QuickLaunch University Webinar Series Transcript
Planning for Exit—Why It's Never Too Early

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Presented by WilmerHale Partners Christopher Rose and Eric Hwang

Chris: Hello, everyone, and welcome to today's QuickLaunch University Webinar. My name is Chris Rose and I'm a partner in the firm's Corporate Practice. I'm joined by my partner Eric Hwang. Over the past few months, we've explored many different legal issues faced by entrepreneurs and early-stage companies as they begin to build their companies. Today we will talk about planning for your company's exit strategy and why it's never too early to prepare. If you're interested in going back to listen to our previous sessions, where we've covered the basics of forming a company, founder equity, and more, the links to the recordings are posted on our website at wilmerhalelaunch.com.

Now, I'll quickly introduce our speakers. Again, my name is Chris Rose and I'm here with Eric Hwang, and we're both partners in the firm's Corporate Practice based in Palo Alto and Los Angeles offices of WilmerHale.

Eric: Two of our main goals here will be to give a basic overview of common deal structures and issues that you'll want to be aware of at a high level when you start thinking about what exits entail and the process for all that. We'll also try to incorporate throughout the presentation things that we think can be done now in advance of an exit, including good habits, and ways to keep files in order that will hopefully make the process more smooth, efficient and have fewer bumps.

We look at this as broken into sort of two components. First are the different types of exit scenarios and the different types of transaction structures that are most common. And then we'll go into the second part of the presentation, which is an overview of the timeline of the deal and gives you a sense of the different phases, what happens in each and the key documents that go along as well as key work streams that you might encounter. And along the way, of course, we will try to mention those tips that I think will be helpful now when thinking about things in the future.

We are going to talk about asset acquisitions, acquisitions of stock, mergers, acquihires and just touch on IPOs. Asset acquisition, though a pretty common deal structure, is probably the most complicated and one where people really have to be careful about what they do. An asset acquisition is where a buyer comes in and, instead of buying the whole company, is only buying parts of it. Now, it can be a small piece, also called a carve-out. For example, in a larger target, this may be a division or a product line. But it could also be as much as buying almost everything.

The thing about asset acquisitions that are advantageous for a buyer is that it allows them to cherry-pick the assets. You can pick the things that you want and leave behind the things that you don't want to a certain degree. Depending on what is being acquired and how much, you may not have to. The sellers may not have to get shareholder approval, so the process will be a bit more streamlined. Of course, as you'll see on the next slide, there are a lot of disadvantages that actually make asset deals far more complicated and potentially problematic from an execution standpoint.

Chris: We're really talking M&A 101 here today for folks who are just getting started at this and are just starting companies. But asset acquisition I think will be the most likely thing that you'll encounter if your acquisition happens early on. The buyer is not going to want to take on other liabilities. They're really going to want to know what they're getting. And an asset acquisition for the smallest of companies tends to be the most frequent thing you'll see. And that'll leave you, as Eric said, with a whole lot of disadvantages in terms of getting rid of the entity, getting rid of the liabilities and those sorts of things. But at the end of the day, you're probably going to be stuck with it if you do a sale early on because you won't have the leverage to fight your way out of it.

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The other time you see these early on is when a company has done multiple things. Maybe it's pivoted a couple of times and there is more than one business at the end of the day. Sometimes the buyer only wants one of those and wants to leave behind the other one and they want you to shut it, or they want to just give it back to you. Other times, the seller is selling off the assets to another company and one of the sellers, maybe there were multiple founders, is interested in one part of the business and not the other. You'll do an asset deal for that reason so that that the founder that doesn't want to go along with the sale can maintain that piece of the business while the piece that the buyer wants can get sold off. There are really two reasons that I encounter most often for startup stage companies to do asset deals. One is the buyer's reluctance to take on unknown liabilities or the desire of the buyer or the seller to split things apart and have one part of the business go with the buyer and one part of it stay behind with a different group of folks.

Eric: When looking at some of the disadvantages when you are splitting up the business, you have to identify specifically all the things that are coming and going—those get scheduled out. That's not an easy process. When you're transferring assets, consents can be required from third parties—another thing to keep in mind. Anytime you introduce a third party whose interests aren't necessarily aligned with the buyer and the seller, you have potential holdout value that's being created there. You also have to transfer employees. If employees are being transferred, they have to be terminated at the seller and rehired at the buyer. That is another process that doesn't normally exist in other alternative transaction structures.

And then similarly if you're splitting up businesses, there may be transitional services. For example, if back-office is staying behind with the seller, there may be some IT support or consulting support that will need to be provided for three or six months post-closing while the split-off business gets up and running. There are a number of other ones. I think probably the one that is important to point out is the potential double taxation of sale proceeds because the money goes to the company and then eventually gets distributed out. There's two layers usually of tax that go along with that.

