

Mergers & Acquisitions: What VC Investors Should Know



Laurie A. Allen
Royse Law Firm, PC
10900 Wilshire Blvd., Suite 300
Los Angeles, CA 90024
(310) 481-0125/(310) 770-2696
lallen@rroyselaw.com

OVERVIEW

- Board Consideration of Acquisition Proposal
- Director Indemnification
- M&A Planning
- M&A Transaction Process & Structures
- M&A Issues with Selling Shareholder Implications
- Litigation Expense Funds
- Holdback Escrow and Escrow Agreements
- Earn-Outs
- Shareholder Representative

BOARD CONSIDERATION OF ACQUISITION PROPOSAL

- Fiduciary Duties:
 - To Shareholders
 - To Creditors for Troubled Companies
- Best Practices Approach:
 - Be Informed About the Company's Value
 - Be Actively Engaged in the Process
 - Consider All Available Alternatives
 - Use a Reasonable Process to Gather Information
 - Appoint Special Committee

DIRECTOR INDEMNIFICATION

- Director Indemnification – Before Assuming Board Seat
 - Update Charter and Bylaws
 - Indemnification Agreement – Include *Levy* language
 - D&O Insurance
- Merger Agreement - D&O Post-Closing Indemnity
 - Buyer's Covenant to Continue Director Indemnity for Specified Time
 - Company Assumes Director Indemnification Agreement or Buyer Directly Indemnifies Former Directors
 - Covenant to Continue or Obtain New D&O Policy (usually for six years and premium cap)

VENTURE M&A PLANNING

- Strategic Investors
 - Do Not Grant Rights to Block Sale
 - No ROFR or Similar Protective Provision
 - Notification Rights OK
- Drag-Along Rights – From Everybody, Especially Founders
- Limit Outstanding Series of Preferred – Think Recapitalize
- Late Stage Investors – Preference not Blocking Right

VENTURE M&A PLANNING

- Long Term Liabilities – Keep Them to A Minimum
- LOIs and No-Shop Clauses
 - Buyer Will Insist
 - Hammer Out All “Big Ticket” Issues as *quid pro quo*
 - Management Roles/Compensation are VC’s Business, Especially if Earn-Out Proceeds Payable to VC Investor
- Company Charter - Ensure Charter Anticipates Exit
- Discuss Exit Expectations at Investment Stage
 - Obtain Buy-In from Management and Board on Timing and Expected Returns

MANAGEMENT M&A PLANNING

- Organize Company Books and Records
 - Corporate Minutes/Board Approvals
 - Cap Table/Shareholder Records/Share Certificates
 - Tax Returns/Governmental Filings
 - Financials/Balance Sheet & Earnings Statement
 - Third Party Consents
- Establish Ownership of IP and Clean-up IP Documents
 - Patent Filings, Discuss Possible Infringement
 - Properly document and record transfers of IP to the Company
 - Review Licenses/Third Party Consents
- Resolve or quantify outstanding lawsuits and claims

MANAGEMENT M&A PLANNING

- Tax and ERISA Issues
 - 409A Issues – Option Valuation, Severance Agreements, Deferred Compensation
 - 280G Golden Parachute Payments
 - ERISA Plan Compliance
- Employment Issues
 - Executive Employment Agreements; Offer Letters
 - Payments Triggered by Change-in-Control
 - Stock Options, Bonus Plans Or Other Equity Awards
 - Comply w/ Employee Classification/Wage and Hour Laws
- Triage Potential Problems with “Consenting” Shareholders

M&A TRANSACTION PROCESS

- Preliminary Due Diligence
- Negotiate and Sign Letter of Intent
 - *Good Time to Involve CFO/GC or Legal Counsel re Deal Structure, Accounting and Legal issues*
- In-depth Business and Legal Due Diligence
- Purchase Agreement
- Ancillary Documents
- Closing

