



# **Funding and Buy-Out Events: Putting The House in Order**

SCORE Mentor Training

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Presented by Steve Phillips, Cindy Grossman

Giordani, Swanger, Ripp & Jetel, LLP

100 CONGRESS AVENUE, SUITE 1440 | AUSTIN, TEXAS 78701

*phone* 512.767.7100 | *fax* 512.767.7101 | [WWW.GSRJLAW.COM](http://WWW.GSRJLAW.COM)

# Focus of Presentation

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- **Overview of things the entrepreneur should be sensitive to BEFORE a funding or liquidity opportunity arises**
  - **Deserves consistent and continuous effort and maintenance**
- **Routine “legal” check up is in order**
- **Getting the house in order at the last minute:**
  - **Sometimes will cause loss of funding/liquidity opportunity**
  - **Similar to “deferred” maintenance**
  - **Very expensive to accomplish at the last minute**

# Overview of Funding/Liquidity Events

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- **Three major funding/liquidity events**
  - **Equity financing**
    - **New partner “buys in” with cash, know how, or other assets in exchange for an equity position**
    - **Sometimes allows partial cash-out of existing owners**
  - **Debt financing**
    - **Lender offers temporary or long-term financing to meet company’s working capital needs or provide financing for particular opportunities (i.e., acquiring a competitor, etc.).**
  - **Equity or asset acquisition – the complete “Exit”**
    - **Outside party buys all of the equity or assets of the company**

# Due Diligence: Overview

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- **Due Diligence – the process whereby a prospective investor/lender/buyer determines whether you are what you say you are**
  - **Requires a “prospectus” of sorts**
  - **Best to build and maintain the components as you go along**
  - **If expected documents and records don’t exist – you will have to create them**
    - **Expensive and time-consuming to do so at last moment**
    - **Could uncover disagreement between principals**
    - **Could cause a prospective lender/investor to “pass”**

# Due Diligence: Key Documents and Records

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- **Existing Entrepreneur Venture Agreement (EVAs)**
  - **Partnership/Company/Shareholder agreements**
- **Employment agreements/Non-competition agreements**
  - **Are key employees handcuffed?**
- **Documentation of asset ownership and security interests**
  - **Who owns what?**
- **Trade secret protection**
- **Existing contracts**
  - **Customer relationships**
  - **Vendor relationships**
  - **Will they stay?**
- **Books and records**
  - **Legal**
  - **Financial**
  - **Tax**

# Equity Financing: What does it look like?

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- **Existing partners may be approached by or solicit:**
  - **Venture capital**
  - **Private equity**
  - **Angel investor groups, individual investor, friends & family**
- **Advantages and disadvantages to each**
  - **Some VC and PE firms specialize in a specific industry, so may be able to open doors for a company operating within that sphere**
  - **May lend specific expertise to company**
  - **Some are active (VC), some passive (PE or angel)**
  - **Some will want large equity stake, expect significant returns, relative short period (VC/PE)**

# Equity Financing: What does it look like? (cont)

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- **Brokers: a word of caution**
  - **Must be licensed (or deal could be undone)**
  - **Can be expensive**
  - **Brokers vs. “finders”**
- **Funds flow from investor directly into company in exchange for equity interest.**
  - **Existing partners are diluted according to terms of partnership agreement.**

# Equity Financing: The Deal – Key Terms

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- **How much equity ?**
- **Pricing**
- **Control**
  - **Day to day operations**
  - **Big picture items (future financing, exit)**
- **Preferences**
- **Redemption rights obligations**
- **Performance thresholds**
- **Preemptive rights**



# Equity Financing: The Deal - Documents

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- **Deal documents for typical equity financing**
  - **Amended/restated EVA**
  - **Equity purchase agreement**
  - **Assignment document**
  - **Note, security agreement, and personal guaranty (if not all-cash deal)**
  - **Appropriate resolutions/minutes reflecting voting requirements met**
  - **Opinion of counsel**
    - **Can be expensive**
  - **Other documents, depending on complexity of deal**

# Equity Financing: Entrepreneur Venture Agreement

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- **Prior to admission of new investor, examine existing EVA**
  - **Determine requirements for admission of new partner**
  - **Will equity offering trigger rights of first refusal?**
  - **Will voting requirements for admission of new partner be met?**
  - **What “reverse” due diligence is required by the selling partners prior to admission of new partner?**

# Equity Financing: Entrepreneur Venture Agreement (cont)

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- **Sophisticated investors will be interested in the following:**
  - **Allocation and distribution provisions**
  - **Transferability restrictions and rights of first refusal on dilution/option triggers**
  - **Buy-sell and key-man insurance requirements**
  - **Voting thresholds**
- **Depending on the sophistication of the agreement and your investor, expect to amend or restate the EVA to meet the expectations of your investor**

