



Exit Strategy Options for Software Companies in 2011-2012

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About J. Matthew Lyons

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Matt practices corporate and securities law, where he specializes in representing private and public technology and other emerging growth companies. Matt advises companies, entrepreneurs and investors on forming and operating businesses, raising capital through private and public offerings, buying and selling companies and assets, and on complying with the periodic reporting and Sarbanes-Oxley requirements of the federal securities laws. He also regularly counsels companies and their boards on corporate governance and executive compensation matters. He represents and maintains relationships with a number of prominent venture capital, private equity and investment banking firms, and he has participated in the formation of several venture capital funds.

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 has also been Martindale-Hubbell "Peer Review Rated" for Ethical Standards and Legal Ability. In 2005, Matt was named a Texas Rising Star in the area of Securities and Corporate Finance by Texas Super Lawyers and Texas Monthly.

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Overview of Exit Alternatives

- M&A transactions
 - Public buyers; proceeds typically cash or liquid securities
 - Private buyers; proceeds often restricted securities
- Initial Public Offerings (IPOs)
- Dual track: IPO coupled with M&A discussions (S-1 as a marketing document)
- Private secondary transactions / Recapitalizations
 - Firms like SecondMarket and Sharepost and secondary venture firms creating markets for private companies
 - Partial liquidity for founders through debt recapitalization or sale of non-control stake to secondary market and growth equity firms

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Overview of Exit Alternatives (cont'd)

- Among the factors that founders and management may need to assess in deciding whether or not to monetize an equity stake include:
 - Future growth prospects and current financial resources of the company
 - Long term competitive positioning
 - Valuation trends for similar companies
 - Investment time horizons and return expectations of other shareholders
 - Redemption provisions and demand registration rights of investors
 - Desire (or lack thereof) for an on-going management role
 - Personal wealth and lifestyle influences

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Overview of Exit Alternatives (cont'd)

INITIAL PUBLIC OFFERING (IPO)

- Advantages

- Easier access to capital markets and future financing
- Ability to use equity as acquisition currency
- Stock option / stock issuance plans (with liquid stock)
- Prestige and public image; corporate credibility
- Possible higher end terminus valuation

- Disadvantages

- Available only if SEC and market requirements are met
- Out-of-pocket expenses in transaction and ongoing
- Failed IPO process can be demoralizing, adversely affect market perception and momentum
- Disruption of operations
- Required transition to short-term orientation, quarterly earnings focus
- Disclosure of sensitive information
- Insiders' stock "lock-up"
- Stock subject to market whims

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Overview of Exit Alternatives (cont'd)

ADVANTAGES OF A MERGER OR ACQUISITION

- Faster exit strategy
- Greater liquidity
- Certainty of sale price
- Reduced disclosure requirements
- Benefits from merging with a larger company
- “Synergies”