BASIC M&A TRANSACTION STRUCTURES

- Tax Free Reorganizations
 - Type A – Merger
 - Type B – Stock for Stock
 - Type C – Stock for Assets
 - *Type D – Spin Off, Split Off, Split Up, and Type D Acquisitive Reorganizations*
- Taxable Transactions
 - Stock Sale
 - Asset Sale
- Partnership Techniques

M&A ISSUES /SELLING SHAREHOLDER IMPLICATIONS

- Conflict of Interest: Seller's Counsel
 - Seller's Counsel represents Company
 - Attorney-Client Privilege Stays with Company
 - Post Closing Dispute:
 - Pre-closing VC investor disclosures compromised
 - Seller's counsel cannot represent VC investors
 - Either Waive Conflict of Interest or Retain Separate Investor Counsel

M&A ISSUES/SELLING SHAREHOLDER IMPLICATIONS

- Working Capital Issues
 - Definition of “working capital”
 - Consequences of Late Delivery of Buyer’s Working Capital Statement & Additional Response Time
 - Indemnification Claim and/or Working Capital Adjustment
- Tax Issues
 - Shareholder Representative to Review and Approve Tax Returns covering Pre-Closing Activity
 - Tax Liabilities Subject to Dispute Resolution Mechanism in Merger Agreement

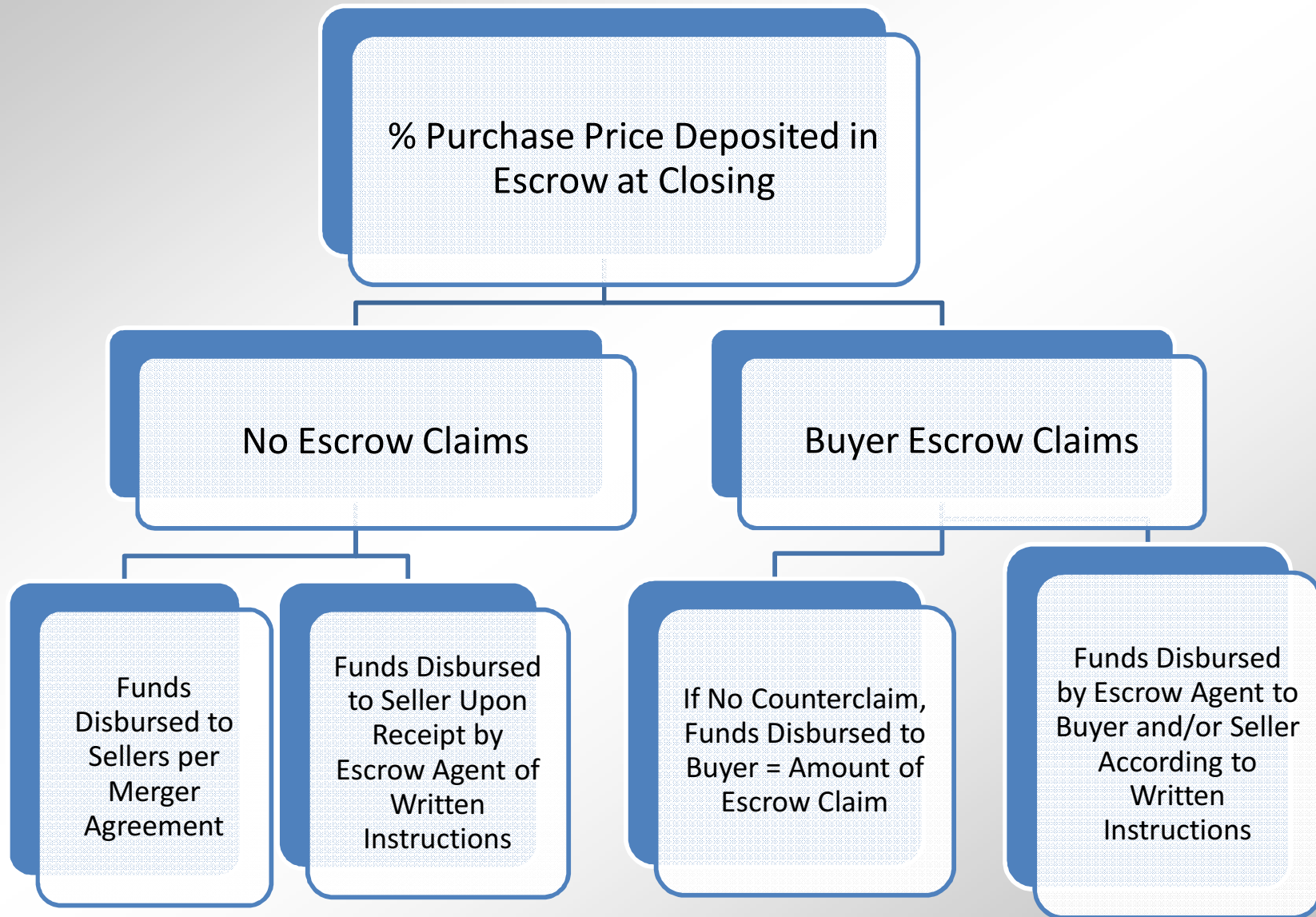
M&A ISSUES/SELLING SHAREHOLDER IMPLICATIONS

