QuickLaunch University Webinar Series Transcript Considerations for Startups on a Path to Exit

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Presented by WilmerHale Partners Daniel Zimmermann and Joe Wyatt.

Joe: Hello, everyone. Welcome to today's QuickLaunch University Webinar on Considerations for Startups on a Path to Exit. My name is Joe Wyatt, and I'm a partner in WilmerHale's corporate practice group in Palo Alto. I'm joined by my colleague Daniel Zimmermann, who is also a corporate partner here in Palo Alto.

Throughout the last year, we've explored many different legal issues faced by entrepreneurs and early-stage companies as they begin to build their businesses. If you're interested in listening to our previous sessions, links to the on-demand recordings are posted to our website at wilmerhalelaunch.com.

Daniel: Good morning everyone. My name is Daniel Zimmermann. I'm, again, as Joe has mentioned, partner here in Palo Alto in WilmerHale's corporate practice. Just very quickly touching on the agenda, we'll be talking about exit scenarios that are available to startups and how we can prepare for them. We will then dive into preparation and timing and some of the considerations that investors, and, frankly speaking, management will have.

When we talk about exit scenarios, we really think about five different types of exit scenarios. We're going to start talking a little bit about acquisition of assets. It's a quite common acquisition structure. Then go a little bit deeper into acquisition of stock and then a merger transaction. These three types of transactions are definitely terms of art. And you will hear that from M&A professionals. They will understand immediately what you're talking about.

Then I'll also very briefly talk about acquihires that have been so prevalent here in the Silicon Valley for very, very early-stage companies, essentially prior to them really raising any significant amount of funding. And then we'll also talk about the king of all exits, if you will, which is the Initial Public Offering, or IPO.

We then, after that, will dive a little bit into a timeline of the deal. And when we talk about a timeline, we really think about it in the sense of what happens first. We'll first start talking a little bit and discussing confidentiality agreements and some of the nuances around that, term sheets, the terms that we would find in term sheets. And then I will also briefly touch upon due diligence in the M&A context.

We wouldn't be doing justice if we wouldn't mention that also that there is a component of definitive agreements ultimately, of course. And those definitive agreements are, of course, the agreements that will govern the relationship between the buyer and the seller. We don't have a whole lot of time today so we will really be talking more about the preparation.

Those different agreements will have representations and warranties, and those would be in the asset acquisition agreement or stock purchase agreement or merger agreement. And those representations and warranties will be of course very part and parcel, if you will, to what the buyer is negotiating as part of the transaction.

Another issue of definitive agreement is always the deal certainty. What we mean by that is really *how certain* is it that the transaction will happen when we sign a definitive agreement. And ultimately, a very big part of definitive agreement is of course, also part of the consideration discussion, is how there are protections built in for the buyer. And those typically include of course escrows and indemnities.

When we talk about exit scenarios, the five typical scenarios that we're talking about, again, are acquisition of assets, acquisition of stock directly from stockholders, merger, acquihire, and IPOs. So, Joe, I'm going to turn it over to you for the first exit scenario, which is the acquisition of assets.

Joe: Thanks, Daniel. As Daniel mentioned, this is one of the common ways to structure an acquisition, which is an acquisition of all of the assets of a company or specified assets of a company, and then whether or not the buyer will assume certain liabilities of the seller or leave all of the liabilities behind with the seller.

Typically, these transactions are done in order to limit the buyer's exposure as it relates to liabilities of the target company. If you look at this from the target's perspective, the disadvantages of this type of structure are that it is mechanically difficult to identify which assets are going to be purchased and which assets will stay with the seller.

Because this transaction is structured as basically an asset transfer, consent of third parties will be required to assign certain assets, and especially certain contracts. So that can often hold up a transaction to the extent that you need to get a consent from a counterparty to a contract, as an example, in order to assign that contract to the buyer.

You also have to manually transfer the employees, which means that the buyer must hire each employee that it wants to hire directly. So that requires the buyer to contact each employee, negotiate employment packages, so on and so forth.

In addition, because the buyer is not actually purchasing the target company, only specified assets, the target company may be required to provide some services post-closing to the buyer to facilitate the transfer of the assets from the seller to the buyer. And again, additional requirements may apply to the transfers of certain assets, most notably patents or real property or even leased property, to the extent that the buyer wants to assume any of those assets.

