



SRS ACQUIOM

VC GC M&A Checklist: *Post-Close Drafting Considerations*

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ELEVATE YOUR GAIN



Presenters



Micah Sucherman

Senior Director, Institutional Client Relations

303.957.2856

msucherman@srsacquiom.com

Micah is a Senior Director at SRS Acquiom, specializing in delivering responsive, knowledgeable, and professional service to SRS Acquiom's many institutional clients, including venture capital firms, investors, and founders. Micah has extensive experience in Dispute Management at SRS Acquiom, managing and resolving dozens of indemnity and earnout disputes.

Before joining SRS Acquiom, Micah was Senior Associate in the litigation department of Gibson, Dunn & Crutcher LLP. At Gibson Dunn, Micah gained significant experience in complex commercial litigation and performed high-stakes internal investigations for corporate clients, including several of the world's largest companies.

Micah is a graduate of the University of California, Berkeley, School of Law, where he was a Senior Editor of the California Law Review, and the University of Colorado, Boulder.



Paul Eastwood

Director—Finance and Accounting

720.799.8604

peastwood@srsacquiom.com

Paul is a Director in the Dispute Resolution group at SRS Acquiom, specializing in finance and accounting. He manages post-closing matters and disputes related to purchase price adjustments, earn-outs, and indemnification claims.

Before joining SRS Acquiom, Paul worked at Alvarez & Marsal in Chicago and AlixPartners in London, advising multinationals and private companies on high-value purchase price disputes, commercial litigation, financial damages, and forensic accounting.

Paul holds an MA in Economic History from the University of Glasgow in the UK and is a Fellow of the Institute of Chartered Accountants in England & Wales (ICAEW).

An Experienced Partner to Reduce Deal Complexity

More deal parties trust us to manage escrows, payments, risk, documents, and claims. We pair tailored, expert service with game-changing data and technology, making complex deals as efficient as possible.

3,300+

deals engaged on to date

\$445 BILLION+

aggregate deal value

265K+

shareholders represented
in over 120 countries

\$200 BILLION+

in payments

99%

of shareholders are paid
within 24 hours*

200K+



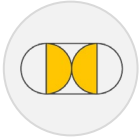

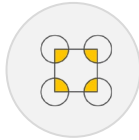
total shareholders paid to date

** Consideration given to those that have completed a LOT.*

Comprehensive M&A Platform

SRS Acquiom offers a robust platform of M&A solutions designed to work together or independently to meet the unique needs of each deal.

Mergers & Acquisitions

 Pre-Closing Solicitation <p>Secure, flexible, online document distribution to securityholders for review or action, plus tabulation and reporting back to deal parties.</p>	 Payments <p>Our online payments process enables fast and efficient payment of parties to an M&A transaction, including parties receiving compensation-based payments. Most shareholders are paid in one day.</p>	 Escrows <p>A better M&A escrow experience, period. Simple, fast engagement, online Deal Dashboard, and a dedicated team.</p>	 Reps & Warranties Insurance Brokerage <p>Get help selecting an insurer that's right for your deal, and gain expert guidance negotiating coverage and policy wording—all with a single-source RWI broker and escrow provider.</p>	 Shareholder Representation <p>Protect shareholder interests with professional representation.</p>
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Agenda

1. Purchase Agreement
2. Earnouts
3. Capitalization Table
4. Paying Agent
5. Escrow
6. Post-Closing Matters

Purchase Agreement

Purchase Agreement Drafting Considerations

Working Capital

- Watch for non-accounting issues in working capital (e.g., tax compliance, reserves for litigation, capitalization). These require legal analysis to resolve. Accounting arbitrators only know how to address accounting issues.
- Watch for overlap in definitions, circular definitions, or reference to documents outside the four corners of the agreement.
- Ask the Shareholder Representative to review draft language (they will be the ones who need to implement/enforce it).

Shareholder Liability

- Review the limit of shareholder liability deriving from post-closing matters, including joint and/or several liability, whether there are caps on liability in the absence of fraud, and the order of liability (i.e., who pays for what, and in what order?)

Baskets and Caps

- Review the language around baskets (e.g., overbroad exclusions, does it allow for potential damages?).

Purchase Agreement Drafting Considerations *(continued)*

Post-Closing Dispute Mechanics

- Ensure at least a 30-day response period for claims and ability to control third-party claims.
- If possible, be sure that if the Sellers have the right to control third-party disputes, they can do so without having to admit indemnification.
- Require that the Shareholder Representative must provide written consent to any settlement as a condition to indemnifications.
- Require that a claim notice be sufficiently specific to identify a claim. This prevents “claim creep” where the Buyer may start articulating new theories after the survival period has ended.
- Determine if a cap on specifically indemnified matters is appropriate.
- Watch for damage calculations based on diminution of value. This kind of provision could inflate claims by the multiple calculated for the deal valuation. That can make damages nearly impossible to agree upon for purposes of claim resolution.

