M&A Seminar Series, Session Five

VC/Board Member View Summary

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Fenwick
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Summary of Discussion Points

Panel

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Optimizing Board Process (Sell Side)

The target board must consider whether or not to use a banker. Bankers can help the board of the target understand how to position for and justify the maximum possible deal value and to understand the likely range of realistic, but still fair, outcomes. But a private target generally does not need a banker for liability--avoidance reasons. Sometimes a buyer will push a target's board to hire a banker to become educated about fair value, but more frequently the buyer would prefer avoiding the additional cost of target banker fees. While bankers can generate multiple bids and drive up deal value, a public company's use of a banker to shop a deal is very tricky, because it is possible that news of the company's shopping efforts will leak out. To minimize this risk of "leakage", and best position the company, the best "shopping" approach may well be CEO to CEO or board member to board member, rather than banker to banker. To some extent, engagement by a public target of a banker can be an admission that there is a problem with the growth engine of the company and thus be a sign of weakness to Wall Street. The critical assessment of whether there is a "vision match", alignment of goals and good interpersonal chemistry is often best done prior to involving bankers. Where a private target is a "hot" enough property to generate multiple bids without banker involvement, the market can set the deal value and ensure the price is right without banker input.

The target board must decide whether to appoint a special M&A committee. Such committees can be highly effective, particularly if the members have deep finance, investment banking, technology or other M&A experience. Such a committee will understand what constitutes good M&A process and will work hard to keep a clean and consistent board record. Use of a committee will also reduce the aggregate time required to get the board up to speed on the merits of a deal. The committee can serve as a sounding board for management and an interface with the entire board and can dive in deep on the issues. The committee can be of great help to management, giving director level insights in real time, and acting as a proxy for the full board.

The target's board should have a good M&A lawyer. M&A deals can be derailed in a number of ways, so the faster the deal gets done, the better, which is why good M&A counsel is great to have. M&A counsel can guide the board members on issues that are vital to establishing a good board process, which is important for litigation risk management, and critical to negotiating, documenting and positioning M&A deals in the proper manner. Despite directors' deep domain and business knowledge and good gut business instincts, it still helps to have someone with a good, current M&A experience for guidance, e.g. in terms of latest (rapidly evolving) case law on fiduciary duties, market deal terms, and how much "shopping" is required. Deals are like having

a baby, you can read a book about it, but you want an expert around when it happens.

Set a record, and conduct yourself, keeping in mind that every action and point of discussion by the board may be disclosed in the proxy and/or become the subject of litigation, so the board should conduct itself in a manner that is decisive, clear, and above reproach and that stands the test of looking good in hindsight. For example, the board's record should demonstrate that the board fully vetted all the relevant alternatives, including staying independent, and was committed to maximizing stockholder value. If you set a record that will withstand litigation scrutiny, that will go a long way towards helping you to avoid, or settle, M&A related litigation.

The Board must help management by taking the long and big picture view. For example, the Board needs to have the objectivity to understand when performing against the current plan is at risk, and when the fact that the company is undervalued by Wall Street over a long period should be viewed as a fair assessment, as opposed to a temporary anomaly. The Board should understand the overall marketplace dynamics, including market consolidation trends, and which large competitors are buying who, and why, and why your company is not getting approached about being acquired. The Board must also understand the long term drivers of increased value stand alone, and how achievable that stand alone model is. All those data points bear on whether it's time to sell, and what the right valuation should be. If your public company's stock is undervalued over a long time period, and the industry is consolidating around you, those are warning signals that the company must be "right sized", and become profitable, before it can drive up its trading price and be viewed as a player.

A director can serve as a valuable advisor to the CEO on a M&A deal. For example, a director can be involved in the negotiations, not to take control, but as an agent to help clarify confusion or ambiguity. Target directors who know the buyer's executives or directors can play a critical role in creating the credibility and comfort needed for the buyer to take the "leap of faith" required to move to the high end of its valuation range. But whether this type of director involvement will be effective really depends on the particular CEO and board involved. CEOs should feel free to reach out to directors for help and directors should make known to the CEO their willingness to provide any assistance that would add value. The reason this is sensitive is that the target company must speak with only one voice, and that voice is most effective if it is the CEO, so directors should never intrude to the extent of speaking as a primary company spokesman.

