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Highlights from IVCA Toolkit: ‘How to Assess Risk and Returns When Selling a Portfolio Company’

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CHICAGO – Negotiating the sale of a portfolio company has always been complex and time consuming with terms being revisited even post-sale. Contractual obligations ensuring that things are as presented backstopped by escrow accounts or third party apparatuses. The IVCA Toolkit presented on November 15th shed some light on buyer behavior post-sale to provide insight on how these complex negotiations ultimately were resolved through the escrow process.

Three stakeholders of those selling points came together at the Toolkit event a Shareholders Rep, Paul Koenig – Managing Director of SRS | Shareholder Representative Services, an attorney Rob Verigan – Partner at Sidley Austin LLP and a venture capitalist, Chris Girgenti – Managing Partner of New World Ventures.. These representatives presented a comprehensive overview of many situations that must be negotiated during and after the sale of a company.

The program began with charts showing the trends of company sales. One chart showed how companies are staying in longer with investor financing rounds before existing, both in number and dollar amount in each round. This has created an environment which allows buyers to be more selective in which companies they acquire. The other chart showed how all-cash deals are increasing as interest rates are dropping; a trend away from stock buyouts.

The following is the take-away statements from the Toolkit, with each panelist offering their unique point of view on each of the topics they introduced (highlighted below) on assessing risk and return when selling a portfolio company.

Common Bases for Post-Closing Adjustments

- Purchase Price Adjustment
- Indemnification Claims
- Earnout

Rob Verigan: The purchase price adjustment is more of a mechanical process, a huge substantive balancing of risks and returns, particularly if you’re financing a deal. Often times you’re financing with some aspect focus on working capital. It’s the hardest area to cover from a legal perspective. If I’m worried about long term liabilities, that area is a little easier to get comfortable with, because I can track what you’re doing with operating covenants between signing and closing.

Addressing Cost, Credit and Control Risk for Adjustments

- Holdback
- Guaranty
- Escrow

- Promissory Note

Verigan: Escrow is the most commonly used device to share these risks, while it adds a little cost of implementation, most escrow agents have gotten to the point where they can execute these very quickly and efficiently, and they tend not to be high-cost arrangements to put in place. It takes the credit risk out of it for the most part and at least levels the playing field on control if there is a dispute.

Chris Girgenti: The goal here is to minimize what is held in escrow, minimize what can be held against you in escrow and minimize the term of the measure. I've found that what they shoot for in escrow is 15% of purchase price, and usually periods of 18 to 24 months. I want third parties to be holding the cash, and I want mechanisms for process and at least know that there is a high likelihood to be heard and getting the cash out.

Paul Koenig: Our experience is that there are a couple large buyers that insist on hold-backs, but in general that is rare, it is 90% percent escrow.

Verigan: Deal insurance is also a tool. Sometimes this third party can cover a specific issue or just generally reps and warranties in a deal, which can be a great bridge, it really comes down to costs. It's not necessarily a replacement for other indemnification tools, but may be as a backstop.

Koenig: When we do see deal insurance, we tend to see it for a specific purpose. Sometimes they need a certainty, for example, that under no circumstances will there be a claim in excess of the escrow at the end of a deal. So a seller will put in for the 15% of purchase price escrow, deal insurance on top of that, but that's it.

Other Purchase Price Adjustment Considerations

- Basis of Agreement
- Initial Statement Preparing Party
- Thresholds and Collars
- Third Party Input/Dispute Claim
- Interplay with other Claims

Verigan: When you think about the baseline - which you're adjusting to - we always try to make sure you're comparing apples to apples. Obviously you need to pick what your threshold is going to be, but also how that is going to fluctuate over time in a way that is meaningful or not meaningful.

Koenig: It's a big deal when claims are made - whether it's a purchase price adjustment or an indemnification claim. If your challenge is that the buyer's financial statements were not in accordance with GAAP, that needs to be brought as an indemnification claim, not as a purchase price adjustment. It's important that you think about this in the context of negotiating the deal.

