Negotiating Exits with the Big Dogs: What Angel Investors and Entrepreneurs Need to Know

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These days, large companies' money is very green and their interest in tapping into entrepreneurial innovation is high. This creates an interesting exit environment for angels and entrepreneurs who want to sell.

"This can be some of the most fun that entrepreneurs and angels have," says Basil Peters, principal of Strategic Exits Corp. "Big companies' interest in acquiring startup companies has been changing for about a decade," he says, "starting after the tech bubble burst and the IPO market went away. It's been accelerating over the last five years."

Peters says that large firms want to buy companies for $20 to $30 million, primarily for the people and the technology.

"It used to be that the best and brightest went to work for big companies," he says. "Now the best and brightest are going to work in the startups. They are the ones doing the innovating. The big companies are figuring out that the combination of entrepreneurs growing companies from small to medium and big companies knowing how to grow from medium to large is what works."

But before trying to dance with the so-called "Big Dogs," it pays to prepare.

Big Dogs are big and have their own corporate cultures concerning acquisitions

"Large companies have more money, more lawyers, and often less time pressure," says Peter M. Rosenblum, senior partner at Foley Hoag LLP in Boston, MA.

"They've done prior acquisitions," he says. "They will perform a lot more due diligence. They will want to turn over every rock and look at every piece of information that pertains to the target company, and they have an army of people to do it. They can overwhelm the small company and angels with their staying power and resources."

A lot depends on why the company is being sold. If the startup is running out of cash or if the investors and/or management team don't want to sustain it, that's one thing. If the Big Dog is coming in with a preemptive offer for a company that is thriving and cash positive, that's something else.

"In the first case, time is on the Big Dog's side," Rosenblum says "They can keep making demands and squeeze the little company. In the second case, the large company is likely to be more eager. There may be a bit more balance because they have a reason to get the negotiation done and will be pushing at it."

Large companies have different cultures that will influence the way they negotiate. They will likely be ingrained in their own procedures.

"Some companies have such a culture of winning that it's almost as if people get paid to win points," Rosenblum says. "Those companies will keep coming up with new points, re-trading the deal right up to the very end. They will blame it on things they find in due diligence when in fact they are re-trading because they can. Don't expect that the deal or process manners will cause them to stay with the deal proposed."

Other companies are very straightforward; what you see is what you get.

"There are companies that have a formula for doing deals. That is how they've done it in the past and how they will do it again," says Rosenblum. "As long as you are willing to operate their way and proceed along their path, it is a pretty straightforward process to closing."

Entrepreneurs and angels may receive a higher price in such transactions with the condition that they must do the deal the buyer's way. "If you are willing to do that, you make extra money," Rosenblum says, "They will pay for the privilege, but you don't get much slack on the terms."

Understand the buyer's motivation and know the players
"The company the entrepreneur is selling is not the company that purchasers think they are buying," says Rosenblum.

"For angels and entrepreneurs the priority with the startup company is usually building revenue and developing a market," he says. "Big companies' motivations are totally different. To move the needle, they need hundreds of millions in revenue. They are buying the small company to get a strategic piece of technology, a key product, the management or development team, or to preclude a competitor. They will pay up for those things."

Most big companies have teams to do their mergers and acquisitions work.

"People in large companies that buy other companies are generally very good at it," Peters says. "Their job is to get the best deal, the lowest price, and best terms for their company and to make sure that no one else is bidding against them because that isn't compatible with the first two."

The small company needs to figure out whether or not the people it is dealing with are authorized to do a deal. The division head at a trade show talking up a deal may just be trying to gain competitive information.

"Not everyone at these big companies has the authority to do deals or access to the dealmakers, even if the business card looks impressive," Rosenblum says.

"You also may have someone who doesn't carry a big title but whose boss has an acquisition budget of $6 billion," he says. "The best deals have a champion at the big company in a powerful position. Look for high-level sponsorship and stay close to your sponsor. Sometimes a deal happens just because of that."

The Big Dogs have an M&A process; the small company must create one
"Due diligence will be exceptionally searching and time consuming," Rosenblum says. "You can't just say to yourself, we have a nice clean little company; it will sell easily. You have to set processes, establish a data room (electronic is preferred), and put someone in charge of it. You have to figure out how to keep company operations going without interruption."

Small companies should anticipate that there will be a corporate clean-up either before diligence starts or in response. Having thorough and up-to-date documentation is important.

"In every situation that I've been close to, the buyers ended up knowing more about the company's financial performance than the management and board did," Peters says. "It's important to have a team; no one person can embody all the things you need. If the CEO tries to do it alone, he or she won't realize how much work it is, and the company suffers well before the transaction is complete. You have to task the right resources if you want to get it done."