Operations of the seller will also continue pending satisfaction of the obligations under the definitive agreement. And usually, there'll be a winding down of the seller, meaning that the seller will dissolve, distribute the purchase price to its stockholders, and cease operations. That's not always the case. In the case where only something like a product line or certain assets are being purchased by the buyer, the seller may not wind down. But typically, in an acquisition of a whole company that's structured as an asset acquisition, you will wind down the seller.

The last point on here is the potential double taxation of the sale proceeds. This is a big issue or could be a big issue for the seller. And what this means is when the seller receives the purchase price, the sellers may have to pay tax on the receipt of that purchase price. And then when it distributes the proceeds from the asset acquisition to its stockholders, the stockholders will also have to pay tax on the receipt of that distribution. Depending on the level of net operating losses that the target company may have that will offset some of that tax at the target company level, it could be a pretty significant disadvantage from an economic perspective structuring the transaction as an asset purchase.

Thinking about the asset purchase, there are certain things that you can do to get ready for that type of transaction, or really any type of acquisition scenario. First, keep all of your corporate documents in one place, like PDFs on a computer. You want to be able to create a virtual data room very quickly and in an organized fashion and make sure that you have fully executed copies of all documents because the buyer will want a diligence of the assets and the business of the seller in preparation of doing the acquisition.

And I should also note, some of these concepts we're talking about today in the context of an acquisition also apply to companies that may not be looking to do an acquisition imminently, but you may be looking to do future rounds of financing. The due diligence points that we're going to cover in today's presentation also apply to those companies that may be out seeking financing. You want to have all of your documents in one place, easily accessible, organized so you can facilitate the diligence process with the buyer, or in the case of a financing, with the investor in their counsel.

You will often get a diligence request list from outside counsel, and you want to organize those documents in accordance with the diligence list. And again, if you have everything in one place, that's pretty easy to do within the structure of a virtual data room. Now I'll hand it over to Daniel to talk about stock acquisition.

Daniel: Joe, what you just mentioned is really critical with respect to keeping corporate documents properly. We're having them managed properly by one or two or a particular group of people. We just recently completed, or signed a transaction, I should say, where it took literally three months for the seller to properly give us access to documents because this was a legacy business for them.

The asset acquisition often involves legacy businesses that are no longer maybe core to a particular company's mission and vision, and therefore, have been maybe neglected. But that really was a big problem for us.

Let's move on to acquisition of stock. When we talk about acquisition of stock, again, in the context of M&A, it's a pretty clear term for M&A professionals. And really what it means is that, now, the buyer is essentially now buying the shares directly from the shareholders of the target company.

Joe, we'll jump into what a merger is, or what a merger typically involves. In this case, again, we really are going specific directly to the shareholders. And this is quite often a very good way to go about it, especially in those situations when you have a very small group of shareholders. And it really involves just a few people. And the merger is maybe a little bit of an overkill. And direct acquisition from the shareholders is potentially very beneficial to everyone.

In particular, again, the advantages here are that an acquisition of those shares really wouldn't affect the corporate existence of the target company, and you would ultimately just swap out the old shareholders and then ultimately hopefully own 100%; that's really the goal of course in all acquisitions, 100% of that target company's shares, thereby potentially owning it if it's a corporate buyer of course 100% wholly-owned subsidiary at that particular point in time.

That is great because, also, it wouldn't affect any kinds of assignment provisions and commercial agreements, and thereby, of course, really reduces the amount of effort that goes into soliciting those third-party consents. And third parties because those are customers who really don't have anything to do with that particular acquisition and are not really interested in what's going on, if you will, on the shareholder level of particular company that they're transacting with.

The disadvantages are of course that you really do need to go out and have the cooperation from every shareholder, which is often quite difficult. You have potentially also other stakeholders like option holders, warrant holders, etc., And depending on how you structure that transaction, if you don't cash folks out, especially if you don't cash option-only stake and warrant holders out, you would ultimately, for assumption purposes, have to get their consent as well. It is quite suitable for smaller companies.

I think the things that you can do to be ready are really, what Joe said earlier, is keep track of your documents. And make sure that if you have a whole host of commercial agreements that, especially for startups, are often not their own agreements but really agreements that some of the 800-pound gorillas serve up and you don't have very intricate provisions around change of control clauses. You really have to stay on top of that. And as part of VC financing and other things, it's good to have control over those agreements anyway.