- Joint & Several Liability
 - Joint Obligors – Do not rely on common law contribution rights
 - Contribution Provision & Letter of Transmittal
 - Joinder and Contribution Agreements
- Indemnification
 - “Damages” – Always Define to avoid claims for special, incidental, consequential or punitive damages
 - Survival of Shareholder Representations and Warranties
 - Carve Outs – Time limitations, Caps and Baskets

LITIGATION EXPENSE FUNDS

- According to SRS:
 - 2 Out of 3 Deals have Expense Funds
 - The Average Expense Fund is over \$268,000
 - Expense Funds Range between \$25,000 and \$1M
 - The Average Expense Fund is <1% of the Sale Price
- Why set up an Expense Fund?
 - Deters Buyer Claims
 - Provides Options for Selling Shareholders
 - Fair and Equitable Allocation of Expenses

ESCROW ACCOUNT PROCESS



ESCROW AGREEMENT ISSUES

- Avoiding “Lock Up” of Escrowed Funds
 - Avoid Indemnity Claims For “Reasonably Anticipated” Damages
 - Escrow Agent will not Mediate Disputes
 - Forced to Either Sue Buyer or Wait for Expiration of S/L
 - Instead . . .
- Perfected Security Interests in Escrow Funds
 - Escrow is a Neutral Fund
 - Properly Define “Merger Consideration”
 - If Buyer won’t Concede, consider a Holdback instead of Escrow
- Tax Treatment of Payments from Escrow
 - Payments from Escrow
 - Imputed Interest

EARN-OUTS

- Structure and Terms
 - Different Triggers
 - Forms of Payment
 - Adjustments for Performance
 - Operational Covenants
- Milestones
 - Should be Based on Clearly Defined Events/Results
 - Financial Milestones should consider Accounting Method
 - Length of Earn-Out Period is Key
- Post-Closing Control of Business
 - Highly negotiated
 - Often Tension between Seller and Buyer's interests

EARN-OUTS

- Regulatory Implications

- Tax - Revenue Recognition, Timing and Income Characterization
- Accounting - FAS 141(R) Requires Buyer to Record Fair Value of Expected Earn-out at Closing
- Securities - Is Right to Receive Earn-out Payment a “Security”?

- Predictability of Purchase Price

- complicates determinations of various payments
 - financial advisory fees
 - preferences due to preferred stockholders
 - calculation of “fair value” for dissenters rights, etc.

