A founder's guide to getting a company ready for an exit

By André Thiollier and Aaron Bonner

Entrepreneurs who come up with innovative ideas with the right team can build a company worth millions and billions. However, a company that fails to avoid certain pitfalls may find that its value (and the shareholders' stock) may have been adversely affected. Pitfalls can be easily avoided with attention to some important details. This quick guide was prepared to help you, the entrepreneur, avoid foot-faults that could potentially have a buyer reduce a company's valuation, hold back some portion of the purchase price (either in amount or time period) beyond what is normal, or even withdraw an acquisition offer altogether.

Keep your records clean

- One of the most valuable things a company can do to prepare itself for a liquidity event is to make sure that its records are clean. Red flags will pop up if the company does not properly maintain its cap table, records of shares issued and options granted, board actions, employment and commercial agreements, and documents supporting intellectual property ownership.
- Records should be kept in an organized fashion. Having a process to keep your records straight might seem tedious and at times costly, but will save you time and money when it comes to a sale of your company.
- Digitization can be particularly helpful and is useful when it comes time to create a data room for a buyer to review. Make sure all records are kept updated in that data room, with fully executed versions, properly itemized and logged.

Have all employees sign PIIAs

- For many companies, the most treasured assets, as well as the most enticing prospects to buyers, are their intellectual property (IP) rights.
- Clear ownership and exclusive use of IP rights allow a company to maximize competitive advantage. A buyer would put a significant price tag on such assets, but will also withhold or reduce the purchase price if it understands that there are risks that the crown jewel is not properly secured.
- A Proprietary Information and Inventions Assignment Agreement (PIIA) is the customary way to make sure that IP rights are protected and should be signed by every company employee. Non-employee consultants, contractors and developers should sign a consulting or contractor services agreement that contain IP rights provisions appropriate for a non-employee relationship (see our article regarding PIIA's and an overview of intellectual property rights including copyrights, patents, trademarks, and trade secrets).
- The PIAA should, among other matters: (a) include confidentiality obligations so that the company information is protected, (b) state that all IP created by individuals who are employees during their employment is "work-for-hire" and is the exclusive property of the company; (c) for those individuals and companies who are providing services to the company as contractors or consultants, include present assignments of IP rights; and (d) require that the employee, consultant or developer return to the company all materials in his or her possession upon termination.

Managing the board

- The board of directors is the supervising body of a company, and members have significant control over the most important elements of company direction, including the circumstances surrounding a sale.
- A company founder who desires to remain engaged should establish appropriate bylaws and be proactive in maintaining that board members share founder interests and goals.
- While investors' appointees should be active in the board room (especially when their experience can help guide the sales process), the founder should retain some checks and balances.
- Proper coordination among founders and the board can help assure that the company proceeds in the desired direction, including how and when to exit.

Establish correct employee classifications

- A common mistake of young companies is to not establish clear employee work responsibilities. Ignoring or imprecisely defining hour, overtime and benefit classifications can expose a company to future litigation risk and correspondingly lessen attractiveness to potential buyers. See our article that provides a more detailed overview of the issues around employee classification.
- It is more common than one would think to have a buyer withhold or even reduce purchase price due to employment and benefit related liabilities, especially in more employee-friendly jurisdictions such as California.
- Properly classifying and paying employees (and the government for associated taxes) can save you transaction costs and reduce your and your investors' indemnity obligations on a sale. After all, no buyer wants to inherit the complaints (contingent or otherwise) of a company's employees caused by prior mismanagement.

Issue securities wisely and sparingly

- The issuance of securities, whether in the form of stock, stock options, futures or debt instruments, can be a valuable mechanism for companies to use to raise needed cash at any stage.
- However, exchanging what may seem to be largely inconsequential agreements for cash can greatly hinder a company's flexibility and attractiveness for sale later on.
- Good practice is to be conscious of what agreements are being made and corresponding company responsibilities.
- Companies should be particularly cautious of issuing an excessive amount of options with accelerated company sale triggers, as this can require that the buyer invest additional capital to retain the people that are necessary to keep the company successful. This usually functions as a reduction to the purchase price.

Tailored forms and contracts for the circumstances

- When first establishing agreements, startups can be tempted to utilize boilerplate language for purposes of ease and expediency. Utilizing general, standardized contracts as a starting point can improve efficiencies; untailored, imprecise forms and contracts can greatly reduce agreement effectiveness and increase the likelihood of unforeseen company liabilities.
- As such, a company should consider carefully, and draft accordingly, terms of agreements which accurately represent the company's expectations. Imprecise contractual language can create holes and misunderstandings that lead to contentious interactions and can convey a lack of professionalism and organization.
- A poorly crafted agreement can cause a prospective buyer to be apprehensive about assuming the terms of and obligations under all contracts that are binding on the selling company.

Resist contractual restraints on your business (non-compete/most favored nation clauses)

- In order to place its products or services in the market place, companies trying to enter a competitive market or industry sector have a tendency to accept any form of agreement that may be presented to them. Be careful. Although being willing to accept customers' terms may speed up the sales cycle, if you have a bit of leverage to ask for something while negotiating commercial agreements, try to avoid clauses that impose limitations on doing business in certain geographic areas or verticals or restriction on prices (most favored nation clauses).
- Remember that you may be faced in the future with a big buyer who more likely than not will have other businesses, and these kinds of limitations may be problematic for a buyer and its affiliates to accept.
- Contractual restraints can chill a buyer's interest in your company if the buyer believes that an acquisition of your company could prevent it from operating its other businesses as it has historically.

Review pending and future tax liability

- In line with keeping your records clean, tax considerations should be given an additional layer of polish.
- Consider whether state sales tax, income tax, or franchise tax is payable.
- Poorly kept records of tax payment (or non- payment.) can result in price reductions at the time of sale, and correspondingly negatively affect the sale price, with the buyer attempting to limit potential liabilities, which can be extended for six years and beyond.
- Often, a buyer may require that the purchase price be reduced or "held-back" by some amount to cover outstanding tax liabilities, if it discovers that taxes were not paid or accounted for improperly.

Accurately estimate the company's value and study buyer competition

- Each of the previous recommendations is founded on the desire to maximize or retain company value. With that foundational work done, it is paramount that a company know its worth in the marketplace.
- This can be done by conducting honest and accurate internal evaluations, employing third-party evaluators (sometimes at a cost), keeping an eye on the sale prospects of competing companies and gauging the appetite for purchase generally. After all, you have been working too hard to lose value on a sale.
- Undervaluation can lead to a loss in capital or control, and overvaluation can lead a prospective buyer to look at acquiring a competitor with an expected sale in the future in mind.

Know when to ask for professional assistance

- Young companies are hotbeds for innovation and often employ individuals who are at the forefront of creativity in their fields.
- During the lifetime of your company, well before you have identified the home-run exit opportunity, you should have partnered with advisors you trust to look after your interest and those of your team members. Engaging the assistance of experienced advisors can make the difference between getting a deal done or letting one fall through the cracks.
- Whereas a mistake or oversight may not seem consequential initially, it is important to remember that a problem that appears to be minor can easily expand into a destructive force. For your startup, it can mean the difference between enormous success and lost opportunity.

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