But in particular, in this situation, if there is sophisticated change of control clause that could be triggered, you need to know that because that could actually ultimately also change the value for the buyer. If, for example, the change of ownership would trigger a potential termination right, or, right to consent.

Obviously, what that means is try not to sign the change of control clauses. Joe will talk a little bit later about drag-along provisions as well. But drag-along could also be helpful in this context if you get everyone signed up. Joe, I'm going to move it over to you to talk about merger transactions.

Joe: Thanks, Daniel. The most common way of purchasing or acquiring a company in my experience is through a merger, and that's for a number of reasons that we'll talk briefly about. But basically, it's an acquisition of a target company through a combination of entities pursuant to state law, usually Delaware law, because most companies are incorporated in Delaware.

What basically happens is, the buyer sets up a subsidiary, which is just a shell company, and that shell company merges with the target company. And the target company becomes a wholly-owned subsidiary by operation of law. And that target company continues its corporate existence just as it had prior to its acquisition. The only difference now is that it's a wholly-owned subsidiary of the buyer rather than being a company with multiple shareholders.

The advantages of this structure are that it can be accomplished by a vote of less than all the shareholders. Under Delaware law, it requires holders of a majority of the outstanding shares, so you don't need all shareholders to approve, just holders of a majority of the outstanding shares and then whatever additional votes are required pursuant to the company's certificate of incorporation.

As an example, if the company has done a preferred stock financing, the acquisition will usually also require the vote, in some certain percentage, of the holders of the preferred stock. This structure, because the target company continues its corporate existent, third-party consents are usually very few, and those thirty-party consents are only ones that are required in connection with the change of control of the target company. As compared to an asset acquisition, the number of third-party consents and other approvals that you'll need to get is usually much lower in a merger acquisition structure. And that's why it's attractive to both the buyer and the seller.

The disadvantage is that it's a creature of statute, so you need to follow the statutory requirements. But usually that's not very difficult, especially if your company is incorporated in Delaware. The statutes are very clear, easy to navigate, and it's usually not an issue at all. Both from a target perspective, meaning that, the whole company has acquired all of the shares held by target company shareholders are converted into either cash or stock of the buyer or some combination of that. You can do it with less than unanimous consent of the stockholders as compared to a stock purchase, a transaction structure. It's really advantageous to both the buyer and the seller to do a merger. And that's why, frankly, it's the most common transaction structure.

Again, things that you can do now to be ready. When you issue equity, make sure that you're getting people to sign up to drag-along provisions. And what that means is that when they sign the documents to when they are initially purchasing their stock, they agree, subject to certain exceptions, that if the board of directors and certain percentage of the holders of the outstanding stock agreed to have the company be purchased, then they have to agree to also approve the purchase of the transaction. It helps facilitate a smooth approval process for getting the merger acquisition completed.

Again, avoid operation of law language in your anti assignment clauses. What this means is when they talk about an assignment in this transaction structure, it's because the target company remains as a corporate entity. You're not assigning any of the assets or contracts or any, really, of the target company's assets to a buyer because the target company remains as a corporate entity. However, if the assignment clauses say you can't do an assignment including an assignment by operation of law, that assignment would be triggered in many instances by a merger transaction.

So, when you're structuring your agreements now early, think about those things that wouldn't normally be an issue, but think ahead and think about how you can structure your contracts in a way as to minimize the potential roadblocks and the potential consent that you need to obtain in order to consummate your transaction.

Daniel: Joe, we have a first question here, "What are drag-along agreements?" Could you maybe elaborate on that a little bit?

Joe: Sure. Drag-along agreements basically say, in a nutshell, that if the board of directors of the target company and a certain percentage of the holders of the capital stock of the target company approve a deal, then Joe Wyatt, as a stockholder of that company, also has to approve the deal. Meaning, if I don't like the deal and I wouldn't vote for it, but other stockholders who make up the requisite percentage of the holders of stock that are required to approve the deal pursuant to the drag-along provision

And this is the contractual provision. This is not a statutory provision. These are contractual provisions usually in a voting agreement that's entered into in connection with the company's first preferred stock financing. But it basically requires me to vote in favor to the deal, which helps facilitate the approval of the deal.

Daniel: Let’s move on to acquihire. AcquiHire has become sort of a term of art as well even though it is certainly not in any dictionary. But you will find it, especially here in Silicon Valley and other tech centers around the country; you'll hear that word a lot. And what it really means is the acquisition of talent. And talent is another word as well. It means people, right? And a buyer is essentially often looking around for interesting technology, interesting people, who are running technology companies but is maybe not completely convinced about buying a company.

