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M&A Primer for Tech Directors

Technology companies evaluating a sale or an IPO must carefully consider the finer details of all possible options.

by Donald P. Clark and Glenn Nieves

Given the vast proliferation of VC-backed emerging technology companies in southern California and the current state of the economy, serial entrepreneurs, investors and board members of these companies are revisiting their strategic objectives and considering an exit strategy involving a sale of the business rather than an initial public offering (IPO). Executives must be mindful of the potential pitfalls that exist when pursuing a strategic sale and should be ready to address the key issues that will come up in the mergers and acquisitions transactions for these technology companies. Failure to adequately address key issues may lead to disruption in both businesses (buyer's and seller's) or the delay or even derailment of bringing good technologies and products to an eager marketplace.

Deciding to be Acquired

For most technology companies, pursuing an IPO may not be the most effective manner to address their principal business concerns. A company may be in a stage of its life cycle where its founders and/or investors seek immediate liquidity or improvement in the company's supply and distribution capacity or where management has concluded that its future success demands access to the type of infrastructure that is typical in a large corporation and that they are unwilling to build their own infrastructure if it means diluting the founders. While an IPO may provide liquidity for founders and investors, it is not likely to immediately adequately address a company's on-going concerns and the building of a new infrastructure may indeed be dilutive for the founders. Other factors such as the continued volatility of the IPO market, costs associated with a public offering and the daunting focus on quarterly financial performance for reporting companies are reasons why most successful companies and their founders pursue an alternative exit strategy.

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A company may be an attractive acquisition candidate if it has a product or service that is critically acclaimed in trade journals, is a strategic fit with a buyer's products and infrastructure and has a strong development team in a mission-critical area. For example, in October 2010, Nordstrom acquired HauteLook, a provider of online private sale marketplace for approximately $270 million. In July 2010, The Walt Disney Company acquired Playdom, a developer of online social gaming software for $573.2 million plus an earnout amount of up to $200 million. These acquisitions are characteristic of the type of deals strategic buyers are looking for. Each of the buyers picked up valuable intellectual property in an emerging area based on the premise that the respective buyer's infrastructure was infinitely superior to that of seller's and that this competitive advantage couple with other synergies would unlock value in the acquired business post-closing.

Once a decision to be acquired has been made, a seller should consider positioning itself to be acquired. Ideally, a seller should demonstrate consistent revenue and earnings growth as well as its ownership of key intellectual property used in its business. The early engagement of qualified legal counsel and an investment banker can provide a seller the ability to address value-enhancing factors and can sometimes lead to an improved valuation.

Deal Issues

Once a seller has gone through the presale preparation, the marketing process, has identified a suitor and preliminary due diligence, seller must negotiate terms of the transaction having identified the buyer's primary concerns and structuring ways to address those concerns while not diluting the value of the deal

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for seller's shareholders. A buyer's focus tends to be on paying no more than seller's value, structuring the acquisition to obtain the most desirable tax and accounting results, and ensuring that key personnel stay with the acquired business going forward. Seller's shareholders, on the other hand, are generally focused on (a) obtaining the highest possible price, (b) receiving payment in a liquid and possibly tax-free manner, (c) limiting their personal liabilities for indemnities and (d) reducing the amount of consideration to be held in escrow as security for indemnifications given to buyer under the definitive agreement. These conflicting concerns will need to be managed when negotiating the acquisition structure, the valuation and pricing of seller's assets, the indemnities and escrows and when addressing intellectual property issues that are disclosed during the due diligence period.

Acquisition Structure

A seller and buyer must decide between acquisition structure alternatives that will have varied impact on their key business considerations. The three acquisition structure alternatives are stock purchases, mergers and asset purchases.

In a stock purchase, buyer may purchase all of seller's outstanding stock from seller's shareholders. This type of transaction tends to be simpler for a buyer because title to the seller's assets is transferred with the ownership of the seller and fewer third party consents are generally required in order to close the deal. There are significant drawbacks to using this structure, such as the fact that a buyer would also acquire all of seller's liabilities and that, unlike a merger, applicable law does not provide a means of cashing out large numbers of dissenting shares under a stock purchase.