Board Process Issues Specific to the Medical Device Segment

In the medical device space, the Board can help management stay tuned to partnering dynamics in the marketplace. In that space, a few dominant players control the space, and those players pick their partners early on, so it is critical to understand the trends that are driving those partnership and M&A deals and to stay ahead of them, so you know when it's time to sell. Drive your business development team to know about all potential deals in your space, in advance. Help your management drive your company to achieve the metrics that will make the company most attractive to a potential buyer, like revenue growth, profitability, product quality and market leadership. Of necessity, the boards of smaller medical device companies spend considerable time discussing what the major players in the space, such as J&J and Baxter, are doing.

In any M&A deal, the board must help direct the due diligence process, whether on the buy or sell side. On the sell side, given what has happened to many public companies, a target taking stock of a public buyer must conduct a rigorous due diligence review. The key difference in the diligence process on medical device vs. software deals is that the buyer in a medical device company deal will spend an enormous amount of time on intellectual property issues--patents, patent applications, product liability claims, QA issues, FDA and other regulatory affairs issues and clinical data—because the target's intellectual property is the primary source of value being acquired. Another difference between the two market segments is that potential buyers of medical device companies are typically members of an oligopoly, so it is much easier to identify the most likely potential buyers. However, there is more reason to worry in the medical device space about shopping yourself to a particular large company, and then walking away, because that may "burn a bridge" relative to future partnership deals with that company. The knowledge base of directors is different in software and medical device companies as well. However, the board dynamics and M&A deal issues are largely the same.

Evaluating Acquisitions (Buy Side)

The buyer's board must decide whether or not to use a banker. A public buyer must be more careful to avoid overpaying, so it will be more inclined to use a banker and obtain a fairness opinion if the deal is material. Bankers also help the buyer decide on an appropriate premium for a public target, which is not always clear—for example, a "normal" premium is 30-40%, high end targets can obtain above 50% in some cases, and there have been some recent exceptions to these rules of thumb. Bankers can also help the buyer pick the right metric for determining the premium, which will depend on the circumstances; for example, if the target just missed a quarter and had a substantial price drop, the premium may appropriately be 70% over the price on the day before announcement (but only 30% over the 30-day average). A good banker can also help the buyer identify other potential competing bidders and what they can pay, which helps buyer management persuade its board to pre-approve a range of approved bid values, enabling a rapid response to any competing bid that emerges. Finally, keep in mind that the larger banks have the clout and credibility to push a negotiating point further than the smaller banks, but the smaller banks do a great job as well, at a lower cost. There is a real benefit to using high quality bankers in a more dilutive public-public deal, as they do a great job of convincing analysts and Wall Street generally to support the deal. Net-net, using bankers, while costly, is good "litigation insurance."

If you are a buyer with significant market share, advance planning on how to manage the Hart-Scott-Rodino (HSR) antitrust review process must be part of your strategy. Again, bankers can help there, by being an independent source of market data. It is often very surprising what the antitrust authorities (the DOJ and the FTC) care about. One issue that is often in dispute is the proper definition of the relevant market; different industry participants will lobby the DOJ for different definitions, as it may help their subsequent acquisitions, or prevent a competitor from making an acquisition, as the case may be.

The role of the board is to keep management focused on running the business, and not being distracted by the glitz of buying companies. You can only buy a business if you are in a position of strength, with a strong balance sheet, revenue growth and profitability. Help management understand it cannot "acquire" its way out of a problem, and that most mergers are problematic and don't generate a good financial return, and that buyers often overpay, overlook strategic fit problems and underestimate integration issues. Also, help management understand what the goal of an acquisition is, in terms of technology, sales channel growth, or other objectives, and make management demonstrate how that goal will be achieved. The board must also be objective about the deal, and be sure that the parties' negotiations and positions are such that they are driving towards getting a deal done. In other words, help management walk away from deals that are unlikely to be consummated. Bankers can play a big role in picking out deals that may fall apart and in having blunt conversations about deal status.