Purchase Agreement Drafting Considerations *(continued)*

Assignment

- Review assignment provisions, particularly if a shareholder is a late-stage fund that may be winding-up during the active post-closing period. Ensure that the fund could easily assign interest in post-closing economics (escrows, milestones, expense funds) if the fund needs to wind-down before all potential distributions have been made.



Privilege

- Expressly address ownership of the selling company's attorney-client privilege*.
- Include pre-emptive conflict waiver so that seller's counsel can continue to represent the shareholders.

PPA Discussion Overview

1. Recap – PPA mechanism
2. Potential obstacles and avoidance
3. Deferred revenue

PPA Mechanism

Recap – Transaction Value to the Shareholders

- Enterprise value
 - plus **Cash**
 - **minus Debt**
 - **minus Transaction Expenses**
 - plus or **minus Working Capital (NWC) -v- Target**
- Reason for the mechanism:
 - Debt, Transaction Expenses, and Working Capital (especially) are not fully known at Closing



PPA Mechanism

Three Measures of Working Capital

- **Target** working capital
 - determined in diligence and negotiated
- **Estimated** working capital
 - **seller calculates** pre-closing
 - **buyer or seller pays** at closing (estimated working capital *minus* target working capital)
- **Actual** working capital
 - **buyer calculates** 2-3 months after closing
 - seller or buyer pays through the **PPA** (actual working capital minus estimated working capital)



PPA Potential Obstacles & Avoidance

Setting the Target

- Basis is likely historical average of current assets minus current liabilities
- This may not be appropriate in the context of the transaction
- Seasonality and date of closing
- Audit or other y/e adjustments
- Scrub the peg for “old” balances. Itemized B/S review
- Deal costs accrued
- Consider a NWC collar

GAAP and Accounting Practices

- Agreement language will reference GAAP and / or past accounting practices
- Competing theories for the PPA
- GAAP is interpretative
- Consider past accounting practices only, or defaulting to past practices absent a clear GAAP violation
- Consider including agreement language re. the intent of the PPA

PPA Potential Obstacles & Avoidance

Inclusions and Exclusions

- Definitional adjustments
 - Cash
 - Debt
 - Bonuses / change in control / one-off transactions
- Contractual adjustments
 - Taxes
 - Litigation liabilities
 - Deferred revenue

Inclusions and Exclusions

- Consider an itemized NWC exhibit as a point of reference
- For greater clarity, prepare at the trial balance level
- For greater certainty, require the closing NWC calculations to be prepared using the same methodology used in each exhibit line item historically

Deferred Revenue

Principal Issues

- Cash received before revenue can be recognized
- Material accounting item for many businesses, incl. software / technology
 - Notoriously complex “old” GAAP
- ASC 606
 - Only one year of history for non-public companies
 - Revenue recognition remains very complex. Multi-step process to evaluate contracts and allocate consideration among various obligations.
- ASC 606
 - For some entities, revenue recognition might be accelerated, e.g. licensing. For others, may be less change or increased deferred revenue.
- Deferred revenue on the B/S will continue to be a material issue
 - Possible less scope for post-closing disputes—fewer rules/more principles

Deferred Revenue

Working Capital or Debt

- Debt equals a \$ of \$ reduction in the purchase price
 - Main point of contention – sellers have received cash but buyer has to fulfil the contract
 - Backed by cash or AR?
 - Nature of the business. Spikes, or a growing deferred revenue balance, may suggest a subscription-type business with upfront cash and lots of work still to do to earn the revenue
 - Consistent balance throughout the period may suggest a timing difference only. Cash received before revenue can be recognized
- Value of the liability
 - B/S amount is not a true measure of the liability under normal operating conditions. Should buyers get credit for this?
 - Costs incurred to meet obligations and satisfy the liability will be less
 - Even greater impact when the deferred revenue liability is revalued as part of purchase accounting
 - Consider a cost-based adjustment to the purchase price
 - Impact on future earnings

Earnouts

Earnout Drafting Considerations

Diligence

- Review Buyer obligations to achieve earnouts/milestones (ideal minimum obligation of commercially reasonable efforts).
- Consider approaches that are intended to minimize post-closing friction between the Buyer and Seller.



Milestone Structures

- Any milestone structure that gives the Buyer incentive to miss it, or that may result in a profitable outcome for the Buyer but no milestones for the Sellers, should be avoided. Examples include milestone “cliffs” after a certain date or overly specific milestone definitions which may become irrelevant if development changes direction.