The Big Dog will review the patent portfolio and other intellectual property and will be very concerned about the small company's freedom to operate its business and about its use of open source software.

"Big Dogs don't want to be embarrassed," Rosenblum says. "They will do an extraordinary amount of due diligence on technology. They come in with a huge team and find things that a small private company wouldn't worry about."

The large company will scrutinize the small company's relationships with partners, suppliers, and even customers.

"If they don't have relationships with the same entities or if some of your business relationships are with their competitors or inconsistent with their policies, you may be in a situation where you are forced to terminate part of your business before the deal closes. You will need a strategy to deal with this," Rosenblum says.

Keeping exit discussions confidential from premature (and upsetting) disclosure to employees also requires process and in the long run may not succeed.

"Most of the time, the right thing to do is to tell people relatively early in the process," Peters says. "If you don't let them know, they will hear from the internal grapevine, which works better than most CEOs think."

Terms of the Deal Documents - non-disclosure

"In the non-disclosure agreement, limit the prospective buyer to talking only with individuals specified by the Board of Directors," Rosenblum says. "Even under non-disclosure, there are things you won't share regardless-trade secrets, the source code to your software, et cetera. Once having seen these things, they could go out and replicate or invent around them."

To perform diligence on these, the small company can bring in a third party expert who signs a non-disclosure agreement (NDA) with both seller and buyer. There are consultants in every industry who do this work. They will typically require a hold harmless clause from both parties.

The large company must be precluded from soliciting the small company's employees. The last thing a small company wants is for the Big Dog to decide not to buy the company and then hire all the good people away.

"A financial buyer wouldn't do this," Rosenblum says. "A strategic buyer could and would. This also should be addressed early in the process in the non-disclosure agreement."

Terms of the Deal Documents - limitation of liability
Large companies may seek to avoid any limits on indemnification or recourse against the sellers or to postpone the time for determining those limits until they have more negotiating leverage.

"Ordinarily, I won't let a client sign a letter of intent without a limitation on liability for representations, warranties and indemnification," says Rosenblum.

"The Big Dog will say they can't set a limitation without doing due diligence," he says. "The answer to that is that there is a market, which we all should know, and standard liability limitations. I tell them that if we find something particularly onerous in due diligence, we will make an exception, but that's no reason not to establish overall liability limitations between 10 and 20 percent of the purchase price in the letter of intent. That way, the sellers know they can count on 80 to 90 percent of the purchase price free and clear."

Terms of the Deal Documents - earn-outs, agreements with employees
Sometimes Big Dogs suggest earn-outs.

"Always walk away from the closing table with the minimum amount of money that you would have taken for the entire business," Rosenblum says. "Don't assume that an earn-out will work. Take the earn-out as icing on the cake and be realistic about what you are going to get. Once the deal is done, things change. Maybe you have a great relationship with the executive who bought your company, and that executive is promoted. His or her replacement isn't as interested, or might not even like you. Maybe the new business is integrated with one of the large company's other businesses which makes it difficult to figure out what the business really earned."

Negotiate to have any earn-out based on revenue, not profit. "It's almost always the case that both companies are aligned to grow revenue," Rosenblum says. "As to earnings, the picture becomes more complex. Large companies spend money that doesn't produce revenue because they are in it for the long term. And then there are corporate expense allocations that can bury a small division."

All big companies have forms and human resources policies. Employees in the acquired company will be asked to sign a stack of documents. "Don't sign anything until you make certain that you have everything there is to sign," Rosenblum says. "Documents could be inconsistent or even predatory."

Terms of the Deal Documents - exclusivity, bridge financing, and escrow
As part of a letter of intent or a purchase agreement, the Big Dog will want exclusivity.

"They will ask for a minimum of 45 days; some ask for 90," Rosenblum says. "Your angel-invested business isn't critical to all the things they are doing. These timeframes will really squeeze you, particular if the provisions put limits on fund raising while the Big Dog has exclusivity. That's why I try to ration the exclusivity. You start with a thirty day period and then, as the period comes to an end, see how much progress is being made."

If the two parties are close to an acceptable purchase agreement in thirty days, the company can always extend the exclusivity.

"Negotiate in an exception that allows you to raise bridge financing," Rosenblum says. "The small company doesn't want to run out of money just to do the deal."

Some portion of the purchase price is often set aside in escrow at closing to protect the buyer. Rosenblum favors escrows when representing sellers in certain situations.

"This approach runs a little counter to popular wisdom," he says, "but I want the escrow to be the exclusive and only place the buyer can go for claims for breach of warranty or indemnification. Exclusive escrow provisions are particularly useful in the angel environment. Angels have deep pockets and are not judgment-proof. "

Once an escrow is agreed to, the big company may want to hold back some portion of the agreed to escrow instead of putting the entire amount in an escrow account with a third party. Rosenblum says no go.