In the board's review of a potential acquisition, it must ask the tough, high level questions. Is there a vision match, are there end user benefits, is there a good strategic fit, will this deal help the buyer, what are the channel synergies and integration risks? If there is substantial product overlap, even harder questions must be asked about product integration and transition paths; it can easily take 2 years to work through substantial product overlap issues.

Experienced board members with extensive M&A experience can often be very helpful in helping an inexperienced management team sort through the soft discussions as to vision match, HR issues, and integration plan optimization, as those issues often are best resolved based on intuition based on deep experience.

The board must help management walk away from deals that don't make sense. Parties tend to become psychologically involved and emotionally invested in deals. The Board must help management to overcome this tendency, and instead be very clinical in evaluating each deal. The Board should do a reality check post-negotiation and ask: if the terms we are now discussing were in the original proposed terms, would we still have proceeded with this deal? If the answer is no, then perhaps walking away is the best course. In particular, the Board should insist on walking away from any deal that offers no tangible end user benefits. A party's ability to negotiate deal points will always be optimized if it is willing to walk from a deal that ceases to make sense. The media is often critical of broken deals, but in fact many deals break because board members properly ask the tough questions and determine that the transaction they are considering does not make sense. If strategic fit is critical to a potential acquisition, make sure you understand what you are getting. There are a number of M&A deals, both large and small, where it is clear in retrospect that the buyers' management either did not understand, or did not drive the

integration process so as to fully capitalize upon, the key expected strategic benefits.

The buyer's board must ask "What does "success" look like in 6-12 months after closing, not just as to accretiveness, but in terms of user benefits of the combined product offering and impact on overall product strategy?" Indeed, achieving alignment of views on a deal among the members of the board of a public acquirer is largely a question of having a clear strategy explanation so the board and management can articulate what success looks like. Some of that is intangible, but much of it is quantifiable.

Where buying primarily for strategic benefits, the buyer must also understand that, in the current financial market, it will not be given any credit for the strategic benefits of a deal, and that it will be penalized for buying a company that is losing money, because Wall Street currently only rewards deals that are immediately accretive. For example, if a buyer has a price/earnings (P/E) multiple of 30, and it buys a target that lost $10M last year, it should expect that Wall Street will ignore deal synergies and that its market cap will decline by about $300M (the $10M loss multiplied by its P/E of 30). So the buyer's board must run its valuation analysis both with and without synergies arising from strategic benefits of the deal, and try to pay the smaller figure. The lesson on that for companies that want to be acquired is, become profitable, so that this P/E multiplier effect works to drive, not drag down, your company's M&A valuation.

The buyer's board must make clear to management that it will be held accountable to deliver an acceptable return on investment (ROI) on a deal; 1-2 years is excellent, 4 years is too long. Product overlap, channel conflict or other integration issues are likely to erode ROI. Conversely, a rapid and effective integration, via capturing synergies early and having rapid management and product transitions, can boost ROI. Unfortunately, some of the hardest integration issues involve layoffs or changes in management-level employees, and while making these decisions quickly will speed integration, it is hard to do on an inter-personal level. The board should insist that management is clear about what is being acquired and why and submits an integration plan that is consistent with that vision. Boards must not allow management to merely pay "lip service" to integration, but should insist that management make integration a priority, assign high level personnel to manage the integration effort and hold management accountable.

Where a buyer has worked hard at building an internal firm chemistry, culture and "DNA", it has to carefully consider whether a prospective acquisition will risk diluting or changing those cultural elements. In a similar vein, the buyer's board must carefully evaluate the target management team members who will become officers of the buyer—if they demonstrate they are serial negotiators, or lack candor, that's an early sign they won't work out and it brings the deal into question.