EARN-OUTS

- Disputes

- Post-closing Disagreements Over
 - Interpretation of a Defined Milestone
 - Confirming Financial/Business Performance
 - Support to be Provided by Buyer
 - Whose Fault When Milestone Not Met on Time or at All?
- Litigation – How Coordinated and Who Pays?

- Earn-outs for Public Company Targets

- Rare, but Doable
- “Contingent Value Rights”
- Third Party Rights Agents for Public Company Shareholders

SELLER FINANCING AS AN ALTERNATIVE TO EARN-OUTS

- Notes at Pre-Negotiated Interest Rates
 - Typically 3-5 yr term with monthly, quarterly or semi-annually
 - Typically subordinate to Senior Lenders
 - Unsecured
 - May be Inadequate Cash for Payments if Material Decrease in Business Cash-Flow
- Less Risky Than Earn-Outs if:
 - Confidence in the Business
 - Trust and Confidence in the Buyer

SHOULD THERE BE A SHAREHOLDER REPRESENTATIVE?

- Public Company M&A
 - Few, if any, post-closing shareholder obligations
 - Target is subject to SEC reporting requirements
 - Seller will pursue litigation against BOD and management, not public shareholders
- Private Company M&A
 - Heavily negotiated shareholder representations/indemnity
 - Escrows and Holdbacks are usually required to protect Buyer from breaches/working capital differentials

SHAREHOLDER REPRESENTATIVE

- Shareholder Representative
 - Speaks and Acts on Behalf of Selling Shareholders if post-closing claim for Indemnification or post-closing purchase price adjustments are made
 - Role assumed by one of Selling Shareholders or Third Party Agent
- Engagement Letter
 - Scope of Authority
 - Expense Fund Parameters
 - Can Appoint Selling Shareholder “Advisor”
 - Indemnity: Who’s on the Hook?

APPENDICES

PORTFOLIO COMPANY CHARTER

- Company Charter May Not Properly Anticipate Exit
 - Merger May Include Escrow, Holdback and Earn-Outs, but Liquidation Preferences not Fully Covered by Closing Proceeds
 - Non-Participating Preferred or Participating Preferred w/ Cap
 - Either take liquidation preference or portion of the proceeds as if converted, but not both
 - Forces choice between payment at closing/forfeit future upside or converting to common/hope for future upside
 - Uncertainty Whether VC Investor Proceeds Subject to Escrow
- Have Discussion at the Investment Stage to Avoid Shareholder Controversies Upon Sale

Fiduciary Duties for VC Board Members

- Fiduciary Duties in Considering Acquisition Proposal
 - Duty to Shareholders, not VC Funds
 - Duty is same whether Target is Public or Private
 - Minority Shareholder Claim Risk in Certain Situations
 - Down Round or Cram Down Financings
 - Former Laid-Off Employee Shareholders
 - Hostile Significant Shareholder without Board Seat
- Fiduciary Duty Compliance and Recordkeeping are Key to Successfully Defend Against Minority Shareholder Lawsuits

Fiduciary Duties for VC Board Members

- Troubled Company Issues
 - If in “Zone of Insolvency,” Directors Duty is to Maximize Value for Whole Enterprise (including creditors)
 - Look for Warning Signs of Insolvency
 - Ensure Adequate Decision-making Processes
 - Document Good Faith Exercise of Business Judgment
 - Consult Counsel, Restructuring and Valuation Experts
 - Demand Management Accountability
 - Consult Creditors
 - Avoid Insider Transactions

Fiduciary Duties for VC Board Members

- Business Judgment Rule – Delaware and California
- Duty of Care
 - Avoid Haste
 - Carefully Review of All Relevant Material
 - Seek Out Relevant Information from Management
 - Ask Questions and Test Accuracy of Information
 - Rely on Expert Advice
 - Advisors Should be Unbiased and Competent
 - Observe Corporate Formalities and Document Deliberations