# Debt Financing: What does it look like?

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- **Debt financing exists in many forms**
  - **Factoring arrangements**
  - **PO financing**
  - **“CAPCO” funds**
  - **“Traditional” financing**
  - **Convertible debt / warrants**
- **Typically is tranche-based upon pre-determined milestones**
- **Many are relatively short-term - usually less than 5 year term**
- **Highly secured deals**
  - **Will often take security interest in equity interests and assets**
  - **Personal guaranties required**
- **May want buy-in option at the end of financing term**

# Debt Financing: The Deal – Key Terms

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- **How much financing provided ?**
- **Interest rate**
- **Term**
- **Security**
- **Control**
  - **Day to day operations**
    - **Control or participate in management**
  - **Big picture items (future financing, exit)**
- **Tranches- how many, how frequent?**
- **Milestones**

# Debt Financing: The Deal – Key Documents

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- **Deal documents for typical debt financing**
  - **Loan agreement**
  - **Promissory note**
  - **Security agreement**
  - **Personal guaranties**
  - **Subordination agreements, intercreditor agreements**
    - **If the company has other unreplaced debt, expect negotiation between the new lender and existing lenders**
  - **Warrants/options**
  - **Opinion of counsel**

# Debt Financing: Entrepreneur Venture Agreement

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- **Prior to debt financing, examine existing EVA to determine requirements for debt financing**
  - **Voting thresholds**
  - **Can manager/directors engage in financing without approval of members/partners/shareholders?**
- **Many debt financing groups will ask for warrants or equity options**
  - **At this point, lender concerns regarding the EVA will be similar to those of an equity investor**
  - **Does the venture agreement contemplate warrants or options?**
    - **How will their transferability (or non-transferability) be handled?**

# Acquisition: What does it look like? - Equity

- **Two primary structures – equity or assets**
- **Equity acquisition**
  - **Buy out of existing shareholders by purchasing equity units**
    - **Can be on tax free basis if seller is corporation and buyer uses stock (merger)**
  - **Can have greater tax advantages for selling partners, particularly if company is a c-corporation.**
  - **Less tax-advantaged for buyer if corporation (no basis step-up)**
  - **Most buyers shy away from equity purchase to avoid unknown liabilities, etc.**
    - **Liabilities (known and unknown) will follow equity acquisition, but typically not asset acquisition**



# Acquisition: What does it look like ? – Assets

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## - Asset Acquisition

- **Acquire assets of the company, leave corporate shell in place**
- **Advantageous for buyer due to**
  - **Tax basis step up**
  - **Avoid unwanted liabilities**
- **Taxes**
  - **Can have terrible tax consequences for c-corporation shareholders – double tax**
  - **Partnership seller**
    - **Tax neutral for seller – equity or asset sale gives same results**
- **More complicated due to need to transfer assets (compare with equity purchase)**

# Acquisition: The Deal – Key Terms

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- **Stock or asset purchase ?**
- **Pricing & payment**
  - **Contingent payments**
- **If asset sale, which assets?**
- **Key players remaining with the business?**
  - **Permanently?**
  - **Just for transition period?**

# Acquisition: The Deal—Key Documents

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- Deal documents for typical acquisition
  - Purchase (stock or equity) agreement
    - Warranties and representations – heavily negotiated
  - Promissory note (if relevant)
  - Security agreement
  - Personal guaranties
  - Assignment document (transferring equity interests) if equity deal
  - Bill of sale if asset acquisition
  - Title transfer documents if asset acquisition
  - Contract assignment documents if asset acquisition
  - Numerous other documents, depending on complexity of sale and assets involved

# Acquisition: Entrepreneur Venture Agreement

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- **This document may not matter substantially to an acquirer, particularly for an asset acquisition**
  - **Acquirer will want to know that seller is granted appropriate authority to conduct sale**
  - **May also be handled in opinion of counsel**

# Housekeeping: Employment Agreements

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- **Employment agreements must be in place for key employees prior to any financing or acquisition**
  - **Employees may be most valuable asset**
  - **Lender/acquirer very interested in their continuation**
- **An entering investor will want employment agreements that provide:**
  - **Clearly defined job descriptions and compensation provisions**
  - **Clearly defined termination provisions**
  - **Adequate non-competition agreements (for key employees) to protect the going concern of the business**
  - **Adequate confidentiality agreements (for all employees) to protect the going concern / trade secrets of the business**
- **Be aware of employment agreements that incorporate “change in control” as a trigger for good cause voluntary termination.**

# Housekeeping: Employment Agreements (cont.)

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- **A new employment agreement may be necessary for entering equity partner who will take an active role in the company**
  - **Be aware of Section 409A if entering partner will take any deferred compensation**
- **How are departing partners permitted to compete with venture following acquisition?**
  - **This may also be handled in the purchase agreement**
- **New employment agreements will likely be negotiated as part of acquisition**
- **Be aware of 409A issues with departing partners/employees who receive severance/termination payments**