Reporting and Opportunities for Meetings

- Review the reporting obligations for deals with milestones (require meaningful substance in reports, opportunity for meetings, etc.).

Capitalization Table

Capitalization Table Drafting Considerations

Pro Rata Calculation

- Review your firm's pro rata on the allocation spreadsheet and ensure it is calculated as set forth in the definitive agreement. This is particularly important if there are liquidation preferences that may impact the share to be received by different classes of stock, or exercise prices that may be erroneously factored into the pro rata calculation.



Paying Agent

Paying Agent Drafting Considerations

Non-Standard Items

- Understand post-closing distribution mechanics, particularly for non-standard items such as tax refunds, the Shareholder Representative expense fund, and earnouts that may be achieved long after closing. Verify with company counsel that the paying agent is retained to handle these potential distributions (or if another arrangement has been made). Note the risks of having an inexperienced Shareholder Representative be directly responsible for distributing funds of any kind (regulatory, financial and administrative risks).

Employee Payroll Taxes

- Determine who is responsible for funding the employer portion of payroll taxes for post-closing payments to optionholders and other compensatory payees. This is especially important on deals with potentially large earnout payments where the payroll tax amount could be significant years after closing.

Escrow

Escrow Drafting Considerations

Distribution Logistics

- Have the distributions from escrow be made to the payment instructions used at closing. Some escrow agents ‘throw away’ payment instructions received at closing, and default to a paper check for distributing the escrow. Be sure the escrow agreement provides for the distribution to be made to the account identified at closing, unless updated.
- The escrow distributions should be made by the paying agent used at closing.



Post-Closing Matters

Post-Closing Matters

Consider Hiring a Shareholder Representative

- Consider retaining a professional Shareholder Representative and establishing an Advisory Committee to direct those post-closing matters that impact all shareholders.

Expense Fund

- Establish an appropriate expense fund—preferably at least \$250,000. Higher amounts are appropriate when there are known issues to deal with post-closing or when there are long-term and/or complex deferred consideration components (e.g., earnouts).
- Arrange for the Shareholder Representative to hold the expense fund rather than the escrow agent. This makes it easier for the Representative to act quickly (no instruction letters to a bank), avoid funds being locked up if there is a dispute, and avoid fees.
- Allow the Shareholder Representative (as directed by the Advisory Committee) to control/decide when to release the expense fund to shareholders (do not hard-wire a date in the purchase agreement).

Post-Closing Matters *(continued)*

Confidentiality Obligations of Shareholder Representative

- Ensure that confidentiality obligations imposed on the Shareholder Representative are flexible enough to permit the Shareholder Representative to communicate with (at a minimum) the Advisory Committee. Without this, it can be very difficult to address post-closing claims.

No Shareholder Representative

- Make sure to address what happens if there is no Shareholder Representative (e.g., majority vote can act until a successor is appointed).

Indemnification

- Ensure appropriate indemnification of the Shareholder Representative by the selling shareholders (typically joint and several). If there is an Advisory Committee, extend indemnification to include this group.

Authority

- Ensure scope of authority covers the full set of payees (e.g., warrant holders, option holders).
- Avoid express restrictions on the Shareholder Representative's authority in the definitive agreement. If needed, address such matters in a side letter where they are governed by the Advisory Committee.

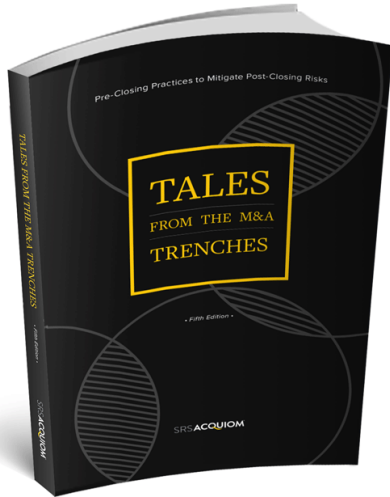
Post-Closing Matters *(continued)*

Obligations of Shareholders

- Make sure that any confidentiality provisions imposed on the shareholders allow for sharing information with any parties with whom the fund will need to share information (e.g., advisors, LPs).
- Review restrictive covenants closely, adhering to your own policies regarding non-compete/non-solicitation agreements and confidentiality.



Additional Resource



Additional Resource

Tales from the M&A Trenches, 5th edition

New & Updated. The go-to handbook for identifying M&A post-closing issues that may cause disputes.

Download the eBook: <http://srsacquiom.com/ebook/>

Thank you.
Questions?