What you will find very quickly often in those discussions is that the M&A team has swapped out by the talent team or the HR folks. And that is a sort of a sign for you to watch out certainly as potential stock seller that they're really only interested in acquiring your talent. That in and of itself of course has a lot of challenges, because if you're looking to really have an exit and sell the company, you need to be careful of how you deal with that type of situation.

But essentially, an acquihire is exactly that situation where the buyer is looking to hire the folks that are either in an enterprise or the founders of a company, and maybe more important technical challenge in that company. And usually what that also means is there is maybe, at the same time, also a license of all the valuable IP and then potentially winding down of that particular company.

This has happened in Silicon Valley I think, in a particular year, what Joe and I have dealt with quite a few of situations hundreds of times. Clearly, why would anyone get engaged or do that? Because it is actually a better or softer landing than potentially trying to run a fundraising effort over a couple of years and ultimately potentially ending up with nothing. It is also a situation where folks are certainly often looking at least telling future investors that, "Hey, I had an exit."

And in that particular instance, you don't have to mention that this was acquihire and the license and just a hiring of best talent. But really, acquihire is different from an actual acquisition that we typically see as either a merger or asset acquisition or stock acquisition. Even though there are sometimes people who are talking about acquihires in that context as well.

Of course, for shareholders or early investors, this typically does not have a lot of value. But I would say this, that investors of course have to also be careful here that there's no “golden parachute,” if you will, in the sense that the founders or talent are basically getting big bonus payments and the shareholders are left holding the bag.

So, what can you do against that? Not a whole lot, I would say. What you can do is make sure that you initially start the discussions really as an acquisition discussion and not as an acquihire, and maybe even stating, "So, hey, look, we're not looking for an acquihire." But it may end up there. That's quite often the case.

Now we've talked about exit transactions in a sense of change-of-control transactions or changing ownership. But of course, we also want to briefly talk about IPOs. There are more IPOs happening again. And, Joe, why don't you take it away?

Joe: Daniel mentioned we've talked about various acquisition structures. And now we're talking about an exit structure, which doesn't involve an acquisition in which the company continues to operate as an ongoing entity, but it does so as a public company. An IPO is this initial sale of stock to public investors, which means it registers or lists its shares on an exchange. It sells its shares to public investors, which allows the company to raise money, but it also provides an avenue for stockholders to liquidate their position and the company.

The advantage of this structure is the mention of maintaining the independence of the company. The company continues as an ongoing entity. It's not acquired. The stockholders remain the same other than the new stockholders that will purchase the shares in the public market, which I'll come to in a minute. And it also provides access for existing stockholders to sell their shares in the public markets, whether it be on the Nasdaq or in New York Stock Exchange.

The disadvantages are that the IPO window is dependent on the strength of capital markets, which means that the public markets, the stock markets, will dictate the windows in which the company can actually go public. And those windows can stay open for a long time or they can be stay open for a very short time. And it could be a little bit tumultuous. It's hard sometimes for companies that are looking to go public to properly time their IPO in a way that's going to give them appropriate access to the capital markets and give them the valuation in the public markets that they're seeking in connection with the IPO.

Time to liquidity: The IPO process typically takes three to six months to complete, sometimes longer, sometimes shorter, depending on the company and the amount of review that the SEC does of the company in connection with the IPO. But in addition to that, once the company goes public, the existing stockholders are almost certainly required to sign lock-up agreements which requires them to not sell their shares and continue to hold their shares for a period of six months following the closing of the IPO.

So obviously, during that six-month period, now that the company is public, you are taking market risk. The value of the shares can go up and go down in the market and you're unable to sell your shares when you want them. So you're taking on that market risk as an existing stockholder.

For the company, there's a fair amount of expense associated with going public. You have to pay lifting fees to the exchanges. You have to pay your lawyers to prepare the IPO-related documentation. And there's a lot of internal expense that's incurred by the company in connection with going public to make sure you have proper financial controls, that you have the proper management and other personnel required to operate as a public company.

Operating as a public company is much different than operating as a privately-held company. There's a lot of required public disclosures. At the very least, you're required to file 10-Qs and 10-Ks, which are your quarterly and annual reports. And then you might have to file current reports, which are referred to as 8-Ks. All of that requires, you know, some preparation, and there's expense associated with it.

