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M&A For Founders

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Preparing for a Sale or Acquisition

Top 8 Considerations

-  1. Maintain Adequate Records
-  2. Protect IP Ownership
-  3. Open Source Issues
-  4. Commercial Agreement Best Practices
-  5. Privacy Policy and Ability to Transfer Information
-  6. Understanding Consents Required (Shareholders)
-  7. Employee Retention and Option Plan Issues
-  8. Litigation Concerns

1. *Maintain Adequate Records*

Corporate Minute Book

- Maintain good records of the board and stockholder consents and meetings
- Easier due diligence process
- Assists in defense of any “piercing the corporate veil” lawsuits.

Capitalization and Stock Records

- Maintain detailed records of each security issuance and transfer (including cancelled securities)
 - Includes board approvals, stock certificates, option documents, warrants and promissory notes, purchase agreements and private placement memoranda, repurchase agreements
 - Keep all 83(b) records for any restricted stock subject to vesting
- Maintain documentation of federal and state securities law exemptions for each security (including proof of Accredited Investor Status)

2. *Protect IP Ownership*

Founder's Assignment upon Startup

- At formation, Founder(s) should execute an assignment to assign all technology and IP created before employment with the company (e.g., business plan, patents and patent applications)

Key Terms of Assignment Agreement

- Description of the assets being assigned;
- Consideration for assignment (typically the assets are assigned in consideration for shares of common stock of company); and
- Further assurance clause

Employee and Consultant Proprietary Information Assignment Agreements

- Company should also have each of its employees (including its Founder) execute PIAAs in order to protect the company's technology and intellectual property

3. Open Source Issues

What is it?

- “free” software – generally, users are permitted to view the source code and to use and alter the software

Pitfalls

- While users of open source may not be required to pay a fee, the license will typically include certain restrictions such as:
 - Resulting software becoming open source;
 - Requiring distribution of source code for resulting software;
 - Attribution requirements

How to Avoid Problem.

- Don't use Open Source (with a documented policy)
- If used, only use for specific, defined projects that won't taint other software (and discuss with counsel)
- NOTE: Some Buyers are using software programs that can detect the use of open source (picks up infrequent uses)

4. Commercial Agreements

Organization

- Keep fully executed, dated copies of all agreements
 - This will make the diligence process more efficient

Contract provisions to avoid:

- Restrictions on assignment or change of control triggers
- Exclusive (outbound) licenses
- Source code disclosure: only provide an object code copy
 - If source code is demanded use an escrow to hold the source code
 - Very important to subject the arrangement to a non-disclosure and non-use agreement in order to protect the intellectual property
- Most favored nation pricing provisions
- Non-competes applicable to the company.

Required Consents

- When a sale transaction is imminent, understand which consents will be required (usually major contracts and lenders)



5. Privacy Policy

Consider ability to treat customer personal information as an asset to be transferred to Buyer. Will customer opt-in or opt-out be required?

Regardless of ability to transfer, Buyer may want to reset privacy policy and get consent of customers in any event.

Determine Buyer's general plans for business and how the privacy policy may restrict those plans.

✓ **6. *Understanding Shareholder Consents***

What distribution is required by charter?

What vote is required by charter and state law?

May have pressure to redistribute consideration when minority shareholder approval is required



7. *Employee Retention and Option Plan Issues*

Founders & Key Employees

- Critical to retain Key Employees in many technology transactions
- Single Trigger and Double Trigger issues
 - Acceleration or payments on:
 - A change of control only (single)
 - A change of control AND termination (double)
- Consider the after-tax impact of the transaction early

Option Plan – Treatment of options upon sale of company

- Acceleration upon change of control
- Acceleration upon change of control only if Buyer doesn't assume option plan
- No acceleration



8. *Litigation Issues*

Be on top of it

- Company's counsel should be looped in on and understand all litigation (or threatened litigation), including:
 - who is suing,
 - what are claims,
 - does it indicate deeper issues with employees,
 - vendors,
 - capitalization

Consider settling prior to sale process to avoid spooking the buyer or giving leverage to the opposing party in the litigation



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Types of M&A Transactions

M&A Transaction Structures

Structure generally depends on:

- What is being acquired and who owns it
 - (assets, form of entity, jurisdiction, number of holders)
- Tax efficiencies
- Form of consideration
- Contract assignability
- Management of liabilities
- Stockholder approval considerations

Structures:

- Stock Purchase
- Asset Purchase
- Statutory Merger
- Other:
 - Joint Venture
 - Recapitalization
 - Tender / Exchange Offer
 - Acquihire

Stock Purchase

Description

- Buyer purchases stock of another company directly from the stockholders
- Typically used when target stock is not widely held or where jurisdiction where there is no merger statute