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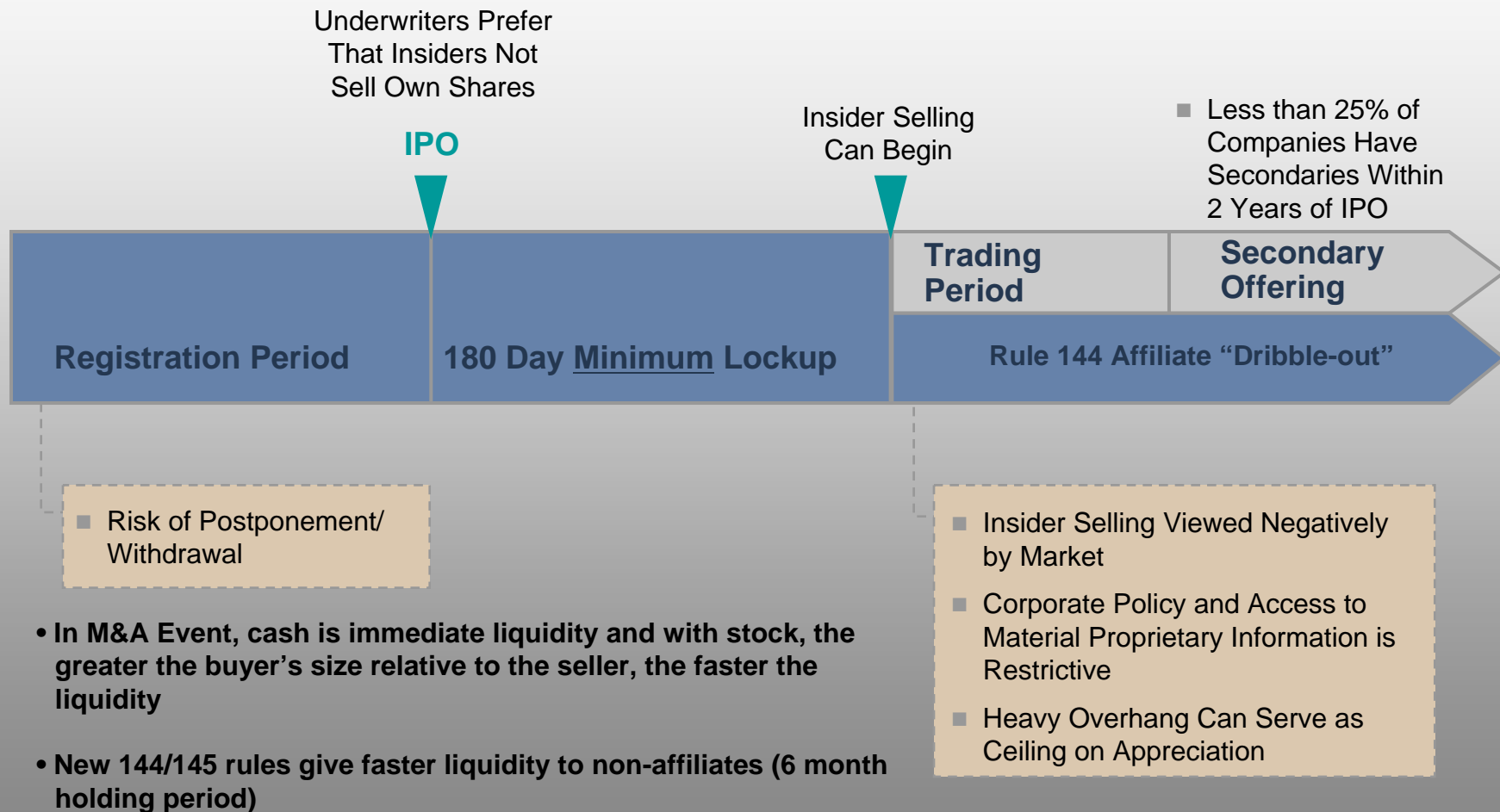
Characteristics of an IPO Candidate

- Significant and Sustainable Growth
 - Strong and Sustainable Annual Revenue Growth
 - Near-Term Potential for Significant Revenues
 - Sizeable Market Opportunity and Significant Growth Potential
 - Four Quarters of Profitability or Cash Flow Breakeven Status
- Proprietary Products or Unique Services
- First Mover Advantage, Barrier to Entry, Sector Leader
- Quality Management Team
- Sufficiently Mature Internal Controls (Sarbanes-Oxley)

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IPO Insider's Liquidity is Severely Constrained



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General Exit Considerations

- Understand potential valuation ranges and risks for different exits
- Secondary transactions may require disclosure of financial information
 - Securities law implications must also be considered
 - Company may not want to participate in secondary transaction
- Should a banker be engaged and, if so, when?
 - Tails and minimum fees should be carefully negotiated
 - Managing bankers in a dual track process can be an issue
- Prepare for due diligence review and ensure corporate records are in good order
 - Consider on-line data site for independent diligence by multiple bidders in M&A process
 - Organize capitalization records and board minutes
 - Analyze pending or potential litigation (plaintiffs tend to emerge in the face of a significant transaction)
 - Resolve outstanding litigation and/or claims if practical to do so
 - Be vigilant about obtaining releases from former employees in forced terminations

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General Exit Considerations (cont'd)

- Option pricing and 409A valuation reports need to be reviewed for cheap stock issues
- Third-party consent requirements
 - For IPO, consider registration rights waivers, automatic preferred conversion thresholds, and potential customer consents for disclosure of customer information in prospectus
 - For M&A, consider supplier, customer, landlord and securityholder consent requirements
- Consider management team bandwidth issues
 - Exits are all-encompassing events – need to keep growing the business

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IPO-Specific Considerations

- Visibility, infrastructure and independent directors are critical
 - Predictable business model and visibility into future revenues is key
 - SarBox, Dodd-Frank, FCPA and Reg FD require good internal controls (and beefed up finance, accounting and compliance teams)
 - Independent board committees should be formed and independent directors should be recruited ahead of time
- Adopt new public company equity incentive plans
 - Consider evergreen provision
 - Review acceleration and vesting provisions
- Review exemptions for unregistered offerings carefully
- Does your company have sufficient capital in the event transaction is delayed?
 - Consider private raise sufficiently in advance of filing S-1 to avoid potential integration issues or need to withdraw offering to complete private round

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IPO-Specific Considerations (cont'd)