Fiduciary Duties for VC Board Members

- Duty of Loyalty
 - Duty Owed to Corporation and its Shareholders
 - Prohibits “Self-Dealing”
 - *In re Trados* (Del.Ch. 2009) – Director could breach fiduciary duty by improperly favoring interests of preferred over common shareholders who received no consideration
 - Implement Process to Represent Common Shareholder Interests
 - Drag Along Rights Alone May be Insufficient
- Good Faith - Duty to Act in a Reasonable and Deliberate Manner and in the Best Interests of the Corporation

TYPE A REORGANIZATIONS – SECTION 368(a)(1)(A) STATUTORY MERGER



- Statutory Merger – 2 or more corporations combined and only one survives (Rev. Rul. 2000-5)
- Requires strict compliance with statute
- Target can be foreign; Reg. 1.368-2(b)(1)(ii)
- No “substantially all” requirement
- No “solely for voting stock” requirement

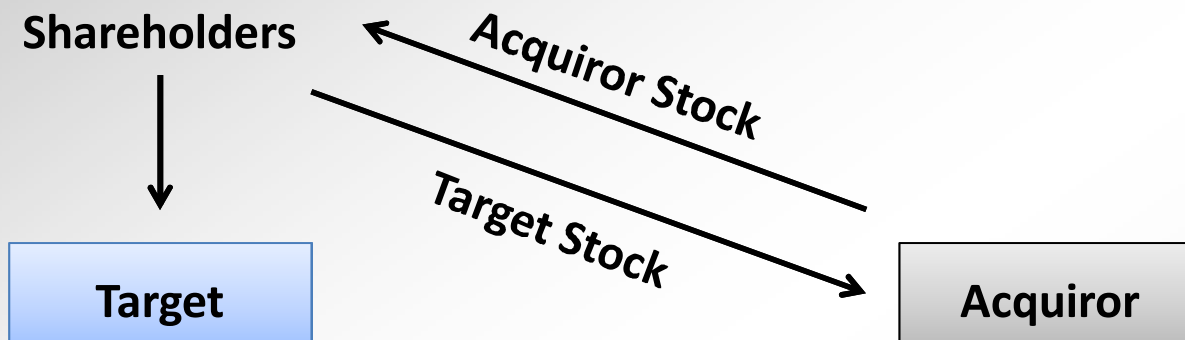
Requirements:

- Necessary Continuity of Interest
- Business Purpose
- Continuity of Business Enterprise
- Plan of Reorganization

Tax Effect:

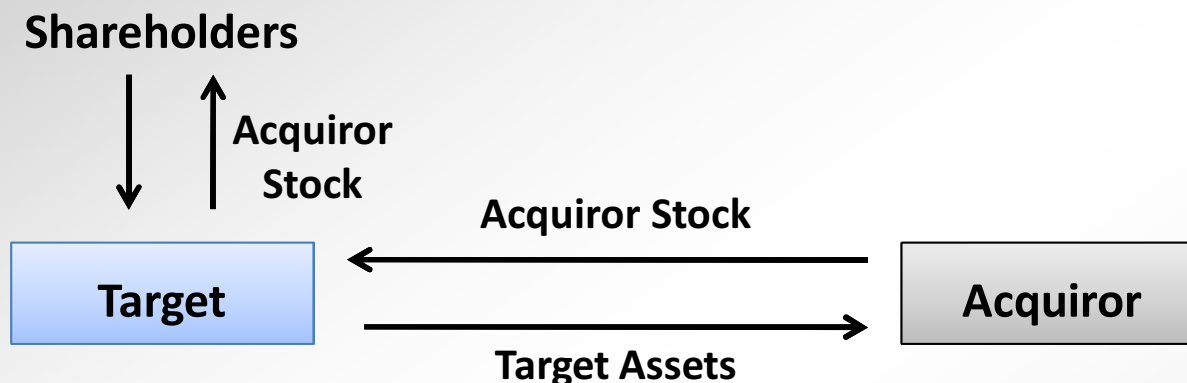
- Shareholders – Gain recognized to the extent of boot
- Target – No gain recognition
- Acquiror takes Target’s basis in assets plus gain recognized by Shareholders
- Busted Merger – taxable asset sale followed by liquidation