Chris: So what can you do now to be ready for an asset deal in the future? The number one thing you can do is keep your files. And I know you're busy and have a lot of stuff going on. I cannot tell you the number of man-hours, woman-hours and wasted dollars that go into the average asset deal because you just can't find signed contracts. You can't find the actual last version of the document. If it ends up that that's an important document, that's a spinning process that will cost thousands and thousands of dollars just to figure out before somebody finally says, "Okay, we're going to let it go because there's nothing we can do about it," or they say they have to go back and get a signed agreement from somebody else that you don't want to inform about the deal proceeding.

So please, when you get your documents, make sure somebody is the repository of those documents. Probably at the early stage it is the CEO and at the second stage it is the CFO, but make sure somebody is responsible and you know where they are. If they can be organized, all the better, but I'm realistic that the best you're probably going to do when you're that busy, having personally worked in the startup world before, is keep them, much less organize them. But if you did have the time and ability to have them organized, it would be smart for you to get that person who holds the documents to get a basic diligence request list from your outside counsel and keep them in that order so that when you get your request list— and you will get lots and lots of them over the life of the successful startup—all the way from your first VC funding, your second, your third, your fourth, to your filing for your IPO and your underwriters and your M&A exit. It is never too soon to have a data room on a disk where you keep your documents.

Eric: Invest as early as possible in an online repository of documents. Make sure that you have a good process for keeping copies of all executed agreements, employment agreements and other things like that. If you have the opportunity, take a look at a sort of standard kitchen sink due diligence request list. It will give you a sense for the things that buyers will be looking at when they're going to do diligence. It will be long and have sort of every type of agreement under the sun, but it'll be important for you to understand, this is what you will be up against in terms of document production while you're trying to run your company in the midst of a sales process. It is distracting, so the more organized you are in the early stages, the better. And that's a lesson that I think applies not just for asset deals but for everything.

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The next type of transaction we'll cover is a sale of stock. This is an acquisition of shares directly from the target shareholders. There is a shorter list of advantages and disadvantages to this. These become a little bit more streamlined processes. It doesn't affect the corporate existence of the target company, all you're doing is changing the shareholder base. Because you're just transferring shares, typically assignments aren't needed. That also means there is no need for third-party consents. And again as we talked about with the asset transaction, having fewer third parties means that can't mess things up for you as the process goes on.

The disadvantages really deal with the structure itself, right? In that if you're selling shares to a buyer, all of your shareholders are coming together. Typically, that means getting all your shareholders to agree to sell, unless there are contracts in place that, will obviate the need for everybody to come along voluntarily.

Chris: If you're in a small closely held corporation, this is the way you're going to want to push your deal if you have the power to do it. The question you have to answer is: can you get everybody to sign a piece of paper? And frequently the answer to that is yes, everybody who's thrilled to be in the sale at that point would sign. You want to push your buyer early towards a sale of stock.

Generally, their biggest concern is, "What are the hidden liabilities?" If you tell them and if it's true that you formed this company when you formed the business and whatever number of years ago that was, and it's never done anything else but operate this business, then you'll be better. If you've done again pivots or if perish the thought, but it happens, people saved a couple of 100 bucks early on and they used old companies that they happen to have from something else that didn't work or that someone else gave them, you're going to be pushed towards that asset sale pretty quickly. But if it's a new company that's never done anything but this business, chances are your buyer will prefer this route anyway.

Eric: And the last bullet is important to consider—when you're thinking about getting your shareholders together, if you have a large group, and if you've done a few rounds of investments with a large shareholder base, this isn't necessarily going to be the right way to go.

Let's also discuss things you can do now to be ready for a sale of assets and avoid any potential slowdown in the process. Consider that the seller, once they've agreed early on to a price, cares most about the speed to closing, because things change quickly and that gives you more certainty. And with an asset sale, the thing that slows you down the most often is missing paperwork.

With a sale of stock, the thing that slows you down the most often is if you've got a bunch of change of control clauses involved, such as special severance arrangements that are being triggered on a change of control or people with rights of first refusal. That's stuff that slows you down from sign to close. Again, keep track of those. Keep them somewhere where you can find them in that data room that you're keeping. And, try not to find them if you can avoid them. You're not going to get out of your real estate lease, the change of control clause if it's there, realistic, you just keep track of it. But to the extent you can keep change of control clauses out of your negotiated business deals, try to do that.