- Consider public disclosure issues
 - Detailed financial, business, executive compensation, corporate governance, sole source suppliers and related-party disclosure required
- Material commercial agreements must be publicly filed; consider confidential treatment requests
- Consider audited financial statement requirements (including financials of significant acquired businesses) and independence requirements for auditors
- Implement public company policies (e.g. insider trading policy other corporate governance policies) and procedures
- Consider implementing 10b5-1 insider trading plans

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IPO-Specific Considerations (cont'd)

Up to One Year Before IPO Kick-Off

- Estate planning for executives with equity ownership
- Plan for any new equity participation by management
- Experienced IPO counsel
- Experienced IPO accounting firm
- Ensure availability of audited financial statements for requisite periods
- Establish website and public communications policy
 - Update website sufficiently in advance of IPO so as to establish a history of ordinary course business and financial communications
 - Limit website and other public communications to ordinary course business and financial matters
- Establish rational fair market value exercise price for option grants, stock issuances and stock transfers, such as gifts

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IPO-Specific Considerations (cont'd)

Up to One Year Before IPO Kick-Off (cont'd)

- Plan for repayment of officer and/or director loans prior to IPO (Sarbanes-Oxley)
- Assess sufficiency of minute books and other corporate records
- Obtain directors and officers insurance and understand required IPO upgrades
- Consider impact of new business initiatives on IPO timing to avoid surprises
- Identify potential independent members for Board of Directors
- Determine whether any additional members of senior management are needed
- Upgrade internal controls, including Sarbanes-Oxley compliance plan, to ensure integrity of financial statements and sound corporate governance
- Organize due diligence materials
- Prepare fact book to support market data

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IPO-Specific Considerations (cont'd)

Two Months (or more) Before IPO Kick Off

- Board of Directors at IPO

- Independence – a majority of Board must be independent committees of all independent directors:
 - Audit committee
 - Compensation committee
 - Nominating and corporate governance committee
- Director compensation for Board and committees;
- Cash compensation: cash retainer vs. per meeting fees
- Equity compensation: options, restricted stock
- Chairman fees; for Board and committees
- Audit committee “financial expert” required (ideally a CPA and/or former CFO or audit firm partner)

- Directors and officers liability insurance at IPO

- Coverage amount and deductibles
- Increased cost of coverage at IPO

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IPO-Specific Considerations (cont'd)

Two Months (or more) Before IPO Kick Off (cont'd)

- Officers

- Titles – review and reconsider management structure and titles
 - “Executive” officers vs. “Senior” officers
 - Section 16 insiders - reporting and compliance issues (a/k/a Form 4 filers)
- Employment agreements
- Incentive arrangements and plans

- Employees

- Non-compete, non-solicitation and confidentiality arrangements
- Incentive arrangements and plans

IPO-Specific Considerations (cont'd)

Two Months (or more) Before IPO Kick Off (cont'd)

- Equity Plans
 - Compliance with tax and securities laws – 409A and Rule 701
 - Consider new plans or plan amendments
 - SEC registration of restricted stock and option shares (Form S-8)
- Charter, Bylaws and Corporate Records
 - Create form of “public company” charter and bylaws for post-IPO- review and make any necessary changes
 - Review capital structure (make sure that there will be sufficient common stock and blank check preferred)
 - Anti-takeover provisions, such as a staggered board
 - Review indemnification provisions
 - Review corporate structure
 - Consider creating holding company structure
 - Consider need for existing subsidiaries
 - Tax issues, including the use of a Delaware or foreign “technology” subsidiary for state tax planning

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IPO-Specific Considerations (cont'd)

Two Months (or more) Before IPO Kick Off (cont'd)

- Share Capital

- Review and clean up existing shareholder list
- Registration rights/notice and/or waiver
- Lock-ups by directors, officers and shareholders
- Are there lock-ups under existing agreements
- New lock-ups to underwriter – 180 days after pricing
- Lock-ups in option agreements
- Preemptive rights; anti-dilution provisions
- Accuracy and completeness of stock book
- Identify all issuances of shares since formation
- Shares authorized and outstanding - amend charter as necessary
- Transition stock recordkeeping to transfer agent
- Stock options and/or restricted stock outstanding and to be granted

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IPO-Specific Considerations (cont'd)

Two Months (or more) Before IPO Kick Off (cont'd)

- Exchange
 - Consider Nasdaq v. NYSE listing
- Corporate Governance
 - New Board Committee charters – public company versions
 - Code of Conduct that includes Code of Ethics
 - Insider Trading Policy
 - Disclosure Controls and Procedures for SEC filings
- Pre IPO Annual Meeting of Shareholders
 - Adopt charter
 - Other required actions
 - Avoids Annual Meeting immediately after IPO