Conversely, buyers must focus hard on retention issues. The buyer must do what it takes to incentivize the target's team to remain with the acquired company. The buyer should avoid taking actions (like insisting on immediate relocation) that inadvertently disenfranchise and demoralize the target team. The induction process should be designed to make target employees feel welcome, encouraged and empowered with enough independence and resources to take a productive role in the integration effort and to help drive value for the combined company. If a buyer loses the target's core team members, it is likely that the maximum deal synergies will not be achieved. The buyer must also be careful to avoid antagonizing the target's executives and key employees early on by over-negotiating employment and non-compete agreements, as that may make them determined to leave as soon as possible, which is likely a mistake, as people are a major part of the assets acquired in any technology deal.

Specific Considerations in the Internet and E-commerce Space

Relative to the criticality of a strong focus on retention issues, the Internet space, for example, is a war for talent. The biggest issue is which company can produce a prodigious amount of code with product release cycles that are weeks, not months or years, long, as required to have the product development and deployment cycles necessary to stay competitive. Winning the talent war is critical to success, so a company must remain intensely focused on having the best engineering talent, and a production/management function that is also engineering-oriented, because winning market share is not a function of marketing/advertising but a function of word of mouth from satisfied users. Given that, in an acquisition scenario, if the deal doesn't justify itself purely based on finances and economics, then the buyer's board must dig deep to understand the defensibility of the target's products and technology, the nature of the target's talent pool and the buyer's ability to retain the key target employees post deal.

In the Internet and e-commerce space in particular, it only makes sense to do acquisitions if the deal will bring clear end user benefits. It is best if an internal champion for the deal can explain the logic for the deal in terms of user benefits for customers at large, not in terms of synergies as to top or bottom line growth or other such "clichés". If the user benefits are well understood and agreed upon, then the deal will often make sense because price becomes somewhat secondary in that situation.

Many acquisitions in this space have been done and are done to build market share. But there are many examples where companies, especially two young companies, have tried to combine to gain market share and it doesn't work out, as the net effect is a lot of dilution and poor execution because management can't manage two sales forces, two engineering forces and R&D on two production lines built on two different platforms and make all that complexity work. It's hard enough to manage one company, let alone two merged together. Board members need to learn from these hard experiences and advise young companies' management teams accordingly.

The history of acquisitions by larger public companies in this space (for example, in deals intended to fill production holes or to add additional network functionality) suggests that a good rule of thumb is, only do deals that truly add end user benefit; if they don't, don't do them – every other consideration is secondary.

Evaluating Selling the Company

If you want to sell your company, first focus on becoming profitable (or at least on demonstrating a path to profitability) so the buyer's P/E ratio can be a driver of your deal valuation, and so you can better position for an IPO and M&A alternatives. Running the business for long term success and ultimate profitability, not looking for a quick flip, should be your driving force. If management focuses on building the company and its products and processes, and drives toward profitability, then M&A opportunities will be a natural byproduct of that effort. If management of a young company starts with idea that it will be acquired rather than build a great business, then it will not do a good job of building the business. If profitability can be achieved, then the target can pick the best time to maximize valuation in a sale, rather than having the timing be dictated by the lack of operating capital.

There are a number of factors that will persuade a target's board that it is time to sell. For example, if you are a public company, but you are having trouble growing revenues or increasing your market cap, or there is consolidation in your market segment, or if the board has concerns about the ability of the current management team to bring the company to the "next level" or to take it public, it may be a good time to sell. To some degree, from a VC's perspective, an IPO should be the exit of last resort, as the VCs lose their liquidation preferences in an IPO, so VCs are often better off pushing the company to be acquired at a discount to a public company exit valuation. If a board wants to position a company for sale, sometimes it is useful to bring in an outside change agent (which could be a new member of management or a consultant) who helps focus the company not just on running the stand alone business well, but also on creating a value proposition for a potential buyer. This can include tuning the company's message and vision to the investment community and/or to potential buyers, for example via a secondary public offering.

At the beginning of deliberations on a deal, the board won't be of one mind; it must work to achieve consensus and that is an important part of the process. To do this, have a number of private sessions without management, and evaluate the company's operations, competitive position, management's leadership abilities, the company's prospects, and so forth.

Obviously, the board must consider whether remaining independent is a viable strategy. If the board believes strongly that a proposed valuation is unfair in light of prospects and an operating plan in which the board has confidence, then maybe the best option is to pass on the bid and remain independent.