Eric: Mergers are probably the most common for more established companies. You see this more often than you do asset deals or stock purchases. And this is essentially the combination of two entities. The entity that's created by the buyer and the target company itself.

Chris: A sale of an early stock is a contract between two people just literally agreeing to sell their stock. In a merger, it's an actual transaction that happens because of a law that exists on the book of the relevant states that says, "If you get a vote of these certain people or the directors, shareholders, etc., you can merge the companies together and extinguish one of them and push out the old shareholders, whether or not they voted for it."

And this is important as your stockholder base gets bigger and more unwieldy and there are folks who either don't agree or you can't find. And the second probably happens more often than the first. You just don't know where they are anymore. They could be former employees, they exercised their options, they

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were investors, they disappeared, they died, you don't know who holds grandma's shares anymore, or who is a founder. You need the merger scenario for this.

Eric: That’s really important. As the company gets older and more established, shareholders can fall off the map. A disadvantage is that this is something that is governed by the statute and by your charter documents in terms of the requirements that must be followed in order to do it. There are a number of steps and they technically have to be followed. But the advantage is that you don't have to get everybody to come along. So, unlike a share purchase where you're trying to buy everyone's shares, you just need to get the requisite votes. And, in some cases, it's simple majority depending on what your charter says. Sometimes it's supermajority, but it's less than 100%. And that's an important thing.

Chris: In some states it's class votes. It all varies by different states. And you just have to pull up the statute, get your lawyer to tell you what you need to vote this one through, and then you can figure out whether or not it's more or less advantageous than some of the other methods.

Things you can do right now to get ready: make sure that when you issue your equity you have a good form agreement with drag- along rights so that you can bring along the folks and get them to sign the things you need in connection with the merger in there. That'll be in any form— a shareholder package that's put together by any reputable law firm honestly. But, you just need to make sure that people have signed those things up. The easy part is doing the documents. The harder part again is honestly what we spend hours and hours on.. I know it sounds silly, but we really do, where the company goes and gets the signature pages from folks and they either didn't get them or they don't have them.

Because I understand, having raised hundreds of millions of dollars in a startup myself, the most important thing is that the money hits the bank account. And after that you're trying to run forward and keep the business afloat, but somebody has to put those documents into a file or they're lost and then you say, “I just wasted $20,000 on this for a lawyer at, $500 an hour." And it wasn't worth the five minutes you saved.

The other thing that slows you down in terms of getting consents, the change of control consents, those come up again, but now you also have ones where your anti-assignment clauses and every contract has a provision in the back that says, "It's not assignable without the consent of the other party." If it includes those magic words, including "by operation of law," then you get jammed up sometimes in the merger context having to go get consents for those ones too.

Eric: The second to last transaction structure we'll talk about is the acquihire, which is, essentially the acquisition of talent. A buyer comes in and doesn’t necessarily want the technology. Instead, they’re interested in a mass hiring because their development team is at capacity. It’s essentially a hiring of all the folks in the company and a license of all the valuable IP and then a shutdown of the existing business. This isn't necessarily the exit path that sellers hope to find themselves in.

Typically, there’s still a lot of work being done of the development end. Instead of having a long road to having a product, it can be a softer landing and an alternative to making the slog down to having a viable product. The other advantage for buyers is that it allows them to get access to large groups of talent that have the relevant expertise that they're looking for rather than doing one-off hires, the traditional recruiting means.

Disadvantages obviously are, similar to those of an asset deal -- stuff gets left behind and the target company is then left with the burden of winding down the business. And, this is again similar to an asset deal where, substantially all of the assets are getting acquired and then you have a target that's left with bare bones and it needs to do an orderly wind down over some period of time following the close.

Chris: Acquihire is a funny one for me. They've increased in popularity over the years. They're really more of a face-saving exercise where the company is either selling out very early and people are taking a small upside and really they're getting brought into a company with a compensation incentive package that's outside the norm with different, bells and whistles for it, where those folks can make tremendous amounts of money individually as they go through the company. And they couldn't get a comp package

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like that without the acquihire piece of it. The investors are generally not getting a lot in connection with most acquihires or they're losing a lot of the upside as they do it, and the entrepreneurs get to save. Why I say face-saving is because generally, they say they had a successful "exit," right? And it's usually not that way. Oftentimes, acquihires are done for first-time entrepreneurs.

Having worked in startups previously, it's hard because you're frequently making under-market compensation for your services and you frequently have a spouse and, having the ability to pay off a house or something else is a gigantic life-changing opportunity, and then you go into a company with a compensation package that gives you a lot of upside to it, it's just not really a sale at that point. Really, if you have the money in the bank, most folks who do an acquihire would turn down the deal, keep rolling at it, and then sell when they can do a merger or something larger that's a real exit transaction.