And lastly, when you go public, you suffer dilution, “you” being the current holder of stock of the company going public because the company is issuing stock and selling that to investors in the public markets. By issuing that stock, that results in dilution to the existing stockholders. So that's something to think about, and you need to think about it similarly as with like in any type of financing. You'll suffer dilution. There's valuation concerns, and then also timing and other market concerns. Those are the things that you need to think about in going public.

Things that you can do now to be ready if you're gearing up to do an IPO: Keep an eye on your competition, comparable companies, and industry stats. And, keep those in a file folder because it'll be helpful in backing up your S-1, which is the document you file with the SEC in connection with going public. So, understanding what your industry is, understanding who your competitors are, understanding what valuations companies within your industry are getting are all things that you can do in advance of going public.

And the second point is, get to know investment bankers in your space early. They will provide a lot of this market data and market insight and let you know when they think the IPO window will open and will close and how to time your potential entry into the market. And then they'll also provide you, to the extent that you're looking to potentially sell yourself, help with your M&A strategy.

A lot of times, when companies look towards that IPO, at the same time, they're looking at whether or not they can provide more value to their stockholders by doing an acquisition. And a lot of times, those two events, the IPO and the M&A transaction, will kind of go hand in hand because the investors in the company are looking to get liquidity. And both of those, both the M&A transaction and the IPO, provide an avenue to liquidity for the stockholders.

Daniel: Joe, we’ve got a question for you here: "At what stage is it usually discussed or negotiated whether our target can run independently or go with the loan? In particular, in the context of an IPO, is that a discussion as the other two discussions are going on, and often M&A should go about our IPO? How do you see that in your practice?"

Joe: When you're talking about an IPO, a lot of the discussion is around the financial status of the company. And what I mean by that is how much revenue is it generating? Is the company increasing its revenue kind of month over month and year over year at a level that will support an IPO? Those discussions are also relevant to an M&A discussion, because if the company is interested in, you know, there's a revenue opportunity that the target company provides, then those discussions will go hand in hand.

A lot of times, though, the M&A discussion is focused on other things. It could be focused on the people. It should be focused on the product. It could be focused on the technology. And while all of those are also relative to the IPO, in many acquisition scenarios, the revenue generated by the company is a lesser concern certainly as compared to an IPO. In a nutshell, there are a lot of the same considerations in both an IPO and an M&A scenario, but there's also kind of a divergence of concerns as well because the M&A strategy may value things differently than they would in an IPO scenario.

Daniel: Another question here was, "When investors ask what is your exit strategy, what are they really looking to understand? How should the company answer that?" And this is maybe for an earlier stage company, maybe Series A or something like that.

Joe: Well, usually, when they're talking about that at the most general level, it's whether or not you're looking to get acquired or go public as your exit strategy. But those such discussions are usually a lot more granular when you're talking to investors in connection with a Series A or Series B financing. And what investors are basically looking at is they want to understand, if you execute on your strategy whether it be IP strategy or product strategy so on and so forth, where do you see your company going? And what I mean by that is, who are the potential buyers of the company? If you develop your product and you execute, what companies, usually public companies out there, would be interested in buying you? And that's what investors are typically looking for with those types of questions.

Daniel: There's one more question about acquihires, "In light of competition laws or non-competes, do you find that this acquihire scenario is most frequent in California? Have you seen these scenarios arise frequently outside of California?"

I would say I think what the question is alluding to is California is notorious for not allowing and making unenforceable non-competes, particularly post-employment non-competes. I would say, in the acquihire situation, we're really talking about even the founders getting out. Everyone is really trying to get out of the company, if you will, and find this soft landing. So, it's less a situation that acquisition talks are started and then a potential buyer is starting to cherry-pick the best, if you will, the best and the brightest from that company. But it does happen, and that is a big problem frankly. And this is why we often try to address that in the initial confidentiality agreements and also agreements, what we call non-solicitation agreements.

I would say there's a very important difference between essentially a non-solicitation and no-hire or anywhere near, if you will, try to legislate that a potential acquirer cannot hire folks out of that acquisition process. That's a very difficult dance to dance as a seller. And it's a very good question. But I don't think that there is a huge difference between California and other states in that matter.