TYPE B REORGANIZATIONS – SECTION 368(a)(1)(B) STOCK FOR STOCK



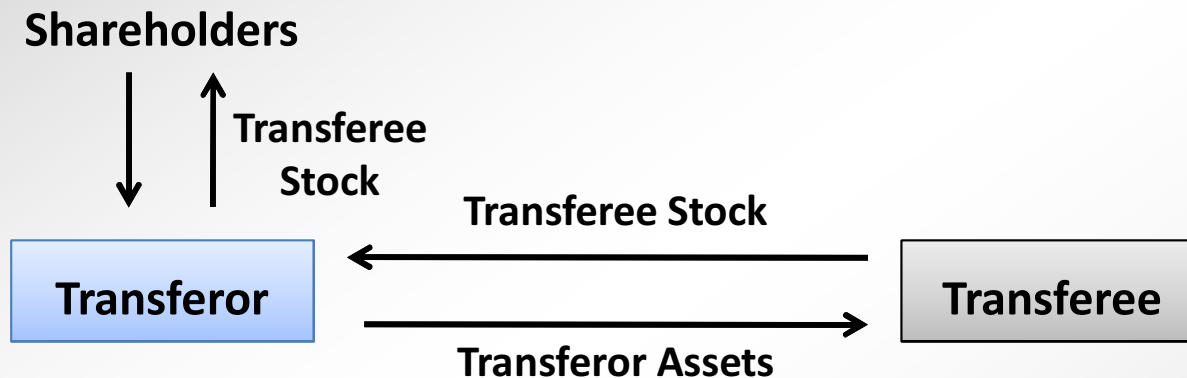
- Acquisition of stock of Target, by Acquiror in exchange for Acquiror voting stock
- Acquiror needs control of Target immediately after the acquisition
- Control = 80% by vote and 80% of each class
- Acquiror's basis in Target stock is the same as the Shareholder's basis prior to the acquisition
- Solely for voting stock
- No Boot in a B
- Reorganization Expenses – distinguish between Target expenses and Target Shareholder expenses (Rev. Rul. 73-54)
- Creeping B – old and cold stock purchased for cash should not be integrated with stock exchange

TYPE C REORGANIZATIONS – SECTION 368(a)(1)(C) STOCK FOR ASSETS



- Acquisition of substantially all of the assets of Target, by Acquiror in exchange for Acquiror voting stock
- “Substantially All” – at least 90% of FMV of Net Assets and at least 70% of FMV of Gross Assets
- Target must liquidate in the reorganization
- 20% Boot Exception – Acquiror can pay boot (non-stock) for Target assets, up to 20% of total consideration; liabilities assumed are not considered boot unless other boot exists
- Reorganization Expenses – Acquiror may assume expenses (Rev. Rul. 73-54)
- Assumption of stock options not boot
- Bridge loans by Acquiror are boot
- Redemptions and Dividends – who pays and source of funds