You're likely to encounter acquihire in about25% of deals now.I It's a non-trivial amount, sometimes 10 or 25%, because they're really smart for buyers. Honestly, buyers I've seen-- and Eric and I do a lot of buyer work-- buyers do really well at acquihire matters because if they spot something that's valuable early on and do an acquihire, they reap the vast benefits for it. And they're smart on the buyer side a lot of times.

Eric: The last one we'll talk about is the IPO, The advantages are that, if you don't sell to someone else, you can maintain your independence and actually shoot your strategic vision. You also get access to capital markets. It's easier to raise money. There are also plenty of disadvantages. The main one being that the IPO window depends on a lot of factors that are outside of your control. It can be there one day and it can be gone the next. It's fickle and timing is a tough thing to match up, I think.

Chris: And for most companies it's not. And for most employees and most founders, it's a long road from IPO to selling out and getting the kind of liquidity that you would get in M&A. That's why the M&A markets again over the years have just become so much more common than they used to be. And I've been doing this for 20 years, so I'm not talking about the ancient days, where IPOs were a more frequent exit that you would see. But it's important to understand them because the threat of IPO, the threat of what you could get through that scenario and the prevalence of doing what's known as a dual-track, where you get to the point where you're doing an IPO and trying to sell the company simultaneously, that's frequent and it also helps you try and get a better valuation because private valuations are lower than public valuations. And if you have the threat of doing a public valuation and an IPO, your buyer will generally pay you more than in a private one.

The things you can do to be ready now: this actually dovetails with the question that someone asked and sent in to us. And that was how valuable is it to have investment bankers involved and should we be doing that if we already have an offer on the table? Investment bankers really serve two purposes in my mind. One is finding deals, the brokerage piece, and two is insurance. When you already have a deal on the table the answer to that prior question is it depends, right?

If you have a small group of shareholders that you know are all happy and they're all going to sign a piece of paper in connection with the sale of stock, you probably don't need a banker because the insurance portion of what they would do for you doesn't exist because you're going to get everybody to sign up so there's no plaintiff left. And the piece of finding a buyer, you've already got a buyer, assuming you're happy with that. Now, if you're not happy with that offer and you think there are other buyers out there, then yesh, absolutely, you need an investment banker because you need somebody to go shop that offer and get you other better offers. Bankers are great at that.

The reason I bring it up now is because as you're thinking about IPO and threat of IPO, earlier on in the process, it's a good idea to get to know those bankers. Keep up on your industry comps, what are people doing, and keep that stuff, in a folder somewhere if you can. When you read cool articles that say “the market size is this big” or “your addressable market is this big” or “this is what your piece of the market is going to go to in the future,” save those because they're really hard to find later. And you're going to use those in two places. You're going to use those in your IPO document and you're going to need to back it up and show where you got that information from to your underwriters later. And that's really valuable.

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The same thing is true if you end up doing a PPM for VC financing or you do a PPM for a private placement memorandum. It basically tells your story. If you do the storybook for that in connection with a sale process, all those things are places where you're going to want to have that stuff backed up. And get to know bankers early. They can turn you onto better sources of information, who better buyers are, etc. I wouldn't sign engagement letters with them early on. That's important. You don't want to engage people until you're really ready to do something because bankers are always looking for an exclusive there, etc.

Eric: When you sign an engagement, they typically come with tails. So if you end up doing a deal within a certain period of time after the engagement expires, they're still going to get their fee. You really don’t want to engage your banker until you know you want to embark on a sale process or an exit process.

Chris: I'm not saying if you want a banker to do something you don't sign a piece of paper with them. Absolutely sign a piece of paper when you're asking them to do something you should both because brokerage law, you will owe them a fee if they start doing things that you ask them to without paper. So be very clear about when you want them to do something and when you don't. And when you do, you should have an agreement with them.

Eric: We'll move onto the second part of the presentation, which is talking through the phases of the deal. What to expect, and the key documents and components of the timeline.

This is a good map, right? You start with your NDA and some initial diligence gets done. We'll start with a little overview here. Before discussions really go on, the first thing you do is you get an NDA in place. And then some discussions happen, no information is shared, you might get a term sheet. And once the term sheet is agreed the parties are going to go full steam ahead in conducting due diligence and simultaneously negotiating a definitive agreement. The final arrow there is the definitive. And that's either your merger agreement, your share purchase agreement, or asset purchase agreement depending on which structure you use.

