

# Hutchison + Mason PLLC

April 15, 2005

## **If you build it (correctly), they will come.**

So, you have defied the odds and turned the idea that you dreamed up in your garage into a high-flying start-up with customers, revenues and, yes, even profits. Your company is the darling of the venture capitalist set and the other companies in your space are starting to take notice. In fact, several of the bigger kids on the block have come calling to see if you might be interested in handing your company over to them for a sizeable chunk of change. So, you've made it. You have finally arrived. After all the blood, sweat and tears, you are now moving to easy street, right? Wrong. Think again. The fun is just beginning.

The bigger kids are not just big, they are bullies and they come fully-equipped with an army of trained professionals who beat down start-ups for a living. But, take heart, all is not lost – there are several steps that a company can take to level the playing field long before they ever go to battle in the M&A arena. This article will discuss what every company should know prior to talking to a potential acquirer.

First some welcome good news – like many of the other leading indicators in the start-up world, recent M&A statistics show strong signs of encouragement. VentureOne reports that while the number of mergers and acquisitions over the last three years has remained relatively flat, the aggregate amount paid has more than doubled from 2002 to 2004. These statistics seem to indicate that the days of the fire sale of the cash-strapped companies are receding, and back are the days when acquirers are willing to pay some premium for a target with potential. While the IPO market has recently gained momentum, a company is still more than five times more likely to be acquired than it is to go public. Given the favorable market conditions and greater likelihood of an M&A exit, it is never too early to start planning for an acquisition. Here are some things to keep in mind as you grow your company:

### **What's your Preference?**

It is a common misperception that all stockholders are created equal when it comes to dividing merger proceeds. Nothing could be further from the truth. If half the outstanding shares are common stock and half the outstanding shares are preferred stock, most likely the proceeds will not be split fifty-fifty between the common and preferred. Why not? Because of a concept known as “liquidation preference.” Simply put, liquidation preference is a right attached to preferred stock which entitles those shares to

receive a preferential payment before any amount is paid to the common stock when distributing the proceeds received in an acquisition or merger.

There are many variations of liquidation preference – sometimes the holders of preferred stock will receive several times their initial investment back before the common stock is entitled to receive any of the merger proceeds, other times the holders of preferred stock receive a payment off the top and the remaining proceeds are divided between the common stockholders and preferred stockholders based on their shareholdings. In all cases, the preferred stock has some advantage. Often times this advantage may be further compounded through anti-dilution adjustments or cumulative dividends that accrue during a company's lifetime. All of these terms are negotiated by the investors (the preferred stockholders) at the time of their equity financing. As a result of these terms, it is not at all rare to see preferred investors walking away from an acquisition with a decent return while the founders (common holders) are left with little or no return on a company that they brought to life.

The time to understand how these terms work and how they will affect the payouts to the founders and other common holders is not on the eve of the closing of the merger, but long before that time. The time to understand these terms is at the time of the financing when the company is negotiating them with the preferred holders. All founders owe it to themselves to understand how these terms will affect future payouts, and if they do not understand how these terms work, they should turn to their lawyers, accountants, bankers or friends to help them get a better understanding of how the money will be divided.

### **Neatness Counts**

The old adage that you never get a second chance to make a first impression is certainly true in M&A arena. Negotiations with a potential acquirer do not start in earnest until they have taken a chance to look under the hood of the target company. This is the point when a company must put its best foot forward, but often the potential target is not ready for prime time. It is during these critical stages of the courtship that the acquirer is making important decisions about what the company is worth and whether or not to make an offer. An organized company will have placed its important corporate documents and agreements into binders from the day of its incorporation. Or, better yet, it will have placed its important documents in a web room that is easily accessible to investors or potential acquirers who are interested in doing some further diligence on the company. More and more sophisticated acquirers are running their due diligence efforts through web rooms these days. If a Company already has a web room prepared, it will save valuable time and it will score bonus points for appearing organized and ahead of the curve.

Besides organizing its corporate documents in readily-marked and easily-accessible files, a company must also make sure that it has taken care of the necessary corporate clean-up before it gets in front of a potential acquirer. It won't be a comfortable moment when the acquirer asks about the intellectual property assignment that should have been signed by one of the company's founders who left the company five years ago or why the company

failed to repurchase the unvested stock of a key employee who was terminated last year. It will be an even more uncomfortable moment, when you have to approach the ex-founder and the ex-employee on the eve of the closing to tell them that the acquirer is insisting that they sign paperwork giving up some of their rights in order for the transaction to close. Odds are you will not escape these situations without giving up a pound of flesh, but they are all easily avoidable. Pay attention to the details as your company grows. Make sure to dot your i's and cross your t's and you will never find yourself in these situations.

### **Avoid the Pepto-Bismol Moment**

Often times when acquirers and their attorneys and accountants are sifting through a potential target's records, they say they are looking for issues that might give the acquirer "indigestion" following the closing. This indigestion can come about in many ways. Many companies' stock purchase agreements and stock option plans provided for "full acceleration upon a change of control," meaning that the employee takes full ownership of the shares and options that he or she would have otherwise needed to work for an extended period of time to earn. An acquirer acquires a technology company in part for the technology, customers and revenues, but in large part it is for the people – the driving force behind the creation of the technology. As a result, you can imagine that an acquirer would not be too pleased to find out that all of the key employees they had hoped to hire in connection with an acquisition had become wealthy beyond their wildest dreams as a result of the acceleration of their vesting of stock or options and had decided to retire to their own private islands without giving any thought to putting in another day of work with the acquirer. In fact, this is often a hot topic for discussion and has been known to kill deals that would otherwise have gone through without a hitch.

A few other issues that could cause acquirers some heartburn – the company's key intellectual property license cannot be transferred with the licensor's consent, and because the licensor is a competitor of the acquirer, the licensor is not willing to consent to the assignment. If the license is a core piece of the company's intellectual property, the inability to assign could prevent an acquisition from getting done. Perhaps, the company has entered into an exclusive sales agreement with a third-party. If an acquirer was looking to promote the company's products with its own skilled sales force, this exclusive arrangement could crater an acquisition. Maybe a company has entered into an expensive lease with a ten year term. If an acquirer is looking to save some money by moving all the employees of the acquired company to its own facilities, it might think about adjusting the purchase price to compensate for the money it will be losing to the target's landlord for a building it doesn't intend to use.

All of these issues can be resolved with some forethought. It may seem like a great idea to accelerate the vesting of all stock and options held by employees in connection with an acquisition when your company adopts a stock option plan, but you may think twice about this provision if you know that it could prevent you from completing an acquisition down the road. Signing a long term lease after your first round of funding may seem like a sign of accomplishment, but if it means that you won't receive full value for your

company in an acquisition, you may want to re-think that decision. It may seem like a hassle to keep tidy corporate records, but if the alternative is life without any prospect of an acquisition, you may start focusing on the details. You may not feel like you need to negotiate the terms of your venture financing once you have agreed on the valuation, but if as a result of the liquidation preference the holders of common stock will not receive any proceeds from a \$50 million acquisition, you may want to roll up your sleeves and sit down at the bargaining table.

Let's face it, the most difficult aspect of getting a company ready for an acquisition is the process of conceiving, nurturing and growing a successful company – the rest is just details. However, the devil is in the details. The little things that you can or should do as your company is growing can make a big impact when it comes time to make a splash with an acquisition. When making important decisions, think about how they might be viewed under the acquisition microscope down the road. Do sweat the small stuff. Remember, you only get one chance to make a first impression, and when the big kids come knocking at your door, you want to be ready to play.