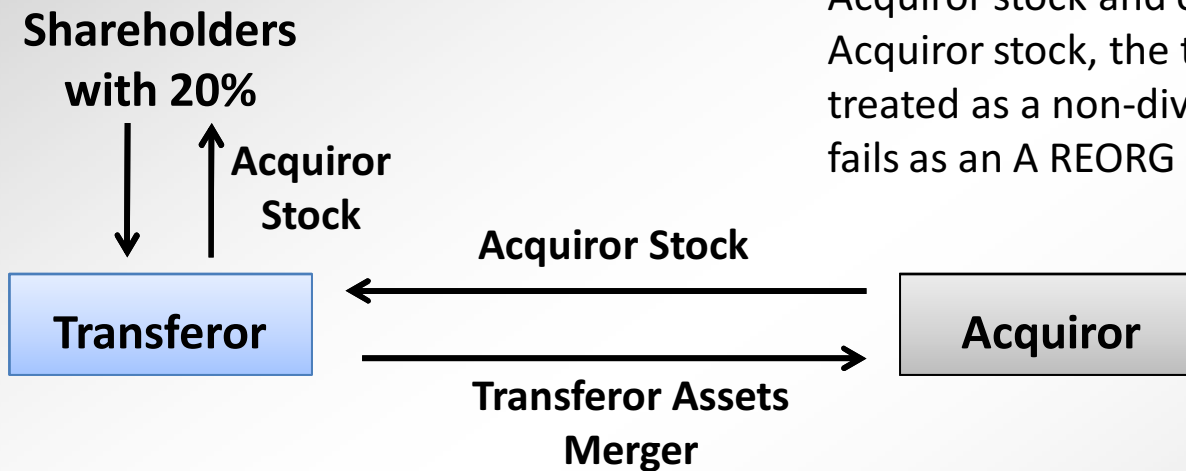
TYPE D REORGANIZATIONS – SECTION 368(a)(1)(D) DIVISIVE SPIN OFF, SPLIT OFF, SPLIT UP



- Divisive – transfer by a corporation of all or part of its assets to another corporation if, immediately after the transfer, the transferor or its shareholders are in control of the transferee corporation. Stock or securities of the transferee must be distributed under the plan in a transaction that qualifies under Section 354, 355, or 356.

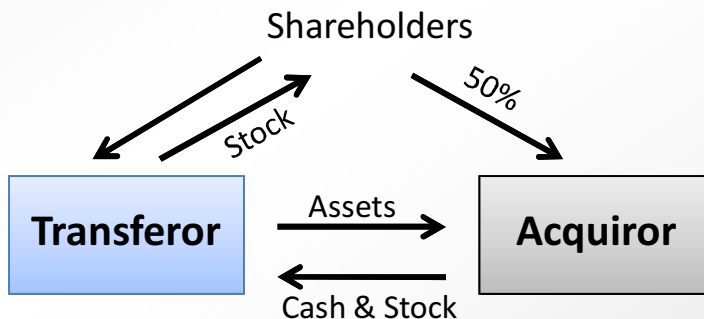
TYPE D REORGANIZATIONS – SECTION 368(a)(1)(D) NON-DIVISIVE

Merger Treated as Acquisitive D

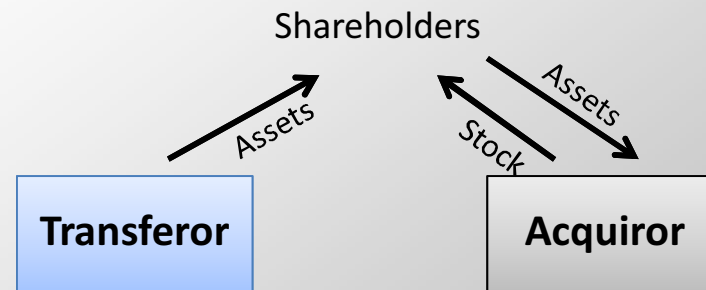


- If shareholders of Transferor stock receive Acquiror stock and own at least 50% of Acquiror stock, the transaction may be treated as a non-divisive D REORG even if it fails as an A REORG for lack of continuity