M&A Exit Considerations

- Pre-emptive due diligence
 - Code scans and source code escrow reviews
 - Change-of-control triggers in third-party contracts
 - FCPA and export control compliance
- Review contracts for restrictions on business
 - Exclusivity
 - Most favored nation (MFN) pricing or terms
 - Non-competes, non-solicits
 - Joint IP ownership (through joint development agreements)
 - Source code escrows
- Capitalization and consent issues
 - How is the preferred stock treated?
 - Liquidation preference – fully participating or capped?
 - Accruing dividends?
 - What shareholder approvals will be required?
 - If the seller has a drag-along, review the coverage and mechanics
- If common stockholders would receive little or nothing, *Trados* case must be considered

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M&A Exit Considerations (cont'd)

- Employee issues
 - Do all employees and consultants have signed invention agreements?
 - Review retention plans and severance arrangements
 - What are the termination and acceleration provisions in the option plan?
 - Consider 280G tax issues and cleansing vote mechanics
 - Review employee / service provider classification issues (exempt, non-exempt and contractor status)
 - Any disenfranchised former founders?
- Should any members of management be granted employment or severance agreements?
- Will management carve-out be needed?
- 409A Valuations need to be reviewed and updated
 - Grants and exercise price of options must be reviewed carefully if transaction is imminent
 - Granting of options when deal is pending is problematic; may have to cease altogether
 - Shareholder representative and escrow expense fund
 - Ensure sufficient D&O policy in place and has “tail policy” or “run off” option

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Structuring the M&A Transaction

- Deal structure alternatives
 - Asset sale
 - Stock purchase
 - Merger (direct, forward or reverse triangular)
- Structuring considerations
 - Business and economic considerations
 - Allocation and assumption of liabilities
 - Taxes
 - Third party consents
 - Corporate law and mechanics
 - Appraisal and dissenters rights
 - Board and shareholder approval
 - special committees needed?
 - Securities laws exemptions in stock deals
- Social Issues
 - Titles, roles
 - Offices
 - Culture
 - Autonomy

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Structuring the M&A Transaction (cont'd)

- The letter of intent (LOI): Key terms should be spelled out in the LOI
 - Non-disclosure Agreement
 - employee non-solicit
 - Consider purchase price adjustments for the following:
 - Working capital, cash, debt, transaction expenses, bonuses and carve-out plans
 - Option exercise prices and transaction expenses
 - Earn-outs...can be very challenging
 - Escrow and indemnity provisions are key
 - Identify size and length of escrow
 - Baskets, deductibles
 - Escrow as exclusive remedy
 - Significant closing conditions
 - Financing contingencies?
 - Material adverse change (MAC)
 - Employee retention
 - Is HSR filing required and are there substantive anti-trust concerns?
 - Length and breadth of no-shop
- Specific LOI generally more advantageous to seller, whose leverage generally decreases as transaction progresses
 - Get as much detail as possible upfront! (if you are the seller)

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Things You Can Do

- Capitalize your company well
- Rapidly achieve positive cash flow
- Make an honest assessment of your core competencies
- Know that the M&A market for private companies generally moves in tandem with equity markets (i.e., a strong IPO market = better M&A valuations, and vice versa)
- Focus on creating value for your customers/end-users and build for the long term
- Don't focus on when the IPO window will open
- Build the strongest, most resilient team
- Have your own product roadmap built out and vetted

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Things You Can Do (cont'd)

- Build relationship with strategic and financial buyers over time
 - Companies are bought, not sold
- Build a company capable of either exit strategy OR of remaining independent indefinitely
- Preparing for any exit actually begins at formation and is a continuous process
- Periodic document / process review
 - Maintain organized files that can easily become diligence files
 - Avoids disruption / notifying employees when documents must be quickly produced
 - Particularly important for companies that have not received external financing
 - Institutional investors typically conduct abbreviated due diligence reviews during financings

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Summary

- Many Facets to Consider When Deciding Between M&A and an IPO
- Valuation in an M&A Transaction Can Match or Surpass an IPO Valuation, but IPOs usually have higher “top end”
- Liquidity Through M&A is Generally Superior to the Liquidity Provided by an IPO
- The Risk Mitigation and Long-Term Value Through the Strategic Benefits of a Merger Must be Considered
- Secondary Sales and Recaps can be Alternatives for Partial Liquidity
- The IPO and M&A Routes Can Be Pursued in Parallel
- Companies should take steps to preserve viability of either option, or allow to remain independent until market conditions permit exit

There Are Likely To Be Multiple Potential M&A Buyers That Can Provide a Faster, More Certain Exit, but the *IPO Still Remains the Ultimate Prize for Many Companies*

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