And once that agreement is final and signed there may be a period between signing and closing or there may not, but we put that in as the final main step. Although in a lot of cases there will be a separate signing and a separate closing that happens later. This is the overview of the second phase, the confidentiality agreement, the term sheet. We'll cover some due diligence topics and what buyers typically focus on, particularly in tech deals. We'll talk a little bit about IP and HR issues and dovetail that back into things that you can do now and building good practices and thinking about what a buyer will expect that will hopefully make things smooth a few down the road, and then just a high-level overview of the definitive and key components and how that generally works.

The first thing is the confidentiality agreement. A buyer may approach you. And again, we're talking about situations where you're in direct negotiations. We're not talking about the situation where you've engaged a bank or you've embarked on a process that might have multiple bidders. But in the situation where a buyer has approached you, maybe have preliminary discussions about a possible combination, before you share any sort of important information the first thing you want to do is get a non-disclosure agreement in place that covers, the confidentiality of the discussions but also the information that's being shared and allow you to start sharing, confidential information that you wouldn't otherwise be comfortable doing.

What you share is up to you. And again, it's your information, you control whether or not you share the secret sauce. Typically you don't, but it'll protect your information. There's a half a dozen things that are really important in confidentiality agreements, including covering what the scope of the confidential treatment is, non-disclosure obligations and non-use obligations so you can’t use that information later on.

And there are exceptions to those, and those are important. So when you're negotiating a confidentiality agreement make sure you have your outside counsel involved because there are some “gotchas” in there that as a seller you definitely want to try and avoid to the extent that you can. It'll cover the duration of

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how long the non-use and non-disclosure obligations run, one year, two years, three years. And then what happens if discussions terminate. Do you destroy, do you return the information, is the buyer allowed to retain copies? And in some cases you'll have non-solicits that tie to who a buyer can be in contact with and try protecting your people post discussions.

Chris: So some things you can do now to be ready: you want to keep all these NDAs in one place. And that's just NDAs in general. You sign so many of these things so often in today's world. It's really hard to track them down later. So just having a procedure where if anybody signs one you throw them into a folder will make life much easier later on. Know the difference between an M&A form and the other forms in connection with this and don't sign the wrong one. If you're doing a general commercial deal with a very big company, they're going to send you their form of NDA and you're stuck with it. In fact, you probably sign it when you walk into their building these days at the front desk in order to get your name badge.

Eric: Whether that's enforceable is a separate question.

Chris: And that's totally different. But if they're looking at buying you, a lot of VCs will tell you they don't sign NDAs when they look at investing in you. And that is true. But that's not true with buyers at companies. They expect to sign a different NDA and they expect to sign it for the most part on your form. Are they going to have all sorts of crazy stuff they're going to want to put in there like residuals clauses and other things that your lawyers will explain to you when it comes up? Absolutely, but they will take your form. So if you're going into an M&A process, this is one point in time at which calling your lawyer and getting a form is probably valuable. And I would get your own M&A form from him or her. Not when you're walking in the building during the general commercial deal.

You generally want them to be mutual in commercial deals because of the number of NDAs you sign when you walk in the door. However, from the M&A perspective, you probably prefer it’s non-mutual, it sits on your form but they’re going to make it mutual and that is fine.

Eric: The next piece is the term sheet. As I mentioned before, after you sign the confidentiality agreement you're going to do some high-level information sharing. You're going to share some financial information, maybe some products, overview information, things like that.

Chris: We have a question that came in on what buyers demand to speed things up They will demand. There are some buyers who will have M&A confidentiality forms. It just depends. Where things are more corporate, they will insist on it and you'll be stuck with it. But at most, the majority of places that I have done business with and that I believe exist, they understand in an M&A deal they'll deal on your form, for the most part.

Eric: Yeah, I think the thing here is, if you're dealing with a really serial corporate acquirer, they'll look at thousands of NDAs a year. And, perhaps from a process standpoint, it might not be worth their time if they have to go and negotiate an M&A. And when you run into those kinds of buyers, it's best to just suck it up and negotiate off their form.

Chris: But if you have a reputable, law firm, and they can tell you who negotiates in their form and who doesn't. And my experience is that you can count on all your fingers and toes the number that are going to insist on their form. More people are hot to try to look at deals and they won't insist on their form.

Eric: After some high-level information sharing is done, financial, some product and technical information, you might get a term sheet, and the term sheet is the document that, essentially is non-binding and lays out the key terms of the deal. And, from a seller's perspective, I think most sellers will just look at the headline price and call it a day. This stage is another part where I think you really want legal advice.

There are other things that you're going to want to make sure you get into a term sheet. They’ll have the deal price, the type of transaction, how the price will be paid, whether it's cash, stock, or combination, and the deal structure. And skipping down to the bottom, exclusivity. Now, that's your light term-sheet,

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that's what a buyer is going to send you. They're not going to send you anything around conditions to closing, your liability package or your indemnity package.