When a target starts considering strategic alternatives, first it must consider whether strategic partnerships would be a good substitute for an M&A deal. Sometimes, partnership or financing discussions quickly flip to an M&A discussion and help position the strategic benefits of the target to what turns out to be the buyer.

To identify the bidder most likely to pay the most, the target must identify the potential buyers to whom the target brings the most synergies. If a buyer is driving to dominate a market segment, or views the synergies of a deal differently than other potential bidders, it may be motivated to make a preemptive bid that far exceeds what other bidders will

offer. The trick is to identify that buyer, and again, bankers help with that.

Obviously, a public company looking to be acquired must seek to generate multiple bids. Factors that can be considered in evaluating multiple bids can include: deal value, premium over trading price, strategic fit, which deal would deliver the best value to stockholders and which deal would provide the best result for employees. Even if an excellent price is obtained and a model (albeit not perfect) process is followed, however, litigation has to be expected where the target is public.

During the M&A process, a good board member will help identify and evaluate strategic alternatives, ask the right questions and insist on a good process and a fair valuation. Where a preemptive bid is obtained, and the private target is closely held, the risk of litigation is low, so there is less pressure to shop the deal, consider strategic alternatives, or obtain a fairness opinion, although all these factors are important in demonstrating compliance with directors' duty of care.

Where a private target does not perceive there to be a logical acquirer, and it faces an uncertain long term future as an independent company, for example due to the prospect of increasing competition, lack of funding and lack of revenue momentum, the "stay independent" scenario is much more difficult for the board to evaluate and it is much more difficult to determine the right time to sell or the right method of conducting a market check. This is particularly true where the only logical buyers are current or potential competitors, who might be tempted, despite an NDA, to start rumors about the company being up for sale or "non-viable".

There are many financial metrics that a target board can review in deciding if a particular deal value is "fair". It must start with a review of how the company is valued today by the market and by the acquirer. The bid's premium to the trading price is most important, as that's the metric that target stockholders care most about; if the deal premium is substantial, the target board must be open to doing the deal for the stockholders' benefit. In evaluating the premium, the target board can't just dismiss or minimize the target's trading price on the theory that it is undervalued. The market is fairly efficient in terms of trading price over the long term and believing otherwise can sometimes just be a lack of clear thinking. In evaluating whether a premium is sufficient, it's important to look at the big picture—what is the history and long term prospects of the company, how successful has it been, what is the board's confidence that the company can perform against its current operating plan and strategy and that doing so will drive stock value? Is management committed to and excited about long term prospects? In evaluating whether to push back hard on the buyer to increase the premium, the board of a public target must understand whether the buyer viewed its bid as preemptive—if so, and the target demands 50% more, for example, the buyer may walk. Conversely, setting a record of incrementally moving the premium up through negotiations is critical in terms of litigation "insurance". Don't get too caught up in individual metrics; instead, view valuation as a whole, taking into account the company's challenges, opportunities and prospects, the risks it faces, the impact of industry consolidation, and so forth.

Parties should only do the deal if they perceive that the target's management is committed to the combined company's success and to working through the painful integration process and that the buyer's management is also firmly committed to the deal and to creating a compelling value proposition to the end user, even if that requires changing direction, or making difficult product, technology or personnel decisions. Much of this persuading of each party's intentions must be done on a CEO-to-CEO basis, but sometimes board members can play a key role by helping to establish credibility and comfort and thereby driving deal valuation.

Where the sale of a young public company is being considered, the board needs to manage the expectations of founders, who probably already have sufficient liquidity and no longer need to sell for financial reasons (and who may view a sale as inconsistent with their long term vision for the company).

One problem that arises when attempting to sell private companies that have a large liquidation preference in favor of VCs is that there is little deal value available for common holders and employees—the buyer may force a recapitalization to re-allocate merger proceeds, or put some of the deal value into employment agreements, to ensure that continuing employees stay motivated. This can be a difficult issue for the target board.