There is one other question about investment bankers and going down the road of IPOs. But I think we may want to address that a little bit later. Let's just jump into the timeline of the deal at this point. Again, when we are talking about the timeline of the deal, they're pretty distinct processes, as if there were almost separate processes that are happening while a transaction unfolds. And again, we're now talking mostly about M&A transactions.

In the M&A context, one of the very first questions will be “when is it appropriate for you to sign a nondisclosure agreement or confidentiality agreement,” which it's often called. This is a difficult situation as well because, in the beginning, the last thing you want to do is to walk into an initial meeting and say, "First, sign this NDA before we start talking." But it may be the appropriate step, and particularly if it's a competitive deal and if you are really talking, you want to have some really meaningful discussions around technology. So, the confidentiality agreement is something that is very quickly put in place in those situations where the buyer and the seller are really interested in moving ahead.

And in those situations, the preliminary discussions that we have quickly move into a direction where it is important to protect the information that is being shared. And, in particular, we talk about these one-way and mutual NDAs quite often where information is being shared one way or the other. In most tech transactions, we are dealing with what we call mutual NDAs just because the product people will start talking to each other about product pipeline, roadmaps, etc., which are of course quite proprietary and therefore need to be protected.

To some extent, I always believe that if a potential buyer is resisting entering into a confidentiality waiver or a non-disclosure agreement, they're not that serious yet. They're just still exploring, trying to socialize and maybe have a transaction etc., but they're not that serious that they're ready to potentially give you a term sheet.

The important part of that NDA in that context that are substantially different from an NDA in the commercial context are really that the purpose for the disclosures are for the purpose of an M&A, a merger attraction. Right? If you are going to use that information in your organization as a buyer that is provided by a potential seller, then it can only be really used for purposes of the acquisition and figuring out how the acquisition is going to essentially be implemented. And also, of course, it governs all of the due diligence that we'll discuss a little bit later, that the information that is provided, the due diligence.

What's important there is that we have clauses that we talk about often and we negotiate, which are residual clauses, what we call residuals knowledge or residual clauses. These are quite important. Because you walked into M&A transactions often providing a lot of information to potential buyers even though, at particular point in time, you may not have a real commitment from the buyer and particular if you're still at the term sheet stage. So, what's important there is what, if anything, can the buyer continue to use and retain, and how is that going to happen?

The other thing is, of course, the duration of obligations. I often counsel my clients that, if you have trade secrets in particular, and if this is not registered IP, you're really walking on very very thin ice if you are starting to disclose information under an NDA that has a limited period of protection for confidentiality.

So, if, for example, if the confidentiality period expires, you know, after two years or three years, well, you have to know that after that time, it is possible for a potential buyer to talk about the information you provided. And if you had trade secrets, that may destroy, or very likely will destroy, your trade secret claim. So, it's quite important what happens there.

Now, in certain situations, of course, we're also talking about, how this destruction information or a deletion of that information that is being provided. Because in certain situations, that is may be the crown jewel that you're trying to protect. And you're trying to make sure that, ultimately, an acquirer who is nibbling around the edges and looking at potentially doing a transaction is not just doing that to really find out who are the best people here, and who are your top 10 customer list, really understanding a lot about the company without having too much skin in the game yet.

Things you can do to now to be ready: Well, really, make it very, very clear to your team internally and then, also, of course, whoever you are dealing with that particular information is actually provided under confidentiality. And you have to make sure that confidentiality agreements are really part and parcel of that transaction.

The next point is, just because your sales folks are telling you, "Oh, we have an NDA in place already because they're already a customer and we're dealing with them all the time." That is not the same, most likely not the same confidentiality everything that you would need for an acquisition transaction. Again, really talking about non-solicitation of employees and customers etc. But also the purpose, the use the use of that information, is only geared towards a very specific purpose, which is the potential acquisition of the company. And of course, again, try to make the confidentiality agreement mutual, especially if you're on the receiving end, also, because you may be sharing information.

With respect to the term sheet, moving on to the next item that is really always a very free-loaded, sort of early discussion, one of the most important things, again, is of course the deal price the consideration, what we call the type of consideration. What we don't want is to have an open-ended discussion over as to whether or not it should be cash or stock or what-have-you. Ultimately, this is something that is so important for decision-making for the board and for all the stakeholders that this is something that needs to be put on the table. Because they have a lot to do also with potential tax issues.

