

Positioning Your Company for the Smooth and Successful Sale

Avoiding the disruptions and surprises that detract from value, delay the deal, and drive acquirors nuts

**Entrepreneurs Foundation of Central Texas
Legal Bites Breakfast Series**

Tuesday, September 18, 2007

Presented by Matt Lyons



Copyright 2008 Andrews Kurth LLP and J. Matthew Lyons
All rights reserved.

ANDREWS
ATTORNEYS **KURTH** LLP
STRAIGHT TALK IS GOOD BUSINESS.®

Positioning for Success - Timeline

- **Positioning for Success**
 - 2-3 years prior to the event
 - Focus on upgrading infrastructure
 - Financial reporting, controls
 - Audits
 - Legal
 - Define and implement wealth management and charitable strategies
 - Review management structure and succession plans
 - Address shareholder issues
 - Identify and establish relationships with potential strategic partners
- **Planning for the Event**
 - 2-3 months prior to commencing the event
 - Review market/industry conditions and transactions
 - (Final) legal/diligence documents (update and) organization
 - Financial/strategic review and assessment
 - Prepare key managers
 - Hire advisors
- **Executing a Transaction**
 - 1-3 months
 - Prepare materials
 - Identify interested parties
 - Present opportunity and materials
 - Conduct sale process
 - Select desired buyer/strategic partner
 - Design/implement integration
 - Close the transaction

Positioning for Success

- Planning begins at inception
- The company with more options has more leverage
 - Banker can sell anything, but cannot optimize the price/strategy unless the Seller has paved the way
- Creating more options requires constant strategic review and positioning
- Identify potential partners and acquirors
 - An ongoing process
 - Know all the direct and indirect players
 - Monitor transaction activity
- Not unlike management of career and personal finances
 - Networking
 - Maintain alternatives and safety nets

Positioning for Success

- Implement wealth and estate planning strategies
- Consider ISO exercises to avoid unintentional “disqualifying dispositions” and AMT issues
- 83b elections
- The Board/management should have at all times a realistic idea of what it considers a reasonable valuation range
 - Unrealistic expectations lead to investor, management and employee disappointment and loss of morale
 - Failure to plan for employee retention incentives
- Understand and maintain liquidation model
 - Be prepared to proactively implement incentives depending on realistic valuation estimates even if no sale process looming
 - Condition expectations

Positioning for Success

- “Drag Along” or Required Sale Provisions
 - Consider stockholder base (e.g. possibility of disgruntled former founders)
 - Down round and Wash out financing
 - Appropriate restrictions on ability of investors to exercise
- Diligence files should be maintained at all times
 - Leverage from prior financing events
 - Permits rapid response without notifying entire organization
- Better prepared and more timely response = less or less harsh scrutiny (hopefully!)
- Maintain stockholder lists and addresses
 - Frequent communication updates
 - Also helps to avoid surprises

Positioning for Success

- Identify and Segregate any non-core Assets
 - Any assets of potential value for which buyer would attribute no value?
 - Spin offs
 - IP Sales
 - Be wary of effecting without buyer input, but buyer input may restrict actions or minimize value
 - Appropriate license back and covenant not to sue
- On ongoing basis, anticipate issues that are likely to arise and develop a plan for dealing with them
 - “How would acquiror view this transaction/agreement, etc.?”
 - Commit all material agreements and arrangements to writing
 - Review and, over time, modify existing agreements to make them as appealing as possible to a potential buyer. For example:
 - The agreements should be assignable without penalty to third parties in the case of an acquisition by a responsible buyer
 - The agreements should have a long enough term to assure the buyer of continuity

Positioning for Success

- Obtain agreements to reinforce the Company's competitive position
 - Employment agreements (minimize use)
 - Confidentiality agreements
 - Non-competition agreements
 - Non-solicitation of customer agreements
 - Non-solicitation of employee agreements
 - Valid IP assignments
- Contractual Issues:
 - Exclusivity
 - Business restrictions
 - Financial
 - Discounts
 - Most Favored Customer (MFC) or MFN clauses

Positioning for Success

- Contractual Issues (cont.):
 - Side Agreements
 - Uncapped future support/indemnity obligations
 - Exclusions from limitations of liability and waiver of consequential damages
 - Assignability Issues
 - By “operation of law” or ownership change vs. third party assignment (e.g. asset sale)
 - Non-terminable leases
 - Bank prepayment penalties
 - Sole source