Advantages

- Buyer acquires all of the assets of the target
 - No need to specifically identify and define all acquired assets necessary to continue operating target business
- Generally target liabilities stay in target (don't become buyer liabilities)
- Target contracts remain in place without consent of third parties for assignment
 - Though, does not apply if a contract contains a "change of control" provision
- Does not trigger appraisal rights

Disadvantages

- Must obtain agreement from every selling stockholder
 - Alternative is to acquire at least 90% of the stock followed by short form merger or invoke a drag-along provision
- Buyer indirectly inherits all liabilities of the target (although isolated within target)
- No "step up" in tax basis of target assets (unless 338 election made)

Asset Purchase

Description

- Buyer purchases some or all (or substantially all) of the assets of target
- Buyer assumes specified liabilities from target
- Typically see when Buyer wishes to acquire some but not all assets of another company and assume some but not all liabilities of another company

Advantages

- Buyer only assumes specified liabilities from the seller (“cherry-picking” of liabilities)
- Buyer generally obtains “step up” in tax basis of acquired assets
- May not require approval of stockholders of seller (unless the seller is selling “substantially all” of its assets)

Disadvantages

- Buyer must identify all acquired assets necessary to operate the acquired business (can be very complex, expensive and burdensome, especially if the acquired assets are spread across several entities)
- Generally, acquisition of contracts will constitute an assignment that may require consent of third parties

Statutory Merger

Primary Purpose

- When a buyer wishes to acquire a target company intact, but target has too many stockholders to obtain agreement from every stockholder

Advantages

- Requires holders of a certain percentage of target voting stock (e.g., majority of all stock) rather than all
- Buyer acquires all of the assets of the target - no need to specifically identify and define all acquired assets necessary to continue operating target business
- Generally, target liabilities isolated in target and do not become buyer liabilities
- Generally, target contracts remain in place without consent of third parties
 - Though, does not apply if contract contains a “change of control” provision

Disadvantages

- Buyer indirectly inherits all liabilities of the target (although isolated within target)
- Generally, triggers appraisal rights

Types of Statutory Mergers

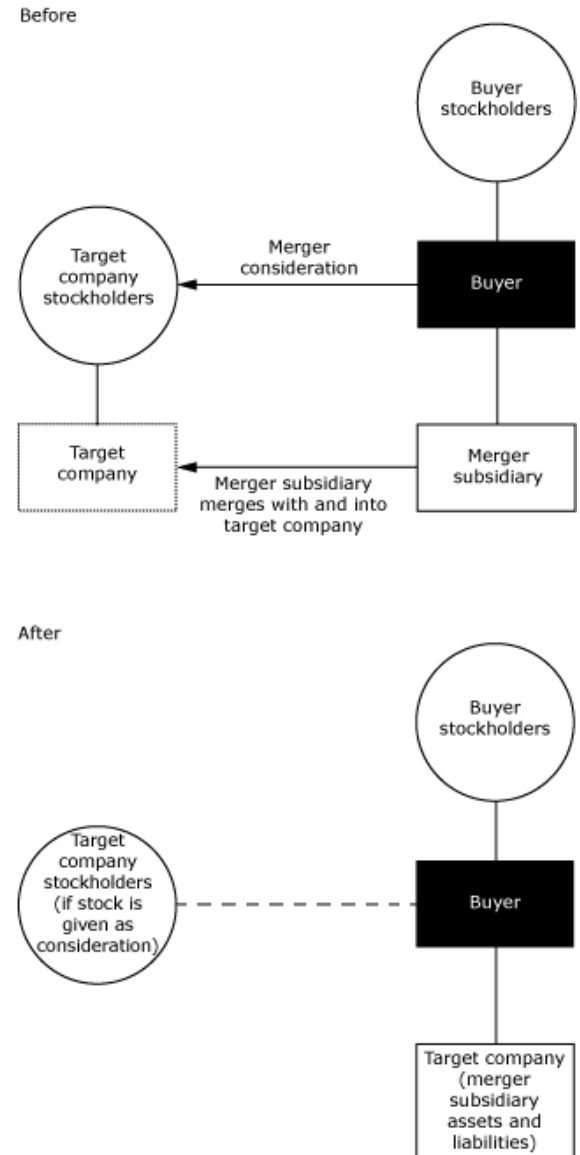
- Reverse Triangular Mergers
- Forward Triangular Mergers
- Other (e.g., direct mergers)

Statutory Merger

Reverse Triangular Merger

- Company A creates a new subsidiary that merges into company B
- Company B survives merger as a subsidiary of company A
- Company B stockholders receive merger consideration (cash, stock or combination)
- Net effect looks like company A purchase of all company B stock