If you, for example, use stock, you may have a taxable deal, and you may ultimately have to provide enough cash for the sellers that they could actually pay their taxes. There's a whole lot involved in that and very important part of a term sheet negotiation.

The deal structure itself: As Joe alluded to earlier, if you're doing an asset sale, you may have double taxation. You may essentially take the purchase price for an asset and then have to, if you want to distribute it out to your stockholders, potentially pay taxes again. This may not be an issue in those situations where the assets exceed, the loss carryforwards exceed that and some of the pricing of the assets or the valuation of the asset is lower than maybe the enterprise value. But in many situations, these tax issues are very important to discuss very early on when they find themselves down in the deal structure.

So, the same thing goes about anticipated signing and to closing. Here, I think what support again is also deal certainty. What we don't want to have happen is that we negotiate a deal and then ultimately don't even know if we could consume it or we can automatically close the transaction just because there are hurdles that are put in place that are egregious or potentially not reachable. For example, if there's a closing condition that say that 95% of the employees need to still be there. Maybe that's the right one, but it also could be quite difficult to achieve. Same thing about regulatory approvals and key third-party consents.

We're currently dealing with a couple of transactions where CFIUS, the Committee of Foreign Investments in the United States, where foreign buyers are buying assets or buying control over companies that are, broadly speaking, in the security space. So, we have we have issues there. Those really go to deal certainty, which are really important to hammer out in the term sheet, because those are not necessarily best left to the lawyers and other people to figure out. These are very important.

Maybe talking about similarly on the liability package, what's also important is not only how much money is going to be paid but how much money is of the consideration is actually at stake potentially in a situation where not everything turns out to be the way we all thought it would turn out. And in that particular instance, we're dealing with escrows. We're dealing with holdback. In certain situations, escrows and holdbacks are quite different. I think that's another thing that's quite often needs to be spelled out. Is it an escrow or is it the holdback? The holdback really means that the purchase price is held back at the risk of not getting ever paid out versus an escrow, which is really put in into a third-party bank. When escrow has been very relatively easily obtainable if the escrow conditions are met.

And then, of course, also talking about the scope of the indemnities and will be indemnified, what a buyer will be indemnified for, and how high those limitations on recovery are. For example, is there a cap? Is there, for example, a percentage cap off the deal purchase price? These again really go very deeply into deal certainty, if you will, and price certainty, where sellers have to negotiate early on, in particular at the terms of stage, what that should be. Those shouldn't necessarily be left open to due diligence. And we're going to dive into due diligence in just a minute with Joe.

Because everything is subject to due diligence, of course. But when we have a term sheet that is non-binding, just to be clear, with respect to most of these items, we do have to have an understanding of what the economics are in this transaction. And they very much entail and include all of these things that I just discussed. What is the purchase price? What's the deal structure? What are they closing conditions? What other conditions are imposed? And what is the ultimate potential takeaway, again, or liability package where the seller may have to ultimately, you know, pony up the cash again or actually give that cash out of escrow, etc.

The other thing that is always very important, especially for the buyer, is the exclusivity. So, clearly, a transaction like this is something that you'll embark on with a lot of effort, not only internally but also externally. You hire lawyers. Both sides hire lawyers. The transaction costs can get very high. And in those situations, the buyer needs to know, of course, what kind of exclusivity period was there. But the seller also wants to know that because, clearly, they can't be tied up forever, and certainly not for a year or six months or longer just because it could create potential issues around what kind of money needs to be raised.

This exclusivity and also confidentiality often is the binding part of a term sheet. It's also important of carve-outs, for example, for the company for a seller, in particular to raise more funds potentially, at least in bonafide venture capital funds if the transaction goes longer. Because otherwise, your sellers potentially with the back to a wall and potentially has to negotiate for a lower price just because of running out of money.

Things you can do now to be ready in this sense is really understand the basics of term sheets. Do research. Find out from your lawyers, find out from investment bankers what are some of the basics around this. What do you need to know obviously are here at the webinar? I think it's important for you to really understand those basics.

And the other thing is, get your lawyers ready, get board members and VCs ready. Who have done this before? And who could be the team that helps you go through. This is going to be quite critical because you're going to have to continue to run the company just like always, hit all your targets, hit your numbers, because that's important, again, through their financial due diligence, and at the same time, run this transaction while making sure that, you know, your team stays together.