Positioning for Success

- Equity Holder Issues:
 - Non-terminable warrants
 - Continuing (or ambiguous) investor agreements
 - Option Acceleration provisions
 - Non-accredited investors
 - >35 may preclude or delay stock deal (requires “registration”)
 - stock option exercises
 - 83b Elections
- IP Issues:
 - Patent ownership and freedom of action
 - Software license rights (distribution/sublicense, right to transfer, etc.)
 - Adequate licenses in/out
 - Source code escrows
 - Domain names
 - Open source code

Positioning for Success

– Employee Matters:

- PIIA Exclusions
- Employee leasing arrangements
- 83b elections
- Consultant/employee classification
- Exempt/non-exempt classification

– Tax:

- 409A
- 280G
- (U.S.) Foreign corporation qualifications (corporate and tax)
- Operation of foreign subsidiaries
- International equity grants

Positioning for Success

- Financial & Accounting:
 - Audited financials
 - Adequate controls
- 409A
 - Third party valuations and documented processes
 - Rational and objective support for option price over time
 - Must review/adjust option price in light of transaction consideration and discussions
 - Review other plans (e.g. transaction bonus plans and severance/change in control agreements)

Positioning for Success

– 280G – Excess Parachute Payments

- If all “parachute payments” made to an employee exceed 2.99 times his or her “base amount” (generally, the employee’s average compensation from the company for the five years preceding the year in which the change of control occurs), then the employee is assessed a 20% excise tax (in addition to regular taxes) on the amount of the payment in excess of 1.00 times the employee’s base amount, and the acquiror is disallowed its corporate tax deduction with respect to such amount
- Some “parachute payments” not “payments” and not obvious
- Privately-held companies may avoid application of the golden parachute rules by having the payments or benefits (e.g., vesting acceleration) that are contingent upon the change of control approved at the time of the change of control by a separate vote of 75% of the corporation’s disinterested shareholders

Positioning for Success

- 280G – Excess Parachute Payments (cont.)
 - Consider contractual cut back provisions:
 - payments subject to reduction to the extent necessary to assure receipt of only the greater of (i) the amount of those payments which would not exceed 2.99 times “base amount” or (ii) the amount which yields the greatest after-tax amount after taking into account any excise tax imposed under Section 4999 of the Code on any “excess parachute payments” in connection with the acquisition or subsequent termination of employee status.

Positioning for Success – Charitable Foundation

Create a “nest egg” to eventually fund the community activities of their choice without impacting corporate earnings or operating cash.

EFCT Example:

Shares outstanding, fully diluted:	5,000,000
1% warrant grant:	50,000
Warrant characteristics:	net exercisable, fully-vested, 10-yr. term
Grant date appraised share value	\$0.10 per share
Grant date exercise price/share	\$0.10 per share
Exercise date FMV/share	\$10.10 per share
Exercise date “spread” value	\$10.00 per share (\$10.10 - \$0.10)
Date of Grant P&L expense	\$5,000.00 (50,000 option shares X \$0.10/share)
Date of Grant tax deduction	N/A, warrant grant a pledge, not complete gift
Date of Exercise tax deduction	\$500,000 (50,000 shares X \$10 per share spread value)
Date of Exercise P&L impact	N/A, warrant exercise recorded through balance sheet

Note: The company’s foundation would have \$500,000 to contribute to charities.

Primary Benefits

No cash consumed in connection with making equity grant

- Minimal dilution to outstanding equity
- Liquidity proceeds create flexibility and future funding for community activities without impacting corporate earnings or operating cash
- Leverage from “upside” of the “in the money” options/warrants
 - Slight, one-time, non-cash P&L charge
 - Tax deduction = exercisable date “spread” value
 - Opportunity to support community even in earliest stage of company’s evolution
 - Recognition and community involvement opportunities for all participating companies
 - Easy way to strengthen corporate culture and morale

Planning for the Event – Initiating the Process

- Most serious risk may be damage resulting from failed sale process
 - Damage to reputation of the seller as a viable ongoing business.
 - Jeopardize relationships with key suppliers and customers.
 - Depress employee morale and increase risk of raiding by competitors or others.
 - Forego or delay important opportunities, divert attention from management or make decisions which are not in its long-term best interests.

- Consider risk of “The Hosing at the Closing”: The deal closes -- but only after seller accepts substantial price reduction or other adverse change to avoid an aborted closing.
 - These risks are particularly great in the case of a sale process which is conducted during a period of economic weakness.
 - These risks are also high in the case of a seller whose business is deteriorating.
 - Negative surprises in diligence process also add to pressure.