Sometimes, a target's prospects erode to the point that it is insolvent, or embroiled in litigation, and it cannot be sold as a whole, but only sold in parts in an asset sale. Buyers are showing an increasing tendency to buy just the technology and people they need to avoid these liability issues.

However, the valuations in these asset deals tend to be very low.

Certainty/Valuation Tradeoffs

Directors' fiduciary duties generally require that the directors evaluate available strategic alternatives and in some circumstances directors must "shop" the company to get the best deal valuation reasonably available. But buyers, at least of a private target, will typically insist on a "locked deal" (where closing is essentially assured upon signing, such as through concurrent voting agreements) as a condition to putting best bid on the table. Often the target directors will agree to "lock" the deal to some extent to give the buyer deal certainty, and in exchange the target will demand a higher valuation and eliminate much of the buyer's ability to "walk" from the deal based on open-ended closing conditions, for example. Directors are often concerned about the risk of being sued for making this tradeoff, as it may preclude their consideration of a subsequent unsolicited bid. The case law in this area gives directors guidance as to the extent to which they can "lock" the deal, and the extent to which shopping is required.

Target directors must be careful not to agree to a "no shop", or to otherwise "lock" their deals, too soon, because the key to maximizing deal valuation is to maximize negotiating leverage, which is largely a function of having multiple bids and other viable alternatives. The leverage of multiple bids helps both in maximizing deal valuation and the liquidity of consideration and in ensuring, on the private target side, that indemnity and escrow provisions are not over-reaching.

Time is not your friend in an M&A process. A deal rapidly gains momentum and hard decisions often have to be made very quickly. So you need to be ready to act when the decision point arrives. The target board must understand its alternatives in advance, and must have reached consensus as to whether the board would accept a bid at a certain valuation point. All of which suggests that directors should complete as much "shopping" as is possible before agreeing to sign a "no shop" agreement. On the other hand, if a target starts the shopping process too early, it might end up with a reputation as being stale and damaged goods. Ideally a public target sets things up to obtain a bid, and then have time to do a quick and efficient market check--that sets the best record. Bankers and skilled M&A counsel can guide the target's board on what level of "no shop" and other "device protection" (like break up fees and forced vote provisions) the target board can properly agree to. Keep in mind that there is no such thing as a perfect record; the board must simply do the best it can and act in good faith and in all stockholders' best interests.

Liquidity vs. Valuation Goals

There is a tradeoff involving deal currency that could be viewed as both a certainty/valuation tradeoff and a liquidity/valuation tradeoff. For example, you may receive a higher bid payable all or in part in stock and a lower, all cash bid. In that case, the board must carefully evaluate the stock currency offered. Bankers can obviously play a crucial role in this analysis. Venture capital funds will generally push the board to sell for cash (or at least readily tradable securities) to be able to distribute immediately to their limited partners.

It may well be appropriate to turn down a higher stock bid for a lower cash bid, due to concerns about the volatility of, or the downside risk inherent in, the stock currency, particularly if the stock is subject to legal or contractual resale restrictions, such as volume limitations. However, if a target accepts cash to obtain immediate and complete liquidity, it loses the upside of the synergies of the combined company, so there should be a higher deal premium. A downside of taking cash is that the board has a clear obligation to shop the company and get the best price reasonably available, so there is greater risk of being second- guessed in litigation as to the lost benefits of additional shopping.

Conversely, the target's board may properly be focused on the appreciation potential in the buyer's stock, where the M&A deal offers considerable synergies and upside, and take the lower valued stock deal (so long as the stock is freely tradable even in light of applicable volume limitations), but this conclusion is also subject to being second-guessed in litigation. Examples where taking an all stock deal over a more highly valued cash, or cash plus stock, deal paid off well are the Junglee/Amazon deal, in which the stock appreciated almost 5x between signing and liquidity, and the NexGen/AMD deal, in which the stock appreciated about 4x over the months following the deal. These examples suggest that where the target board has the capability of assessing both the upside and risks of taking stock currency, it may well be prudent to take an all stock deal. Board members should keep in mind, however, that as fiduciaries, the proper question to ask is, what is the shareholders', not the board members', risk appetite.It is risky to take a higher valuation in the form of the stock of a young public company. Recent events have demonstrated

that bad things can happen quickly, with an immediate downward impact on the buyer's stock price. So the target must conduct diligence on the public buyer to get a sense of the risk inherent in the buyer's currency. This request for "reverse diligence" will often come as a surprise to the buyer.