Transactions that have working capital adjustments are just as likely to have indemnification claims after you get through the working capital period, as if there had been no working capital adjustments. So once you work through the working capital adjustments, there is still not clear sailing.

Under the Basis of Adjustment, pay close attention to non-cash items. We will see merger agreements that sometimes say working capital equals closing assets minus closing liabilities, consistent with the seller's past practices. In my view, that might be an arcane definition, but before you land there you need to work with the CFO and the chartered accounts and say, 'Walk through me the eight things you have in current assets, and the 12 things you have that are current liabilities. Let's go through them line-by-line and then you tell me if it has an impact on the value of the business.'

The ones that we've seen that are big problems are deferred tax assets and liabilities, which are non-cash and have no impact on the value of the business. We have had working capital adjustments come in where there has been a half million dollar purchase price adjustment for a reason that is technical, but not practical. And we told the buyer, "you know and we know its a non-cash item, it doesn't impact anything, it's accounting fiction". And their answer was - and they were right - go read the definition that says pay close attention to non-cash items.

Key Indemnification Considerations

- Size of Claim Limitations
- Other Limitations (anti-sandbagging, role of disclosure schedules)
- Survival Period
- Control of Defense of Claims
- Definition of “Damages”

Verigan: Anti-sandbagging is when the buyer knew something so they can't bring a claim. Whenever we're arguing against that type of provision it's just fodder for litigation, it's a way to come in and conduct reverse discovery. When we're arguing for that provision it's just the epitome of fairness. [laughs]

Under “Control of Defense” of claims, a buyer may defend more or less aggressively than a seller would, depending on where they are in the transaction, and how critical that claim is to ongoing business.

Under definition of “Damages,” if you are a buying a more mature business at a 5X multiple, and then you realize that there is a problem with something that has an impact of two million dollars on EBITDA, it's not clear under the typical formulation if that's a two million dollar claim or the way you priced the deal whether that ought to be a ten million dollar claim.

Koenig: We've been involved in some disputes that are exactly that issue. If it's not spelled out in the contract, you're going to end up in court. The parties won't split the difference on that one. We have to get a judge to tell us which one of us is right.

Girgenti: If you are going through a transaction, if you're a business owner, it's probably a significant event in your life and the life of your company. It's worth hiring specialists, somebody who has been through this a fair number of times, and knows what to expect and can negotiate on your behalf. That can significantly reduce your risk and your worry as you go through the process.

Koenig: One of the interesting things we found in our study of the Survival Period is continuing a trend of going up over time. The study we did just last year the average was 15 months, this year it has increased to 17 and a half months. So the length of time is increasing and the amount of money at risk.

Girgenti: All of this is negotiable. We had a transaction where we were able to negotiate the escrow to five percent of the purchase price. They started at 15, we got it down to five. It was interesting to see how flexible it was from the buyer's perspective. It does depend on the circumstances. Also if you know you're going to sell, there are many preparations you can make in anticipation of selling.

2011 SRS M&A Post Closing Claims Study

- Frequency and Magnitude of Claims
- Impact on timing of releases

Girgenti: Most of the time it goes smoothly, but when it goes bad it tends to go in a really bad way. Some of that is knowing the history of your buyer. If you're lucky enough to have choices out there as to who your buyer will be, look into how they behave when they are making their transactions, which is good information to have as you're making your decision.

Koenig: One thing I've experienced is that you can't read too much into how buyer behaves through the negotiation phase. There are buyers that will just beat the hell out of your during the negotiation phase, but then they never bring a claim. Their philosophy is that they're trying to figure out a way that we don't need to bring up a indemnification claim. If they need to bring one, it's because something has screwed up. They were just trying to find that all early. Other buyers can be exactly the opposite.

