PREPARING FOR EXIT: STARTING EARLY

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A Basic Rule

- THE GOAL: Money in your pocket at the end of the process after taxes and payment of deal liabilities.

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Common Themes In all Exits

- Due diligence by other parties.
  - What is “due diligence” anyway?
- The need for a “corporate clean-up.”
  - What is that?
- Other parties look for sources of value.
  - Give them a reason to pay you more.
- Company and capital structures and related documents have impact.

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Creating Value

- Intellectual property strategy
  - Not just “I have patents”
    - Virtually every business has intellectual property even if it is not patentable
- Good agreements with customers
  - Document properly
  - Avoid common traps
  - Use for value creation
    - Stream of revenue
    - Extending terms, etc.
  - Make them assignable in case of a sale of the company
- Good employee/consultant agreements
  - Invention agreements
  - Confidentiality agreements
  - Non-competition agreements (if possible)
  - Non-solicitation agreements
  - Make them assignable in case of a sale of the company

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Do Not Destroy Value

- Be systematic.
  - Start-out dotting “i’s” and crossing “t’s”.
  - Do not rely on the “corporate clean-up” which happens immediately before a deal.
  - It is less expensive to develop good habits and follow them.
- Avoid bonuses/acceleration of vesting tied to exit.
  - Will be a deal killer in some circumstances.
  - Board can always grant these rights later.
- Avoid substantial severance or other post-employment obligations.
  - Who will pay it?
- Characterize your employees and consultants properly.
  - Comply with wage and hour laws.
  - Pay all withholding and other employment taxes promptly and fully.

Do Not Destroy Value (continued)

- Avoid contracts with long “tails” or which purport to grant business rights of first refusal to others.
- Avoid burdensome employment and other contracts.
  - Generally early stage businesses should not have “employment contracts.”
  - Substitute an offer letter and an employee inventions, confidentiality and non-competition agreement.
  - Everyone should be “at will.”
- Avoid grants of “blanket” security interests.
  - How are they discharged?
  - How do you sell pieces of the business “free and clear?”

Company Structure

- Structure your business with a view to likely exit strategy.
- Do not say “I want a C corp” or “I want an LLC” without thinking through implications.
- Limited liability company may be the answer for licensing entities, consulting businesses and businesses for which exit is a sale of assets.
  - Not for everyone.
  - Capital accounting and interplay with tax regulations is <u>very</u> complex.
  - Many opportunities for mistakes: some will impede exit or cost a lot of money on exit.
- C corporation
  - Simplest
  - But it will cause loss of money in certain types of exits because of tax effect.
  - May be highly desirable under current law because of ability to lawfully avoid tax on sale of qualifying small business stock if held long enough.

Capital Structure

- Liquidation preferences
  – Multiple preferences
  – Participating equity
  – Remember “liquidation” includes sale
- Be wary of vetoes by classes.
- Make sure that options and warrants can be retired in case of sale.
  – Even warrants can be a problem with IPO.

Documents Related to Capital Structure

- Drag along rights
  - What are they?
  - Can other stockholders sell the company out from under you?
  - How do you mitigate the problem?
- Tag along (co-sale) rights
  - What are they?
  - Who can get them?
  - Are they valuable?
  - Avoid being “frozen in.”

Documents Related to Capital Structure (continued)

- Right of first refusal for the company or its assets
  - Potentially a deal killer.
  - Business people are too easy-going about them.
  - Right of first offer
    - What is the difference?
    - Is it better?
- Balloon pay-offs on certain exits.