Chris: You get exclusivity on that.

Eric: But there'll be price, there'll be structure and exclusivity. And that's what a buyer will typically send over. From a seller standpoint, you want to try to get as much negotiated up-front because the more you can negotiate in the term sheet upfront, the better. Because what it does is smooth the process down the line. Because when you get a buyer agreement two or three weeks into diligence, it's going to have a lot of other things that weren't contained in the term sheet that are going to be very unhappy surprises. Primarily around your conditionality to deal, how certain you are that you're going to be able to get the deal done and what you're going to be required to do between signing and closing, and then also your liability package, which is the indemnification that the sellers will provide to the buyer with respect to losses that might arise because you had a representation that you breached or you had a covenant that you breached or a representation that was untrue.

And that's going to be really important because if you have a headline price of $100 million and you don't talk about what the indemnity package is, is there a 10% escrow, is there a 20% escrow, or is there a 5% escrow, or are you using rep and warranty insurance? All of that cuts into that $100 million at the end of the day and puts that money at risk. So understanding that there are other things in there outside of headline price is probably the most important thing.

Chris: That's absolutely right. Eric, the one thing that I would think about with respect to the term sheet is your leverage never gets higher than the day you get the term sheet. And that's true in both VC and an M&A. You really want to get things in there. In the VC world, the documents had become based on standard forms called the NVCA forms so much so that I don't know that the leverage point matters as much. If you get the right price, there are four or five things that are, in a VC term sheet that you really can negotiate that are important, but an M&A term sheet is super important because most of the time the buyer doesn't even send over the indemnity package.

And if you don't know how much of your money you get to keep after the closing, it's a really important thing. Because you may find that a lot of your selling proceeds are tied up and you may find under a lot of the terms of current VC deals that those at-risk proceeds go to the founders under at least the terms of the deal, whether or not the buyer will accept that ultimately is another issue, but your proceeds as founder could be more at risk than others on a deal that you've negotiated that you thought was pretty good at the beginning.

Eric: There's a question regarding no-shop best practices. No-shop is this concept of exclusivity and that occurs in two places, here at the term sheet and in the definitive agreement, which we'll talk about later. It's basically a promise that, while you're working towards a deal with the prospective buyer that's at the table, you're not going to talk to anyone else. And there are other bells and whistles that say “if somebody comes in you have to let the buyer know” and how much you have to let them know, such as who it is, price, and all that stuff in terms of the offer that get negotiated very heavily. But for the most part, the concept is you're not going to shop the deal while you're in exclusive negotiations.

And the question is, if a company is bound by a no-shop and another buyer comes in with a better offer and the target company would like to keep the new offer warm without running afoul of fiduciary duties, what do you do? I think, if you signed exclusivity you're exclusive, there's not really a whole lot you can do, unfortunately.

Chris: I guess the question asks, "What are the best practices?" So I interpret those words "best practices" to mean, "What do most people do?" And if I'm being honest, a lot of people breach it.

Eric: That's not the best practice.

Chris: That's not the best practice. Eric is absolutely right. There is no way legally or generally out of it to keep one warm without the other. What you would do really in the best practices scenario, I think, is

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you'd go to your buyer and you'd say, "Look, I got another offer, it's better than yours. We're going to negotiate this with you through the remaining 20 days that we have left, but what you should really do is let us out of this because we're going to have somebody else or you should up your offer to match to somebody else."

Eric: That's exactly right.

Chris: But is that what people really do? Unfortunately, I am realistic, no, they don't. People violate them. And having been on the buy side of violated exclusives a number of times, I can tell you it was very, very hard for me to do anything about it. When you talk to the court folks, what they say is, "Yeah, trying to run into court and get seen and do anything about it is going to be very hard because there's only 20 days left on this thing. It's probably not even going to get seen by that important time and it's going to be moved."

But there is a very, very powerful moral obligation of an exclusivity clause, and that moral piece of it is enforced by the fact that if you violate someone's exclusive on the other side, people know that, people find out about it around here because people talk, and your buyer will walk away, and then you're really in trouble. Because if your buyer walks away, the other deal was a long way from beginning, as you'll discover, to closing. There's a whole lot of risk in that interim phase. So, if you violate it you can lose the deal in hand and you can lose any future deals. And you can lose a lot of faith and a lot of respect within the Valley. So, the best practice is not to do it. But do people violate them? Yes, they do. And are there a lot of remedies? No, there are not, but that's not the right answer in the repeat-player world.