Planning for the Event – Initiating the Process

- In light of damage from failed sale process, the first and most important step to minimize its pre-closing risk is (if possible) not to initiate sale process that does not have high likelihood of a successful outcome
 - Gather intelligence regarding financial market conditions, sale processes conducted for other similarly situated companies and industry trends
 - Develop a preliminary idea as to the valuation of the seller's business and the factors that influence valuation
 - Refine a strategy which is designed to maximize valuation
- Develop and refine a believable plan
 - The seller is likely to be penalized if its business plan is not believable
 - Failure to achieve the business plan during the period prior to closing will invite the buyer to renegotiate the price down
 - Developing an overly aggressive business plan will invite the buyer to propose an unrewarding – but hard-to-refuse earn-out

Planning for the Event – Initiating the Process

- Once seller has decided to initiate process, it should do everything possible to increase the chances of a successful outcome and to minimize the damage resulting from a failure to close.
 - Proactively identify potential deal killers – typically unquantifiable major risks such as IP, tax, litigation exposure
 - Identify and minimize other issues, which may exert a significant negative effect on valuation or delay transaction
 - Make preliminary plans to eliminate potential deal killers
 - Final resolution should be made with buyer input
 - Identify key employees and provide them with appropriate incentives such as stay bonuses or change of control agreements (with “double trigger” provisions)
 - Ensure business continuity to meet plan during and after process

Planning for the Event – Initiating the Process

- Management should have thoughts and plans for integration and social issues prior to entering a process
 - Key employment/retention agreements
 - Relocation issues
 - Maintaining organizational structure/team/culture
 - Identify cultural mismatches early

Preparing for the Event – Selecting a Banker

- Should you use a banker?
- Difficulty of sale; need for negotiation support
- Management attention (available/desired)
- Ability to affect value
- Fairness opinion
- Fiduciary concerns
 - Evaluation of Buyer Stock
 - Market checks
 - Auctions
- Very clearly understand how the fee is calculated
 - Employment agreements
 - Severance?
 - All liabilities?
 - When earn-out/escrow paid?

Executing a Transaction – Confidentiality Agreement

- Likely to be first agreement negotiated during process
- Signed by all of the bidders – including actual or potential competitors of the seller and buyer
- Commercial NDAs not acceptable substitutes
- Resist requests for “evenhandedness” or reciprocity
 - Seller is far more likely than the buyer to enforce
- Define the term “Confidential Information” broadly
 - Include all information concerning the business and affairs of the seller
- Limit use of Confidential Information other than for the evaluation and negotiation of the proposed transaction
- Provide for the return or destruction of the materials if the proposed transaction is not consummated
 - Address electronic information that is difficult or impossible to delete
 - Retention of archival copy for litigation/regulatory purposes?

Executing a Transaction – Confidentiality Agreement

- Must contain employee non-solicit - typically 12-24 months
- Consider customer and supplier non-solicit/non-interference (especially for competitors and strategics)
- Issue: Applicability of non-solicits to affiliates (e.g. equity backers or financial buyers with interests in strategics)
- Provide for assignment (without consent) of the seller's rights
 - Enables the seller to assign its rights under the confidentiality agreement to another bidder or a future acquiror
- Note: Even under confidentiality, should limit buyer²¹

Executing a Transaction – Letter of Intent

- Seller’s bargaining leverage generally greatest immediately before signing the letter of intent and declines thereafter (until expiration of exclusivity period).
 - Note: If Buyer is public company, seller may regain some leverage following public disclosure
 - Maintain leverage with
 - adequate (internally generated) funding
 - appropriately brief exclusivity period with “fiduciary out”
- Should Seller resist LOI and proceed directly to agreement?
 - Generally no

Executing a Transaction – Letter of Intent

- Seller’s best interests are usually served by insisting that the letter of intent be explicit and detailed with respect to the material terms of the transaction. Such detail may serve to:
 - Reduce the likelihood that the deal will fail to close as a result of a misunderstanding between the buyer and the seller as to fundamental deal terms
 - Note regarding transaction structure: In most cases, the seller will prefer that the transaction be structured as a merger or sale of stock rather than as a sale of assets. Seller should insist that the letter of intent specifically describe the structure of the transaction.
 - Do not forget “social issues” at LOI stage
 - Reduce the likelihood that the seller will ultimately conclude that the provisions of the definitive agreement are too onerous to make it worthwhile to proceed with the closing
 - Psychological threshold crossed even if “non-binding”
 - Reduce overall time and expense by providing detailed framework for counsel