Perhaps the most difficult situation is where the highest bid is in the form of stock, but the buyer requires that the target's major shareholders (due to their large holdings in the combined company) agree on resale restrictions, say, for 90-180 days post closing; this presents a direct tradeoff between valuation and liquidity.Where the buyer is a large public company, and the stock will be registered as of closing, and its float is such that a large number of its shares can be sold without impacting the stock price, the buyer's stock currency is essentially equivalent to cash, in which case there may be no tradeoff between maximizing deal value and obtaining liquid currency.

There is tension between giving liquid deal currency and the ability to retain key target employees (especially given that retention is typically necessary in order to justify a stretch valuation). A standard approach on this is to use delayed payments via earnouts (which are inherently not "liquid" and work as a retention mechanism), in exchange for agreeing to bridge the valuation gap. Most VCs/preferred stock holders of targets will accept these earnout arrangements to get a higher valuation, but they will insist that any stock issued in the deal be freely tradable once issued. To increase the buyer's ability to retain employees, but again at the expense of "liquidity", the parties may effectively place some of the deal value into employment contracts in the form of vesting restricted share grants, which are a cash equivalent with less uncertainty than options. Another liquidity-impairing tactic is a "holdout" arrangement, where the buyer makes payment of a portion of deal proceeds contingent on achieving retention targets.

Pushing Management/Bankers

The board should coach the CEOs to pick good bankers and good M&A counsel.

The board should also urge the CEO to use every sales agent available—including the CEO, board members, bankers, and counsel, in a careful way to manage for the best result for the company, keeping in mind that CEO to CEO discussions are often the most effective. Sometimes, however, the board must help the CEO realize that bankers can more effectively position certain matters or even play the "bad cop". But as noted earlier, sometimes bringing in bankers too soon can prevent the parties from properly aligning their goals.

In general, the management team pushes itself very hard during M&A deals and it doesn't need to be pushed so much as supported and guided by the board. There are many stressful times during the M&A negotiations, such as where a diligence point threatens to kill a deal, and board members should try to be a calming influence.

It is critical, as a VC and board member, to keep management focused on the business rationale for the deal, the integration and PR aspects, and strategic and cultural fit issues.

On the sell side, try to keep the deal team as small as possible, so the rest of the team can stay focused on running the business.

On the buy side, if you are buying a company for its product line, you have to work hard to keep the current product team motivated, as they will feel under-appreciated and at risk. When dealing with personnel integration issues, particularly when exacerbated by earnouts, the buyer must not tolerate any employee resentment or lack of teamwork—the message must be, either you are on the combined team, or you are out. But when that means terminating a long time, loyal employee, that is a difficult task for any director or officer.

Certainly, if the target board does not have confidence in its management team's ability to get the deal done, the board needs to take action, or, in the extreme case, board members should consider resigning.

A key point on pushing bankers is to demand that they distribute banker books in sufficient time to give the board time to digest them. This is critical to demonstrating compliance with the directors' duty of care.

Litigation Concerns re Shopping, Lockups, Washing Out Common, Management Perks

The board of a public target should anticipate a lawsuit will be filed to challenge an M&A deal, and create a record, crafted by experienced M&A advisors, that will stand up to scrutiny.

M&A litigation is very frustrating. It is often clear that the originally-filed complaint has no basis in reality or fact. It

will allege that the directors did not shop the deal and did not consider a stay-independent strategy, even if in fact they did both. Further, plaintiffs' counsel will threaten to seek to enjoin the deal for lack of adequate proxy disclosure, even if the facts do not justify that, in order to increase their settlement leverage. Nevertheless, plaintiff's counsel should not be underestimated.

