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Negotiating Strategies for the Successful Sale of Technology Companies

Vicki Dallas, Esq.

The number of mergers and acquisitions of private technology companies has increased in recent years. Established companies often have a lot of cash, a need to prove to their shareholders the potential for future growth, and inadequate in-house development resources to handle it all. Many times, it is easier to buy rather than build. A target company (Target) may never fully understand all of the dynamics of what makes it attractive to a potential acquirer (Acquirer), but there are tools Target should implement to improve its chances of a successful sale.

Identify the Strategic Reason for the Acquisition

Founder and investor liquidity is usually a motivation, but often not the major reason Target desires to be acquired. Target may require access to complementary products and markets, improved distribution capacity and customer base, access to capital without further dilution to founders and investors, an established infrastructure to accelerate growth, as well as liquidity for founders and investors. Target should also identify what makes it attractive to an Acquirer. Target may have a product line or technology which is unique, or a management team with specific expertise and talent. An Acquirer is more likely to make an acquisition to gain creative, technical or management talent, acquire key technology, distribution channels or sources of supply; and/or expand or add new product lines. Often, an Acquirer will make an acquisition to get to market more quickly, or to eliminate a competitor.

Identify the Attributes of Target That are Most Valuable and Initiate Internal Due Diligence.

Having proprietary technology is always a competitive advantage, particularly when such technology is a market leader in a fast growing market segment. Strong management teams are key drivers for adding value to Target, as they lend credibility to future growth projections. Target's financial performance and the synergies and growth potential to be created through an acquisition are important factors. Any performance volatility will be a negative factor, along with litigation threats or excessive known or contingent liabilities. Initiating legal and financial due diligence prior to going to market is extremely important so that any problems/issues can be identified and remedied prior to Acquirer commencing its own extensive due diligence.

Due diligence checklists prepared by an Acquirer generally include legal matters (formation, capitalization, management and employees, intellectual property and material contracts), and business matters (financial, industry and market information). The purpose of collecting information from the due diligence process is to address the strengths and weaknesses of Target, enabling an Acquirer to determine the "fit" between Target and Acquirer, and to validate the valuation and allocate risks inherent in the transaction.

Intellectual property (IP) is typically a driving factor in a technology based business. Internal due diligence should include the preparation of a comprehensive list of all IP assets, including patents, patent applications, trademarks, service marks (registered and unregistered), fictitious name filings, internet domain names, software and databases, registered and unregistered copyrights, trade secrets, proprietary know-how, technology or processes, and rights of publicity, each for federal, state and foreign jurisdictions. All IP should be reviewed for filing dates, renewal periods, security interests, validity, enforceability, and freedom to use. Anti-assignment clauses in IP licenses and other contracts that may be triggered on a change in control should be addressed and the process for obtaining any requisite consents should be clarified. Invention assignment and confidentiality agreements need to be reviewed for all employees and consultants that have contributed to the development of the IP. License agreements (which may affect field of use and other restrictions) and other IP-related agreements also need to be reviewed, including research and development agreements, joint venture or other strategic partnership arrangements, co-marketing agreements, manufacturing, supply, distribution agreements, and covenants not to sue.

Identify the Most Advantageous Deal Structure for Target.

The typical forms for structuring acquisitions are stock sales, asset sales or mergers. Transactions can be taxable, or all or partially tax-free depending upon structure. In a stock sale or merger, liabilities are transferred to Acquirer by operation of law, in contrast to an asset sale where only designated and certain "successor" liabilities are assumed by Acquirer. Third party consents must typically be obtained prior to closing an asset acquisition, in contrast to a stock or merger, where third party consents typically are not necessary unless there are changes to the control provisions in contracts. Target's board of directors and shareholders must approve an asset sale if the sale constitutes a sale of all or substantially all of Target's assets. A stock sale requires all selling shareholders to approve the sale. If obtaining 100% selling shareholder approval is not achievable, a merger can be employed establishing certain mutually agreed upon thresholds between Target and Acquirer for shareholder participation. In a merger, shareholders who do not consent and question the adequacy of the deal consideration often have "dissenters rights" or "appraisal rights" under applicable corporate law. It is important to check with tax and legal advisors to determine the best form for the structure of the deal before

approaching an Acquirer, so that Target is best equipped to evaluate competing offers.

Identify Negotiating Strategies

Whether Acquirer will prepare a one-sided or a relatively "balanced" first draft of the definitive agreements will depend on negotiating style, perceived deal leverage, other potential bidders in the process, and the intensity of the desire of Acquirer to consummate the transaction. Acquirer will negotiate for broad representations and warranties (with limited materiality qualifications and limited knowledge qualifiers), joint and several liability for representations and warranties, low caps and baskets for indemnity provisions, and indemnification beyond the applicable escrow or holdback amounts. Acquirer will also look for a minimum target net worth and satisfactory due diligence closing conditions, as well as "no shop" provisions with no (or very limited) fiduciary outs available to Target. Target should attempt to narrow all of these by arguing for more limited or narrow representations which are knowledge based with materiality qualifiers, and incorporating limitations on the survivability of the representations and warranties. Very detailed disclosure schedules should be prepared by Target with a view of protection from indemnification claims, and Target should negotiate for a maximum liability cap for indemnifications claims, baskets (minimum claims which must be met before Acquirer can make any claim), and deductibles (where the Acquirer can only make claims above a certain threshold amount). Target should also consider whether to agree to any no-shop provisions; and, if it does agree, Target should determine the appropriate time period to provide Acquirer with exclusivity to negotiate and complete the transaction.

Planning for the acquisition process up front will enable Target to be proactive in its negotiations with Acquirer. It will also pave the way for a smoother acquisition process resulting in a successful closing that meets the objectives of Target's shareholders.

Vicki Dallas is Co-Chair of the Firm's Corporate Practice Group and a Shareholder in the Orange County office. She can be reached at 949.224.6438 or vdallas@buchalter.com.