Executing a Transaction – Disclosure

- Do not defer disclosure of potential problems
 - No surprises!
 - Do not disclose potential problems without solutions
 - Bargaining power higher early in the process
- Control the flow and maintain a “drumbeat” of flow of information
- Phase access to key information as confidence in process and certainty of transaction grows
 - Minimize the risk to the company if process fails
 - Key customer and supplier contacts only after signing agreement (and as closing approaches) or via investment banking “cut out”
 - Source code access post-signing
 - Technology review via mutually selected third party consultant

Executing a Transaction – Disclosure

- Attempt to maintain physical separation from company offices
- Take steps to minimize the number of employees who are aware of the sale process and develop a contingency plan for dealing with leaks and rumors
 - another reason to accelerate process

Executing a Transaction

- Target ≠ Passivity
 - Control the process
- Continue momentum
- Frequent organizational calls
- Detailed T&R list; establish accountability
- If process fails, should be early – not late
- Control destiny – adequate funding through process
 - Investor bridges and fiduciary duties
 - Acquiror bridges

Executing a Transaction – Fiduciary Duties

- Private company Boards have fiduciary duties
 - Sales for cash require diligence and must be shopped
 - Cash from strategic is still cash
 - No shops and termination fees
- D&O insurance and indemnity agreements
 - Ensure policy makes “tail” or “run-off” available (6+ years)
 - Written indemnity agreements
 - Indemnity obligations should be expressly assumed

Executing a Transaction – Fiduciary Duties

– If selling for cash –

- Seller’s Board must “focus on one primary objective – to secure the transaction offering the best value reasonably available for the stockholders”
- Does not always mean highest price (certainty, timing, etc.)
- No prescribed procedure; no duty to conduct open “auction”
- No duty to be fair to bidders – if aim is to maximize value
- Market checks
- No-shops & “fiduciary outs”
- Role of investment bankers, fairness opinions

Executing a Transaction – Duty of Care

- Board must act in informed and deliberate manner; must avail itself of “all reasonably available material information”
 - Take time, don’t rush – more than one meeting
 - Information packages in advance
 - Document the process
 - Email is not a substitute for meeting deliberation; email chains are not “deliberation”
 - Summary of key terms – need not read all docs word for word
 - Financial adviser, fairness opinion – buy-side versus sell-side
 - Access to advisers, corporate personnel
 - Presentations by legal, financial, accounting advisers, officers
 - Active board
 - Market info; alternatives; pros and cons of deal, risks
 - Corporation’s long-term goals and plans for achieving them²⁹

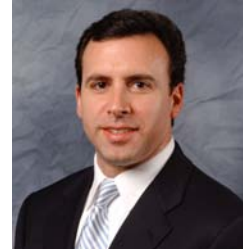
Executing a Transaction – Duty of Loyalty

- Conflicting financial or other (including personal) interest
- Not every interest disqualifies
- Director's interest as stockholder OK, but must be aware of distinction
- Must be significant personal financial interest, different from other stockholders

A Focus on Emerging Growth

ANDREWS KURTH LLP
Emerging Growth and Technology Practice

Andrews Kurth's Emerging Growth and Technology Practice is the leading Texas-based business law firm for entrepreneurs, emerging growth companies and their venture capital and private equity investors. Our attorneys develop business structures, help to secure financing, take companies public, advise on acquisition and strategic alliances, counsel on executive compensation, and help our clients protect their intellectual property. We represent clients in the areas of semiconductors, telecommunications, computers and electronics, enterprise software, life sciences, aerospace, Internet and e-commerce, consumer products and retail. We also represent and have extensive contacts with market leading investment banking, private equity and venture capital firms from coast-to-coast.



MATT LYONS

phone: (512) 320-9284
fax: (512) 320-9292
email: mlyons@akllp.com

Matt Lyons is an Austin partner with Andrews Kurth, where he specializes in representing private and public emerging growth companies and entrepreneurial interests. He advises on all aspects of forming new businesses, raising capital, M&A, and securities laws & regulations. He also regularly counsels companies and their boards on corporate governance and executive compensation. Matt represents and maintains relationships with a number of prominent venture capital, private equity and investment banking firms.

Matt has consistently been named as one of the leading lawyers in Texas for the area of Technology: Corporate and Commercial in the Chambers USA Rankings. He also has been Martindale-Hubbell "Peer Review Rated" for Ethical Standards and Legal Ability. Matt has been named a "Texas Rising Star" in the area of Securities and Corporate Finance by Texas Super Lawyers and Texas Monthly Magazine. Matt received his undergraduate and law degrees from the University of Texas at Austin.