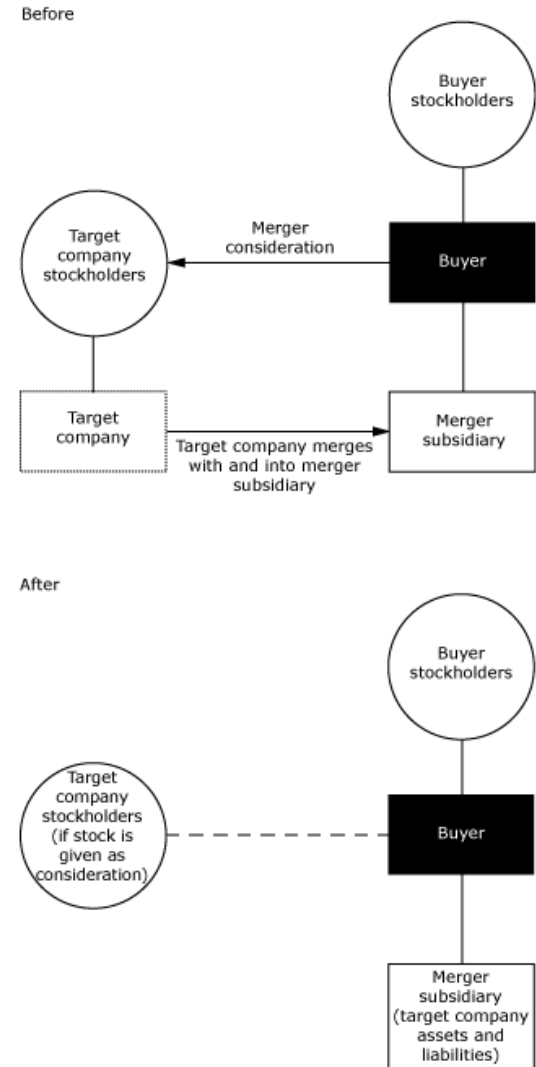
Most sales of typical VC-backed targets are structured as reverse triangular mergers



Statutory Merger

Forward Triangular Merger

- Company A creates a new subsidiary and company B merges into new subsidiary
- Company A subsidiary survives merger and remains a subsidiary of company A
- Company B stockholders receive merger consideration
- Net effect looks like company A purchase of all company B assets – rarely used unless necessary to qualify as “reorganization” for tax purposes
- Constitutes a deemed assignment of assets



Joint Venture

Description

- Two or more companies contribute the assets (and liabilities) of a business to a newly formed company, retain an equity interest in the new company and negotiate joint operational and governance rights for the benefit of the JV participants

Primary Purpose

- Hybrid acquisition structure that enables two or more companies to partially sell or acquire a business, while retaining an equity interest and some operational and governance control over the business

Advantages

- JV participants can combine business strengths to generate synergies without completely selling or buying an entire business
- JV participants retain an equity interest in the business
- JV participants can retain some operational oversight or control over the business

Disadvantages

- Operational and governance complexity
- Exit complexity

Tender Offer / Exchange Offer

Tender Offers:

- A tender offer is a public offer to acquire the securities of another entity directly from its securityholders
- Exchange Offers: A tender offer where the buyer's stock is used as consideration
- Usually, tender / exchange offers are followed up by short-form mergers to squeeze-out securityholders who do not tender their shares
 - Delaware 251(h) – Permits back-end merger without stockholder vote if at least 51% acquired in tender offer if certain conditions are met

Advantages

- Generally, enables the buyer to close the transaction more quickly than a merger
- Buyer acquires all of the assets of the target - no need to specifically identify and define all acquired assets necessary to continue operating target business
- Generally, target liabilities isolated in target and do not become buyer liabilities
- Generally, target contracts remain in place without consent of third parties
 - Though, does not apply to a contract contains a “change of control” provision)
- Generally, more limited and expedited SEC review of requisite tender filings

Disadvantages

- Buyer indirectly inherits all liabilities of the target (although isolated within target)
- Generally, triggers appraisal rights in second step merger

Acquihire

Corporate transactions driven by buyers' desire to hire an assembled team

No set definition -- these transactions can range from talent driven M&A deals to team employment with related payments to the seller

Talent Driven M&A deals

- Asset purchases or Mergers
- Often using “lightweight” documents

Alternative transaction formats

- Hire a key employee team and pay “seller” for:
 - Release agreements
 - Covenants not to sue
 - License agreements, which generally are intended to protect against unintended incorporation of IP into buyer's products, rather than direct commercialization

Acquire: Talent Driven M&A Deals

How do these deals differ from standard M&A deals?