"Once the deal is done, it's the sellers' money, not the buyers' cash to use," he says. "The sellers should not have to sue the buyer to get their money. Rather they should be able to make a claim against the escrow for money already set aside by the buyer."

Keeping sellers' interests aligned

When the Big Dogs' focus is on the management team, they may be more interested in compensating that management team than in compensating shareholders. This sets up a potential conflict between management and stockholders, especially if the management team negotiates their own deal. It is not necessarily because anyone is badly intentioned, but more that interests aren't aligned.

"As a practical matter, make sure that you have outlined a deal first for the stockholders. After you have that deal set up, allow the key employees to negotiate their own deals-but only on a fully disclosed basis," says Rosenblum.

"It is important to get a letter of intent at a very early stage," he says, "so that the terms are established with the buyer before employees start negotiating their own deals. When there is a real conflict, the Board and company counsel should make sure that the employees have their own attorney."

Some companies have a carve-out plan or an acquisition bonus plan to pay the employees based on what the stockholders receive. That encourages the key employees to focus not only their own employment deals but on enhancing the returns to the stockholders.

The role of a mergers and acquisitions advisor or iBanker

"The strongest advice I have is don't try and do it without professional help," Peters says. "Hiring a mergers and acquisition advisor or investment banker, often called an ibanker, improves the probability of a successful exit."

Peters suggests looking for an advisor who has a reputation for completing a large percentage of the transactions and is close to the company geographically.

"People think they have to go to New York or San Francisco for this kind of expertise," he says, "but that's a bad idea for an exit under $100 million. Today advisors can't afford that much air travel and won't rent an apartment and so they try and do too much of the transaction remotely. The face-to-face contact theyneed isn't with the buyers, it's with the sellers; the farther away the M&A advisor is, the less likely the transaction is to get completed."

It may be difficult to track down accurate information about M&A advisors-especially if it's negative. "There are lots of people who say they can do this work, but few that are good at it. The Board really has to do diligence," Peters says. "Unless you know the person you are asking for the reference, you aren't likely to get the information you need."

Peters says to think of the iBanker as the sales person for the deal. "They have the knowledge of how the transactions work. They work with the buyers, company, lawyers, and accountants to coordinate. They negotiate and help the buyers appreciate the value. They increase the probability of success and get the best price and terms for the company."

If there isn't an M&A advisor, Board members who have participated previous exits could be a good choice. "They are familiar with the company," Peters says. "Where things go wrong is where the CEO thinks that he or she can do the work alone and their other job, too."

Waiting out the Big Dog or sometimes saying "no"

The startup can inexpensively push back. "It doesn't cost a lot of money to say no and wait the big company out, as long as you have cash in the bank," Rosenblum says. "Get them to believe there are alternatives. If your company is good enough, there will be alternatives."

Peters cautions against any situation when there is only one bidder.

"A big company may come along and make an offer hoping that no one else is aware of the company. They will make a reasonably low offer and tell the company they have a short time to say yes or no," he says. "When there is only one buyer at the table the chances are slim that the deal will get completed. Life being what it is there are a hundred things that can go wrong."

A refusal of reasonable limitations of liability may be a reason for the seller to walk away. "If they can sue you for 100 percent of the purchase price or more, there is no reason to do the deal," Rosenblum says.

If the buyer conditions some portion of the deal on substantially disrupting the business of the target company, for example firing distributors or canceling license agreements with the buyer's competitors, the entrepreneur should think twice. If the big company's M&A team is too aggressive about wanting to see certain kinds of information too early, for example customer lists, it could pay to hold back. Sometimes big companies window shop or fish for useful market information or technology.

Sometimes the Big Dogs have time pressures too.

Sellers can use timing to their advantage, too, especially if there is reason to believe that someone high up in the Big Dog hierarchy wants progress to be made.

"One of the oddities of these types of deals," Rosenblum says, "is that they will bump along for a while with no apparent progress being made and then will speed up drastically. There will be hardball negotiation for a period of time and then someone high up will focus on the deal and ask why there is no signed letter of intent, definitive acquisition agreement, or closing. Suddenly, all the obstacles go away."

Peter Rosenblum, a partner at Foley Hoag LLP, counsels clients in diverse industries concerning business and regulatory matters, financing strategies and structuring of corporate transactions. He is actively involved in the firm's corporate and corporate finance practices, with an emphasis on mergers and acquisitions, public and private offerings of debt and equity, joint ventures, private equity and venture capital.

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