Plaintiffs' counsel try to focus on an inadequate DCF analysis, as it is easy to second-guess the assumptions that underlie that valuation, and that methodology normally overstates the value of technology companies, whose future revenue streams tend to be difficult to predict. The DCF method also ignores the costs and risks of building out the sales channel.

The target should also make sure that the buyer understands that litigation challenging the deal is likely and insist that the buyer not have a right to walk if private party litigation challenging the deal is filed or settled. On a related point, where buyers insist on a "locked" deal, thereby exposing target board members to a suit for not shopping enough or for signing a lock up too early or for breaching their fiduciary duties, target directors should insist that the buyer indemnify them that buyer-induced litigation risk.

Board members must take their fiduciary duties very seriously, not just because of the litigation exposure, but also because of their responsibilities to all the levels of stakeholders, which include stockholders, debt holders and employees.

Sorting out (particularly VC) director responsibilities can become particularly difficult in evaluating a proposed merger in which the valuation is so low that common stockholders will realize nothing due to the liquidation preferences of preferred stockholders. In that case, the board and majority stockholders must strive to structure an M&A deal that is best for all stockholders, which can often be a challenge. The litigation risk in this situation is heightened if there were earlier "wash out", "cram down" or "recap" financing rounds that heavily diluted the common without giving them an opportunity to invest pro rata.

Recent cases make clear that directors must be sensitive to the optics of management benefits in M&A deals. Directors should only approve management arrangements triggered upon a merger or change of control if they are consistent with the notion of improving stockholder return and they are justifiable based on comparable arrangements at other companies. Similarly, CEO compensation generally should be set so as to align CEO compensation with increases in stockholder value.

On a related litigation point, in the medical device space, many companies are faced with terrible press coverage on occasion, such as a patient death--it is critical for such events, and even related litigation or regulatory actions, to be excluded from the definition of a "material adverse change" that would otherwise allow the buyer to walk, because, in fact, such developments are just a risk of doing business in the medical device and drug fields.

In the end, every deal involves litigation concerns. Hire good M&A lawyers and good bankers, and run a good board process, to minimize the risk. But as a board member, a VC, or a member of management, that can't be the focus—the focus has to be on building value. If you've run a good process, you should be able to have any M&A litigation dismissed outright or for a nominal settlement amount.

Sometimes, buyers become overly conservative in terms of wanting to be indemnified even for known, fully disclosed risks of potential litigation against the target—sometimes a target just has to be willing to walk from merger negotiations, or at least threaten to do so, to induce the buyer to back down on unreasonable indemnity demands.

There is a concern that, with SOX and the threats of plaintiffs' strike suits, companies will become so litigation adverse that they will lose sight of running a business, and it will become increasingly difficult to operate as a public company. Since VC business models depend on the availability of IPO exits, this is a real concern.

Evaluating Wall Street Reaction

On the buy side, where the deal is dilutive, the buyer must justify the deal's benefits and guidance impact to Wall Street, and explain how it has managed the integration risks. This takes time and resources, which gives large public buyers a decided advantage over smaller public buyers in selling deals to Wall Street.

On the sell side, if a deal involves a substantial (say, above 50%) premium to the trading price on the day before the deal was announced, most target stockholders will be pleased with the high premium. They will often take that as an opportunity to lock in the gain, and sell to arbitrageurs, who understand the small risk of the deal not closing at that

high premium and trade on that risk spread. Knowing that market dynamic, however, the public parties need to be sure to highlight and clearly explain all the closing risks in their public filings, since Regulation FD prevents them from taking calls from individual stockholders as to closing risks without making related public disclosures.

Wall Street seems a bit nervous right now, more so than last year, and that translates into a more difficult M&A environment. Some of that is a predictable reaction to the uncertainty and costs around SOX compliance, which should decline substantially next year as the SOX process become more systematized. Nevertheless, a buyer can still sell a good deal to Wall Street today, if the target has demonstrated good growth and profitability and has a strong management team. In the end, Wall Street's reaction is a good barometer of real value. Currently, however, Wall Street places far too much emphasis on short term results, and has far too much concern about factors that drive short term volatility, such as reaction to current events.

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