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.
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

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.
Starting The Deal

- 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

Selecting The Deal Team

- 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."
Confidentiality Agreements

- 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

Fiduciary Duties

- 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
Letters Of Intent (continued)

- 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

Due Diligence And Related Activities

- 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
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

THANK YOU