Joe: Going back to my initial statement, these are considerations that you should think about if you're doing an M&A transaction, if you're doing an IPO, or if you're just leading up to a financing. If the exit transaction is not kind of in the in the near future but you are looking to get financed, these are things that you should think about because the investors will want a due diligence as well.

So, a buyer or an investor's level of diligence will depend on its sophistication, and to some extent, the relative leverage between a buyer and seller. But as a general matter, diligence is kind of market-driven, meaning most sellers and most buyers will know what level of diligence is going to be done. And the things that are kind of at the top of the list are the capitalization of the company and its equity plans and its employment agreements.

Because ultimately, the buyer will want to make sure at the end of the transaction that the target company is a wholly-owned subsidiary if structured as a stock purchase or a merger, or if it's structured as an asset purchase making sure that it understands what approvals will need to be received from the company stockholders in order to do the asset transaction.

IP chain of title, sustainability of key products and code bases. That's kind of shorthand for IP. So, obviously, in our geographic area, most of our M&A transaction or transactions are tech-focused. Making sure that the target company owns its IP that it purports to own, can show that it owns its IP, has taken the requisite steps to protect its IP, all of those things will be diligence by the buyer.

Similarly, key inbound and outbound licenses, key supply manufacturing, or similar agreements. Or just look at it as any agreement that governs a material aspect of your company's business. The buyer will want to look at those very carefully. Going back to our prior statements, if there's change of control provisions or there's other provisions that would have permit the counterparty to terminate that agreement in connection with the transaction, that will be of keen interest to a buyer, and the buyer will want to make sure that post-closing, it gets the benefit of those agreements and those agreements are not are not cancelled or terminated.

Again, material contracts for change of control issues and commercial terms, liability issues. Those are if the target company has ongoing indemnity obligations to its customers or suppliers or others, these are all things that once the company is acquired and is a subsidiary usually of the buyer company, those obligations continue. So, the buyer will want to understand what those obligations are and understand where their potential exposure is.

And then, lastly, pending or threatened litigation investigations or other third-party claims. If your company is subject or is involved in litigation, especially if it's the defendant in the litigation, that's going to be of great interest to a buyer because the buyer will want to understand what the potential liabilities and obligations are of the target company should the target company lose that litigation. And that obviously has an impact on the overall value of the target company. So, the buyer will be interested in that as well.

Other areas of review, key and key transitional employees. That actually should probably be moved up to the high-priority piece. In the transactions that we do, one of the key assets of the target company in many, if not most, instances is the people, the founders, the technical team. Those are all people that the buyer is extremely interested in.

And in most of the acquisitions that I do, whether on the buy side or the sell side, there is usually an employee closing condition that Daniel alluded to earlier. And what that means is a certain number of employees and then certain specified key employees must continue to be employees at the closing for the buyer to have to consummate the transaction. So, employee considerations and human capital is of keen interest to the buyer.

Other areas of review, product and cost-saving synergies, compensation of benefit plans, financial statement diligence. Again, the buyers will want to understand the financial status of the company. And then related party transactions. And those are transactions between the company typically and its executive officers and directors that may impact the business. And again, that falls into the general bucket of, you know, what obligations are there going forward both in connection with the deal and following the deal that the buyer should be concerned about.

Daniel: There's another here. "If we get a letter of intent to memorandum of understanding, how soon do I demand a full term sheet? Is it expected that there's a standard amount of due diligence between getting the LOI or MOU and when you get a term sheet?"

Joe: An LOI or an MOU typically is just another term for a term sheet. LOIs and MOUs, depending on who the buyer is and kind of the nature of the transaction, will be more or less detailed. What usually will happen is the buyer will come to management, you'll sign an NDA, and then there'll be some level of due diligence. It's usually pretty high-level due diligence. There might be some technical due diligence involved. But the buyer basically needs enough information to, one, determine if it wants to make an offer. And two, if it does want to make an offer, frankly, what's the purchase price? What kind of values are they willing to pay in order to do the transaction? So, they need to do enough diligence to get there.

Once they get there, that's when the LOI and the MOU will get negotiated. And purchase price being the most material term of it, but also all of the other terms that Daniel went through in his presentation will be negotiated. Again, some buyers will leave some of those terms to be negotiated in the definitive documents. Others will want to do it at the MOU level.

We are out of time but have a few closing remarks. First, thanks, everybody, for joining us. We hope you found our presentation helpful and informative. And we also hope that you will join us for our next session in October when we will focus on IP strategies for startups.

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