Resolution Issues

- Defending Indemnification claims takes time
- Claims were frequently paid out, but at a reduced amount
- Impact of dollar baskets

Koenig: Statistically, four percent of deals with a claim end up in arbitration. Which doesn't sound like much, but if you are the individual that is named as the shareholder representative in a lawsuit, it can cause personal problems.

Baskets are better at deferring claims than reducing claims. Deals with first dollar baskets had more than twice as many claims. The reason for that is if you have a tipping basket, that means if you meet the threshold the buyer gets to recoup all of his losses. It's just not economic analysis, it also impacts how much work you're setting yourself up for after closing. Because if you agree to one of these tipping baskets, you're going to get more claims for the buyer, which means more stuff on your plate to think about.

Intellectual Property Claims

- Patent trolls are becoming more common
- Those trolls are not the most common type of claim, but tend to be large and take long periods of time when they do hit
- Tend to come early in the escrow period, if at all
- Carved out from baskets, caps and survival periods 20 to 30% of the time

Girgenti: We're seeing these outside of transactions where you've got people buying up patents and filing lawsuits against companies. It's an interesting business, because most companies want to pay for it to go away.

Koenig: If you have a patent troll claim come in, and the buyer has your escrow to make this troll go away, maybe they will behave differently than you would behave. If they have a \$10 million dollar escrow, and can make this patent troll go away for \$2 million, why not? But we on the sell side might say there is zero merit to this thing, and we shouldn't be paying anything.

Buyer information - Impact on Claims

Verigan: What we've found, on average, is that public company strategic buyers will bring fewer claims than financial buyers. Some of the answers are that sometimes big company buyers just get things lost in the overall machine. This study is based on about 150 deals studied with admittedly few transactions including a financial buyer.

Key Earnout Considerations

- Basis for Targets
- Earnout Structure and Time Period
- Input in Ongoing Operations
- Third Party Input/Dispute Resolution
- Buyout Rights
- Tax Treatments

Verigan: Generally speaking, for a buyer, earnouts are a way to get a deal done. The seller wants it all in the purchase price. You have to pay attention to what the measures are, and making sure that it is ultimately achievable.

Koenig: We're seeing an increase in the number of deals with some type of financial test. There are two reasons. One, if you're buying a business and their financial performance matters, then you are more likely to have one of these financially based test as part of your earnouts. Secondly, we didn't see many earnouts outside of life sciences deals that is starting to change a little.

Escrow Agreement: Overview and Key Considerations

- Role of the Parties
- Payments Secured
- Investment Alternatives
- Length of Escrow and Release Mechanics
- Compensation/indemnification of Escrow Agent
- Exclusivity of Remedy

Verigan: The escrow agent is going to play Switzerland in the whole deal, and not do anything unless it is agreed by the parties as to how they're going to instruct the escrow agent. Unless they get joint instructions, they tend not to do much.

I think one of the most substantive points is whether the escrow is an exclusive remedy or whether the

buyer has the ability to go around the escrow and make direct claims against the sellers. In my experience, they tend to be an exclusive remedy, but it depends on the deal and it does depend who the seller is. From the seller's perspective, having the escrow as the exclusive remedy is pretty critical.

Girgenti: You should set up an expense bucket for the shareholder rep, as expenses come along the way, like legal expenses to defend against a claim. The point is you don't want to go after shareholders down the line to try and collect dollars to go into an expense bucket. If it's not used, it just gets distributed back.

Koenig: My only comment on this is there are no good investments alternatives right now. Banks don't want the money. Bank of New York toyed with the idea of charging for deposits. When you look at the alternatives you'll find five unappealing options as to what to with the escrow.

For more information about this IVCA Toolkit, contact Paul Koenig of SRS | Shareholder Representative Services (pkoenig@shareholderrep.com), Robert Verigan of Sidley Austin LLP (rverigan@Sidley.com) or Chris Girgenti of New World Ventures (chris@newworldvc.com).