Eric: I think to add to what Chris was saying, is the other thing you have to keep in mind when you're neck deep in this sale process, is that management is distracted. It's a lot of distraction to the business and oftentimes businesses will not perform as well as they typically perform during this couple month period. And the idea of starting a process over, right, and saying, "Thank you, buyer, we'll run out our exclusivity, we'll terminate, and we'll go start this process with someone else," does entail itself its own risk.

You should comply with your exclusivity obligation, you have an obligation. You probably have an obligation to tell them that another offer came in. You don't talk to the other party. And if you can get a better price out of it, great. But I think you have to continue through to the end. And you can at that point I think use the upcoming termination as a leverage point.

Eric: Things that you can do now to be ready: we sort of covered the first one, which is, make sure you understand, what goes into a term sheet because, again, this is one of those places where I think what Chris said before, your leverage is never going to be higher. Once you've signed the term sheet and entered into exclusivity, the buyer starts to really take control of the process and you're going to find yourself without a lot of ammunition. Understanding that and making sure you have the right folks in the room when this process begins and knowing who those folks are in advance is important, because the last thing you want to do is run off and start doing things without the right constituents that you need at the table. So, whether it's folks on the board, your key VCs and your lawyer, having those people, on your Rolodex and ready to go is an important thing.

Chris: Identifying them to yourself and to your founder and CEO is important because you're probably in the business, you're neck deep with your team all the time out there in the trenches and you're excited when you get this. And if you haven't thought about it in advance it's not always the best idea to talk to your CTO about it five minutes later because that person may not get any work done from there and it's decided. And you may not actually be interested in the deal. Until you've really decided you're interested in the deal and you have to get your team on board to help get it closed and help present it, it's probably better if you're not talking to your internal team about this and you're talking to an external group of advisors. One of your board members is probably the person you most often have the relationship with and call. It's either your lawyer or your board member or both, and you're talking to someone with them and you don't get your team distracted with it until later if you can avoid it.

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Eric: The next phase, once you've got the term sheet signed up, is due diligence begins. This is when you get that 20-page long due diligence request book that we think is always good to just at least put eyes on in the beginning so you know what to expect. It's going to ask for everything under the sun, and you're going to be inundated with document production requests. We have on this slide two buckets of information, high-priority, and other areas. And the way that I like to think about this is the high priority review means the type of diligence that a buyer really just needs to do in order to actually know how to get a deal done.

It’s understanding your cap table, it's understanding that the IP that you say you have, you own. Figuring out where the key dependencies are from a third-party standpoint, key in-licensed products, whether or not there are change of control provisions that might need to be looked at and third-party consents are important. What the material contracts are and whether or not there are disputes, litigation, and things like that. A lot of buyers are becoming increasingly sophisticated and increasingly earlier on in the process focusing on things that will help them integrate the company more quickly and more efficiently.

And so you'll have a bunch of folks from a buyer, especially a sophisticated buyer coming in and saying, "Okay, I need to figure out really detailed level information about employees so that they can do mapping." Figuring out where the synergies and the cost savings might be, understanding compensation benefit plan level so that they know what obligations they're stepping into and how to keep people happy post-closing is important. And then doing other types of financial statement diligence. Looking at AR/AP and understanding whether or not the financials they have are accurate. Understanding for example on software deals, whether or not your rev reg policies, are the right ones and that you're recognizing revenue correctly so that your financials actually say that, yeah, you did have that revenue.

Chris: This is a part of the deal that you're going to hate the most if you're the founder. And the problem is you've now gone from having built a business to having had someone come in, make you an offer for it and sign a term sheet. And in your mind you now just want to get to closing as fast as you can. And you have to embrace this process in the middle. You have to understand most of the time what the founder is doing and saying, "Are we done? Are we done? Are we done? Are we done? Are we done?" That's not helpful, and it's not going to get you to the end. You have to embrace it and keep going back to your team saying, "What is it they're looking for before diligence is done?" And trying to get from the other side definitive lists of what is it they really need.

And they'll just keep pointing to the 20-page due diligence checklist. Try to get past that and try to get them answers. Try to dive into that at this point in time and embrace it in the same way you have building the business. Because if you don't and you just try to smash this down because all the people doing this stuff are the outside lawyers or they're junior executives on the other side or they're in HR on the other side or somewhere else and you try to just drive over the top of them, it's not going to get done faster. I promise you. It's not going to get done more cheaply. And it may not get done. And it may turn out that you've irritated the person on the other side who seemed like they didn't have any swing but actually was connected to someone who did.