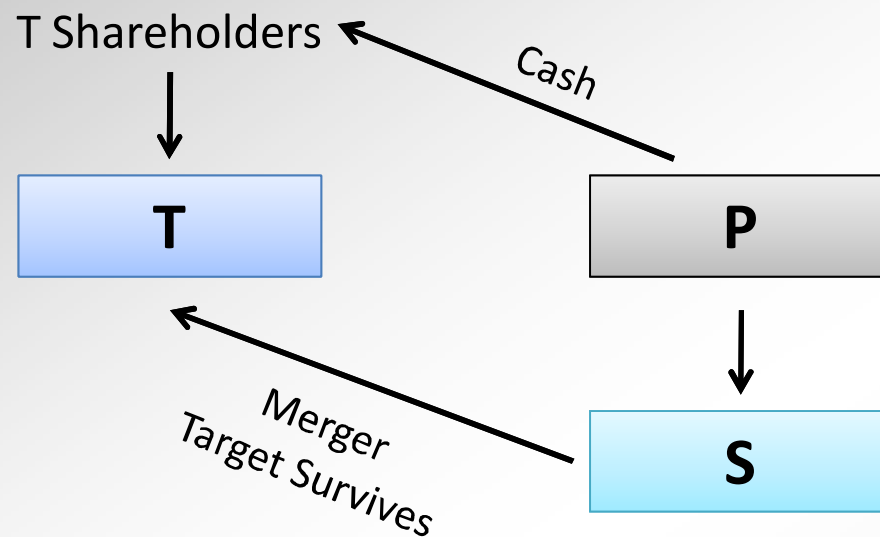
Failed Type C Treated as D



Liquidation / Reincorporation



TAXABLE STOCK PURCHASES



Cash Reverse
Triangular Merger

Treated as Stock Sale

- Shareholders have gain or loss
- P takes cost basis in Target shares

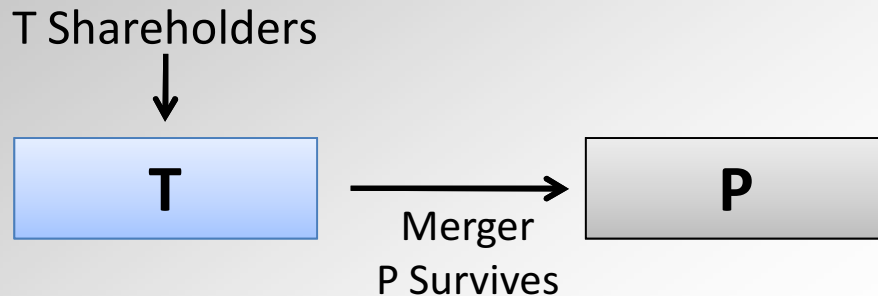
Key:

T = Target

P = Acquiror

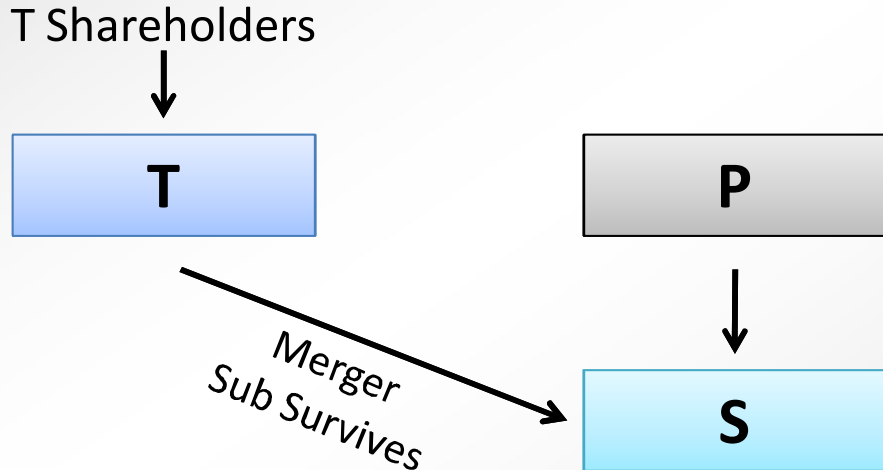
S = Merger Sub

CASH FORWARD MERGER



Asset sale followed by liquidation of Target

Variation with Merger Sub:



- Target has gain on sale
- Target shareholders have gain on liquidation (unless 332 applies)
- P takes cost basis in Target assets

Key:

T = Target

P = Acquiror

S = Merger Sub

