospective buyer that is a competitor. Remedies:
 - Delayed disclosure
 - Third party review of technical or other sensitive information
- How does due diligence affect the deal?
 - Effect on liability limits - - special items
 - Prospective buyer resistance to negotiation of liability limits before diligence - - usually a pretext
 - Effect on representations and warranties
 - Provides information for disclosure schedules in purchase agreement

Due Diligence And Related Activities (continued)

- How should the sellers and target company prepare for due diligence?
 - Assembly and review of documents
 - The “corporate clean-up”: dotting i’s and crossing t’s
 - The myth of the “clean little company”
- How much due diligence is enough?
 - Setting limits on due diligence – if possible
 - What to do about never-ending requests?
 - Don’t the lawyers/business people/accountants on the other side have anything else to do?
 - Is this really about the deal or do they have another agenda?
 - The “big” company problem
- Remember: due diligence can be very expensive for the target.
- What do sellers do when the prospective buyer tries to re-trade the deal “as a result of” due diligence?

Deal Structures – A Very Brief Introduction

- What are typical deal structures for exits?
 - Stock purchase
 - Stock purchase structured as a reverse merger: A reverse cash out merger if consideration is for cash.
 - Why is it reverse?
 - Asset sales
 - Redemption/recapitalization
- How is the deal structure chosen?
 - Deal structure is negotiated. For corporations with numerous stockholders/option holders, parties will assume a reverse cash out merger or other stock merger.
 - Tax considerations often drive choice of structure.
 - Sellers or buyer may have liability or insurance concerns that dictate approach
 - Asset sale form can be more difficult to execute because of need for consents to transfer and transfer documents. Can be very time consuming and expensive.
 - However, in appropriate circumstances, asset sale form can be used to generate tax benefits that raise price. Tax attributes of asset sale approach can sometimes be applied in a stock purchase format with a tax election.

Purchase Price Adjustments And Deferred Payment

- Purchase price adjustment provisions are common
 - Most typical, is a price adjustment concerning net working capital of the target company as of the closing time.
 - Parties set target working capital.
 - The purchase price increases or decreases on the basis of determination of net working capital.
 - If determination is “as of closing”, buyer makes first calculation. A danger to sellers.
 - Need review/dispute resolution mechanisms.
 - This is an opportunity for post-transaction conflict.
 - Adjustments are also sometimes made on the basis of net worth metrics or cash/debt amounts of the target company.
- Earn-Outs or Milestone Payments: Additional price payments based on subsequent events
 - Often tied to a formula related to revenues or earnings or specific events
 - Revenue approach more closely aligns interests of buyer and sellers

Purchase Price Adjustment And Deferred Payment (continued)

- How do sellers influence (guarantee) results/payments?
 - They cannot. They have lost control of the business.
 - Do they have any security? Usually not.
- Thus, earn-out/milestone payments should not be accepted by sellers as resolution of basic price disagreements.
- See the second basic rule above.

The Definitive Documents

- Purchase agreement: whether in purchase or merger agreement form, contains:
 - Specific price and terms of payment
 - List of other basic closing documents
 - Representations and warranties about the target company and transaction
 - Lengthy (often very lengthy) description of different aspects of the target company in legalese
 - Modified by a disclosure schedule prepared by the target company and sellers--but negotiated with buyer
 - Important and time consuming; liability is created for false heavily-negotiated representations and warranties
 - Information obtained by buyer in due diligence usually does not help: "sandbagging."
 - Indemnification provisions
 - For what?
 - Who is liable?
 - Buyer is searching to expand the scope of coverage. "Market" practices may be changing.
 - What particular items found in diligence are covered by indemnification?

The Definitive Documents (continued)

- Liability limitations and escrows -- follow letter of intent
 - Limit on liability – percentage of purchase price
 - Basket -- minimum amount of claims to trigger liability
 - Deductible
 - Tipping basket
 - Time limit on claims – internal statute of limitation
 - Escrow or holdback against liability
 - Can be a good thing -- believe it or not!
- Closing conditions
 - Important first decision: is there a simultaneous signing and closing?
- Provisions for representative of sellers
 - Administers post-closing liability and claims
 - Need to provide authority, liability limitations and fund for expenses of representative
- Termination provisions
 - Sellers need ability to terminate the agreement after some period of time if no closing.

The Definitive Documents (continued)

- Employment/Consulting Agreements/Non-Competition Agreements
 - Key for management, of course
 - Maintenance of alignment of interests
 - When are they negotiated? Can be tricky.
 - Remember that payments to management can affect net purchase price to sellers. Buyers focus on enterprise value.
- Closing documents. Examples:
 - Consents and approvals. Defined by the deal and the target company's business.
 - Licensors, customers, suppliers, lessors, etc.
 - Government
 - Note: for larger deals, Hart-Scott-Rodino or other clearance may be necessary pre-closing
 - Specialized issues: for example, CFIUS review of acquisitions by non-United States buyers
 - Certifications as to compliance with representations and warranties and covenants

The Definitive Documents (continued)

- Secretary's certificate as to resolutions of directors and stockholders
- Legal opinions
 - What more do lawyers have to say?
- Documents of transfer in stock sale or asset sale
- Certificate of merger
- Post-closing Documents
 - Transmittal documents from shareholders in merger
 - Documents related to purchase price adjustments
 - Resale registration statement under the Securities Act of 1933 (hopefully on Form S-3) if consideration is stock

Upcoming Exit Events

2011 ACA Summit – April 4-6, Boston, MA

- Monday – (Pre-Summit) 8:00 am– 12:00 pm
Early Exits Workshop – Led by Basil Peters
- Tuesday – 12:30 pm– Last appointment
Curbside Consulting with Foley Hoag
- Wednesday – 10:30 am– 11:30 am
VC's and Angels – Optimizing Exits



Founded by
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Early Exits Workshop

- Pre-Summit Workshop in Boston – April 4th, 8:00-12:00
- Focus on strategies for building companies for exit
- New program, based on work of Basil Peters and Bill Payne
- Available for presentation in your city
- Other programs on April 4th –
 - Angel Investing Overview
 - Valuation of Early-Stage Companies
 - Technology & Investing Showcase



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THANK YOU

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