The founders that I've found that have been really successful in this process are the ones who, and I know they don't believe it because it sucks, smile and embrace it and they get in the middle of trying to help everyone in this process. Sending flowery emails back when they get that terrible list from the person in HR on the other side looking for things that the founder knows aren't important and they say, "We're on that. We'll get that back to you quickly," and they ride hard on folks to get that stuff, that's the thing you've really have to get ready for in this unpleasant four to six weeks of your life. And I know everybody told you it's two, it's not. It's four to six. And you have to get in there and get it done because that would get you to closing and the money in your bank account faster.

Eric: When considering doing tech deals, what are the two most important things? It's IP and people, right? The two key areas of real diligence that the buyer is going todo is IP chain of title diligence and open source review for software companies, for example, and HR diligence. When you’re thinking about how to keep your paperwork, another thing that's important is making sure you get invention assignments. If someone had exclusion damage, make a note of that. Make sure you remember that.

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And figure out whether or not there are things that are being done that are based on things that you don't own.

Make sure that your developers understand open source licenses and have a strong and robust policy and make sure people really understand that not all open source is okay. That if you have a dependency on certain third-party licenses that you understand that you have the right to use that technology and the deployments that you're considering or that you have. So making sure that this is really buttoned down from the get-go is important because if things get forgotten and lost, that can cause real problems. You had somebody come in who was a key developer, they worked on and early piece of critical code, things didn't work out, they left, didn't sign invention assignment. That's not a good thing. Make sure that you have these processes locked down.

Chris: It happens a lot, and it's definitely not a good thing.

Eric: That's right.

Chris: We had a question on price. When the price gets defined at the term sheet, it's difficult to renegotiate. What do you suggest in order to renegotiate the price when you have other offers during the exclusivity period? Through hundreds of deals, I can count on one hand again when the price has ever gone up. It gets renegotiated a lot.

Eric: Usually down.

Chris: Usually down in the vast majority of things. And that comes out of the due diligence process for the most part. That's why we say your leverage is at the highest when you're a seller.

Eric: And when you're negotiating the term sheet.

Chris: Exactly. The only thing going to probably push it up is if there are other offers during that time period. Eric was talking earlier about things going bad during the interim period in the business because everyone's distracted. I've only seen two deals where things have gone better than expected, and it generally has nothing to do with what's happening at the company. The two that come to my mind had to do with businesses where part of the reason they were selling was they knew there was about to be a regulatory change that was going to affect their business adversely, and it didn't happen. And then, all of a sudden, they had trouble with the investment banker giving the fairness opinion because the business had gone better. But again, nothing to do with operations, it was external forces. I don't think you're likely to get your price negotiated up. You better get the best you can at the term sheet stage.

Eric: We have another question about indemnification escrow, hold back period, and what the reasonable time period is for those. It’s something that varies but it's usually between 12 and 24 months. Typically, it falls between 12 and 18 months. Very rarely do you see it less than a year.

Chris: Almost never.

Eric: Most buyers will say that they need essentially a full audit cycle in order to uncover where the skeletons are buried.

Chris: The only time I've seen it less than a year is where it was a very big seller with audited financial statements, and it turned out that the audit cycle was in a cool spot for the seller, where it was within four months of closing. They knew that they could get through an audit and then they tied it to the completion of the audit, but not anything else. Generally, one to two years is what you're looking at. Over two years and you're outside the zone.

Eric: We talked about IP issues, so we will quickly discuss HR issues. HR is critical to any tech company, so making sure you understand who has special arrangements and key employees is important for transition. Of course, people will not be around long-term but have knowledge that needs to be

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transferred. When you're thinking about hiring executives, make sure you understand deals you've cut where a change of control may be implicated.

Those are the two main areas of diligence, but there are a lot of other areas that buyers will be focused on. This will probably be one of the most unpleasant four to six weeks of your professional lives. Just be ready for it. There is a lot you can do in advance to plan for it to make it go more smoothly. No matter what, it's not going to go smoothly, and it's going to be painful, but the amount of pain can be influenced by how much you prepare in advance and how good your records are.

Chris: Embrace the process as you go through it. There will be twists and turns, but you will be prepared for that just by having worked in the startup for a period of time. It's unlike life in general in my experience in the startup. There's always an intergalactic comet coming to end you.

That concludes our presentation today. Thank you all very much for joining us. As we mentioned, you'll receive a copy of today's webinar materials by early next week. We'll continue this webinar series in 2018, and you'll also receive information about upcoming topics soon. If you have any additional questions about any topics discussed today, please feel free to reach out to either of us. Our contact information is on the last slide of the deck. Thank you again for your attendance and participation, and happy holidays.

Eric: Thanks very much.

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