- Lighter reps, warranties and operational covenants
 - Fewer operational reps
 - Fewer operational covenants
- Lighter indemnification terms
 - Smaller escrow
 - Shorter escrow duration
- Key employee focused terms
 - Vesting/re-vesting
 - Covenants and conditions re employee offers
 - Non-competes/non-solicits

Effectively, two “escrows”:

- “Deal” escrow, to cover indemnity claims, funded by all stockholders (and potentially option holders)
- “Retention” escrow, created by vesting or re-vesting of employee consideration

Tax treatment of unvested equity is key – **CONSULT TAX ADVISORS EARLY**

Acquihire: Alternative Transaction Formats

“Buyer” identifies key employees and makes employment offers and closing is contingent upon acceptance of these offers

In exchange for payment from the Buyer, the “Seller” agrees to covenants to reduce buyer’s risk of being sued for hiring the employees and the possibility that the employees will use company IP while working at the buyer.

- Covenant not to sue
- Seller agrees to general release
- Grant of IP license to Buyer (generally to avoid claims rather than to commercialize Seller’s IP)

Post Closing status of Seller:

- Wind-down?
- Distribute consideration?
- Continue operating?



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M&A Transaction Documents

Principal M&A Agreements

Preliminary Agreements

- Confidentiality Agreement
- Letter of Intent
- Exclusivity Agreement

Transaction Documents

- Acquisition Agreement
 - Stock Purchase Agreement (or Unit Purchase Agreement for LLC targets)
 - Asset Purchase Agreement
 - Agreement and Plan of Merger
- Disclosure Schedules
- Ancillary Agreements
 - e.g., Non-Compete Agreement, Employment Agreement, Transition Services Agreement

Definitive Agreement Terms

Parties

Definitions

Transaction structure

Payment mechanics

Purchase price adjustments

Representations and warranties

Covenants

Closing conditions

Termination provisions

Indemnity

Miscellaneous

Consideration

Pricing

- Typically priced in the aggregate as opposed to per-share for private company acquisitions
- Can become very complex depending on mix of equityholders and post-closing adjustments

Types of Consideration

- Cash
- Stock
 - SEC registration / liquidity issues
 - Due diligence considerations

Purchase price adjustments

- Net debt
- Working capital
- Change of control payments
- Unpaid transaction expenses

Contingent Consideration

- Earn-outs
- Restricted stock / RSU grants

Representations and Warranties

Statements by seller or target as to the condition of the business and the effect of the transaction

Serve three primary functions

- Due diligence / disclosure
- Allocate risk of closing
- Allocate post-closing indemnification risk

May be qualified by “materiality,” “MAE,” “knowledge” or specified dollar thresholds

Disclosure Schedule

- Qualifications/exceptions to reps and warranties
- Should be read together with the reps and warranties
- Disclosed items shift risk to buyer
- Kitchen sink approach

Representations and Warranties

Disclaimer

- No other reps/warranties (four corners)
- No reps regarding projections, estimates or budgets

Buyer representations and warranties depend on:

- Cash vs. stock consideration
- Relative size of buyer vs. target
- Status of Buyer – public vs. private

Financing rep/solvency of buyer

- Sign and concurrent close v. sign and delayed close

Covenants

Promises to do something in the future, generally the interim period

Closely tied to risk of closing and post-closing indemnification

Interim covenants (or conduct of business covenants)

- Intended to preserve the value of the assets to be acquired
- Ordinary course of business
- Negative covenants (things the target cannot do without consent of the buyer)

“Efforts” to get the deal done

- Governmental approvals (e.g. anti-trust, other regulatory)
- 3rd party consents
- Stockholder meeting, SEC filings, Financing (buyer debt to fund transaction)

Treatment of Employees

- Hiring obligations
- Benefits / 401(k) / Options

Relationship between the parties

- Non-solicitation – “No shop”
- Confidentiality and access to information
- Expenses
- Notifications

Closing Conditions

If a closing condition is not satisfied (or waived), the party that benefits from the condition is not required to close the transaction

Generally, sellers / target will be harmed if the deal fails to close

Customary conditions

- Reps and warranties true (materiality / MAE overlay) – “bringdown”
- Material compliance with covenants
- Regulatory and stockholder approval
- No injunction, litigation
- No MAE

Often, and particularly in private deals, additional conditions will be present that shift certain risks to sellers / target

- Employee retention, non-competes, 3rd party consents, appraisal rights, clean-up (invention assignment agreements), etc.

Indemnification

Post-closing contractual remedy for seller and/or target breaches and the limitations thereof

Often buyer's remedy is subject to limitations

- Survival period, baskets/deductibles, caps and carveouts (fraud), type and measure of damages
- Sole remedy

Mechanics for the disposition of direct and third-party claims

Sometimes paired with arbitration provisions

Special indemnities allocate specified risks to sellers

- Pre-closing taxes, litigation, shareholder claims, appraisal rights payments, known liabilities

Escrows and holdbacks serve as security for potential claims

Generally, not applicable in public/public transactions