# Housekeeping: Ownership of Assets

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- **Is the company's ownership of its assets well-documented?**
  - **Investor will want to know the company owns everything it says it does - particularly with regard to intangible assets**
  - **Contribution agreements, acquisition agreement, license agreements – are all in place ?**
- **Tremendous due diligence involved in asset and stock acquisitions**
  - **Must locate and list all assets**
  - **Expect to show proof of ownership and title to all assets**

# Housekeeping: Ownership of Assets (cont.)

- **Are any assets serving as collateral for other loans?**
  - **Investor many dictate that a portion of funding be used to pay down existing debts and free company assets from security interests**
  - **Expect lender to perform a “UCC-1” search, which will identify any existing liens against the assets of the company or its owners**
    - **Consider performing preemptive search**
  - **Will granting of new security interests in collateral, even if in a junior position to existing debt, trigger acceleration or default of existing debt?**



# Housekeeping: Ownership of Assets (cont.)

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- **Lender will want to know what its position will be in with regard to secured assets**
  - **May require intercreditor agreement - sometimes complex**
  - **May require a portion of funds lent be used to pay down existing debt**
- **Be careful of representations and warranties in loan documents, i.e., representing that no other liens exist or will exist...this can be a source of trouble**
  - **Lenders will be concerned about lien perfection**

# Housekeeping: Trade Secret Protection

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- **Use of non-disclosure agreements with potential investors**
  - **Nice in theory, difficult to do in practice**
- **Is all used intellectual property actually owned by the company?**
  - **Lenders will want to know exactly what their collateral is**
  - **Investors will want to know that intellectual property is secure**

# Housekeeping: Trade Secret Protection (cont.)

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- **Trademarks, copyrights, patents**
  - **Ownership or license agreement in place ?**
- **Ownership of intellectual property created by employees/contractors?**
  - **Should be handled in employment agreements or consulting agreements**
- **Similar to asset ownership issue**

# Housekeeping: Existing Contracts

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- **Identify and locate all existing contracts**
  - **This can be extremely time consuming- it is best to keep accurate records from the beginning**
- **Transferability**
  - **Which contracts are transferable? What steps must be taken to transfer them?**
- **Change in control provisions**
  - **Identify contracts that contain change in control provisions that may be triggered by equity buy-in, exit event, or even debt financing (be aware of warrant grants that could trigger CIC down the road when they are exercised)**
- **Debt ratio in other contracts**
  - **Will taking on new debt cause default under other loans?**
  - **Lenders will be extremely concerned about terms and conditions of other loan agreements**

# Housekeeping: Corporate Legal Records

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- **Corporate legal records should be well-maintained**
  - **Minutes and resolutions for important events in company's existence (admission of new partners, acquisitions, election of officers and directors)**
  - **Share ledger and capitalization table should be up-to-date**
  - **In an asset acquisition, the acquirer may ask to review certain records, but will be mostly concerned about records that demonstrate seller's authority, ownership of assets, validity of existing contracts**
  - **In a stock acquisition, the acquirer will want to see a complete corporate history (they will be sensitive to existing or potential liabilities of the company)**

# Housekeeping: Corporate Financial/Tax Records

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- **Corporate financial/tax records should be well-maintained**
  - **Are financial statements compiled, reviewed, audited ?**
  - **All tax returns filed ?**
    - **Income, employment, franchise, sales tax**
  - **“Foreign” registration and tax obligations ?**
    - **Are there any?**
  - **Be sure to separate business from personal matters**
    - **Perhaps restate earnings to exclude personal items**
  - **Lurking skeletons in the closet ?**
    - **Particularly important for stock acquisition**
    - **Face up to them NOW**

# Firm Background

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## **GSRJ - U.S. and International Tax Planning**

A common denominator and distinguishing feature of GSRJ attorneys and other professionals is their deep and thorough understanding of U.S. and foreign tax and entity issues—an understanding that is essential to an effective estate, asset protection, and entity planning practice, both in the U.S. and abroad.

GSRJ professionals are trained and committed to understanding the intricacies and nuances of state and federal income tax, estate and gift tax, state franchise tax, and the various charitable tax regimes. This training and commitment allows them to work with clients to define their goals, and to design and implement creative strategies to achieve those goals, always with an eye on optimum tax results. The professionals at GSRJ strive to use their collective understanding of tax issues to meet each client's individual needs within the context of all relevant tax environments. Individual GSRJ professionals each specialize in distinct facets of tax law, but all maintain a broad-based understanding and appreciation of income, estate and gift tax matters. As a collaborative group, they can recognize, react to, and shape the universe of tax implications that arise from virtually any transaction in which their clients may engage.