A merger offers flexibility in structuring a transaction in a way that is tax-free to seller's shareholders. There are three types of mergers: straight merger, forward triangular merger and reverse triangular merger. In a forward triangular merger, the seller's liabilities are isolated in the newly formed subsidiary of the buyer and, as such, do not put the remainder of buyer's assets or business at risk. That being said, a reverse triangular merger is a common structure that is used when a buyer is concerned that non-assignable contracts or licenses will equate to extortion of additional consideration by third parties who have contracted with seller. With the assistance of competent tax counsel, the parties may be able to have a merger transaction qualify as a tax-free reorganization under the Internal Revenue Code provided, among other things, that the buyer continues seller's business in some form and the seller's shareholders do not sell back their buyer shares received in the merger to buyer. The qualification for a tax-free reorganization is available to the parties regardless of the acquisition structure they use, provided that the requirements for tax-free status (which vary depending on the actual acquisition structure that is used) are met.

Glenn Nieves

After considering a stock purchase or a merger, a buyer may decide to acquire a seller's assets rather than merger with seller if it wants to avoid unrelated seller liabilities and attain a step-up in basis of the acquired assets for tax purposes. While attractive for the foregoing reasons, an asset purchase may prove to be more costly because of consents and assignments that may be required in order to close the deal.

Valuation and Pricing Issues

Company valuation is a highly subjective area. In the M&A context, valuation of a seller can be contentious due to the fact that you have a buyer who generally is focused on paying a fair value for the seller while a seller and its shareholders may be concerned with attaining the highest purchase price. Buyer's tend to use four methods to identify a reasonable seller valuation:

- Market value of stocks of comparable, publicly traded companies in seller's industry
- Deal value of comparable transactions
- Multiples of seller's earnings or EBITDA
- Discounted cash flow analysis whereby a buyer assigns value in today's dollars to the cash flow to be generated by seller's future operations

Each one of these valuation methods poses risks and concerns for each of the parties.

If the purchase price components include stock of a buyer which is a publicly traded company, buyer must address certain market risks, such as the possibility of a significant fall or rise in buyer's stock price between signing and closing, when determining how to express the purchase price. One way of addressing this

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concern is to price the deal subject to a collar. A collar is a range of buyer's stock prices within which there is an agreed-upon pricing method. A profitable seller may also want to negotiate a purchase price adjustment to address the possibility of an increase in its working capital from the signing date to the closing date. A buyer may agree to a two-way purchase price adjustment meaning that if seller's working capital declines between signing and closing then the buyer would be entitled to a purchase price reduction based on the amount the working capital decreased.

Indemnities and Escrows

One of the biggest concerns that a buyer has in acquiring a high-technology company is the risk of infringement by seller on a third-party's intellectual property rights. A second concern is data protection. These concerns fortify a buyer's desire for strong indemnification provisions and the elimination of baskets. When addressing specific intellectual property indemnification concerns, a buyer should focus its diligence on pending claims that are attributed to technology that is unique to seller's business. This is so because of the reality that high technology companies routinely face third party claims relating to basic technologies that are used by virtually all participants in that space. In most circumstances, the parties agree that it is inappropriate for buyer to make claims for every dollar of liability that is discovered after the closing. The parties generally agree that seller's breaches must cause a certain threshold of damages (basket) before buyer has any right to indemnification. The real negotiating points come down to whether recoverable damages will be limited to a cap or whether buyer can recover all damages or just those in excess of the basket. Lastly, the parties will have to reach consensus on what portion of the deal consideration will be held in escrow as security for the seller's indemnification obligations and for how long.

Intellectual Property Issues

Due to the nature of the assets being acquired, a thorough investigation of a seller's intellectual property is necessary in order to discover risks, evaluate risk and allocate risks in the definitive agreement. A successful IP due diligence should (a) confirm the ownership and sufficiency of seller's intellectual property that is used in the business (and address joint ownership issues), (b) understand and evaluate infringement issues surrounding the intellectual property being used in the business, (c) provide a thorough understanding of restrictive covenants and royalty obligations that may surround seller's intellectual property and (d) highlight any source code issues.

Once a company and its shareholders have decided to seek an exit strategy, it should involve its investment banker and legal counsel early on. Doing so provides a seller's deal team the opportunity to address and plan for issues discussed herein and a host of others that will likely arise when negotiating with a buyer. Going through with the sale of a business is one of the most challenging experiences an entrepreneur or investor will go through in their business lives, but there is a huge reward that awaits those who prepare and set objectives before they enter into negotiations with a buyer and pursue their exit strategy.

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