A significant aspect of GSRJ's tax practice involves the representation of clients with tax controversies pending before the Internal Revenue Service and state tax agencies. GSRJ frequently deals with IRS examining agents and appeals officers in audits and administrative hearings. The firm's attorneys are intimately familiar with tax filing and other compliance requirements, including especially those arising from cross-border and international transactions, and are experienced in the preparation, examination, and appeal of various federal and state tax and information returns.

# Firm Background

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## Emerging and Established Business Ventures

GSRJ not only assists its clients in maintaining and protecting their wealth—GSRJ helps them create it. In this regard, GSRJ professionals readily apply their own business and legal expertise to counsel and advise their entrepreneurial clients in planning, structuring, and implementing corporate and partnership investment and business entities, and provide legal counsel for their recurring and nonrecurring transactions, such as:

Buy-sell agreements

Angel and later round debt and equity financing (investor and investee)

Executive compensation

Equity compensation

Vendor/customer relationships

Strategic joint ventures

Succession planning

Mergers and acquisitions

Corporate reorganizations

Private exit and other liquidity transactions

GSRJ delivers these services to clients in a variety of industries from real estate investment and development, to technology and other services, to manufacturing and distribution of consumer tangible products. For their clients' start-up entities, GSRJ professionals apply their tax, legal, and business expertise to ensure their clients conceive and incubate their entrepreneurial ventures on sound footing. As to those entities entering mature operational and exit phases (or those already there), GSRJ professionals assist their clients in maintaining the course through both the expected and unexpected occurrences along the path to wealth creation. When significant monetization and liquidity events occur, GSRJ can summon its specialists in the estate, insurance, and asset protection areas to ensure that resulting wealth is maintained and protected in a tax-efficient manner.

When clients expand internationally, GSRJ professionals assist them with proper planning and structuring of in- and out-bound cross-border transactions, as well as with strategic offshore placement of business assets for asset protection and tax planning purposes. In a global marketplace, almost any client can find themselves faced with the prospect of tapping foreign markets. GSRJ stands ready to prepare for and guide those efforts. With the assistance of GSRJ's many foreign contacts and peers, GSRJ is optimally positioned to provide prompt, efficient, and effective guidance.



# Firm Background

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## **STEPHEN L. PHILLIPS**

Steve Phillips is a seasoned and experienced tax and transactional lawyer, guiding and advising closely and publicly held entities and their entrepreneurial principals in a variety of industries from real estate investment and development, to technology and other services, to manufacturing and distribution of tangible products. From start-up, through mature operational and exit phases, Mr. Phillips plans, structures, and implements corporate and partnership entities, and their recurring and nonrecurring transactions, such as buy-sell agreements, negotiated angel and later round debt and equity financing, executive compensation, strategic joint ventures, succession planning, and mergers, acquisitions and other exit transactions. When his clients expand internationally, he assists them with proper planning and structuring of in- and out-bound cross-border transactions, as well as with strategic offshore placement of business assets for asset protection and tax planning purposes.

A significant component of Mr. Phillips' practice focuses on individual estate and income tax planning for active and retired entrepreneurs, and the delivery of legal and tax services to private clients and their family offices. When the need arises, he represents his individual or corporate clients in federal and state tax controversies, both administratively and in court.

Mr. Phillips is and has been Board Certified in Tax by the Texas Board of Legal Specialization since 1995.

## **Education**

University of Texas School of Law (J.D., with honors, 1985)

University of Texas at Austin (B.B.A., Accounting, with highest honors, 1983)

# Firm Background

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## **CINDY L. GROSSMAN**

Cindy Grossman's practice encompasses a wide variety of corporate and partnership transactions with international, federal, and state tax implications, including stock and asset acquisitions, partnership freeze transactions, planning, structuring, and implementation of mergers, real estate transactions, and other recurring and non-recurring business transactions. Ms. Grossman has a breadth of experience in corporate and partnership formation and operation, entity conversion and reorganization, business planning, business succession planning, and asset protection planning. She represents business clients at all stages of their ventures, from establishing start-ups and negotiating and structuring angel and later round debt and equity financing, to growth planning and implementation, to devising and implementing appropriate exit strategies, including equity and asset sale transactions. Ms. Grossman also assists clients with proper planning and structuring of cross-border transactions, as well as with strategic offshore placement of business assets for asset protection and tax planning purposes. Ms. Grossman utilizes her expertise in tax-efficient entity planning to assist individual clients in the establishment or maintenance of complex estate planning structures involving partnerships, limited liability companies, and other entity types. In addition to her experience with entities, Ms. Grossman has represented clients in federal and state tax controversies.

## **Education**

University of Texas School of Law (J.D., 2004)

University of Tennessee at Knoxville (M.A., Philosophy, Concentration in Medical Ethics, 2002)

Emory University at Atlanta (B.S., Biology, B.A., Religious Studies, 2000)



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