<u>Five Biggest Mistakes Founding Shareholders Make in Selling Their Company</u>

I was delighted to represent Spectrum Law (Lawyers and Legal Advisors) in the International Bar Association's 5th Mergers and Acquisitions in the Technology Sector Conference held in Barcelona. Various interesting corporate related topics were raised throughout the two-day event. Nevertheless, what caught my attention the most is the discussion between M&A lawyers on a roundtable about mistakes their clients make in selling their company. Founding shareholders face many challenges in selling their companies, but some of the biggest challenges are mistakes they unwittingly make. The following are the five most common mistakes and how to avoid them:

1. <u>Being tempted by Proprietary Deal</u>
   One of the biggest mistakes founding shareholders make in selling their company is being lured into a proprietary deal. This occurs when the seller fails to create a competitive marketplace, thus, the buyer knows he does not have any competition and tends to make weaker offers with more punitive terms since he knows nobody else is bidding.
   Founding shareholders should avoid the proprietary deal by creating a competitive process for their company. Indeed, there is nothing that will give the seller more leverage in connection with the sale of his company than a competitive bidding process. Bidders can be played-off of each other and, as a result, the seller will be able to strike the best possible deal.
   Therefore, founding shareholders should not be tempted to accept the first offer that comes across the table; hence, multiple buyers are always a scenario that benefits the seller. The best way to avoid the sharks is to play them at their own game.

2. <u>Not having a proper Term Sheet/LOI</u>
   Founding shareholders must understand that their strongest leverage as a seller is prior to the execution of a Term Sheet or in other words a letter of intent (LOI). Once the LOI is signed, the leverage typically swings to the buyer since the latter will request a "no shop" clause or exclusivity provision prohibiting the seller from talking to any other bidders for a period of time. Therefore, not negotiating the material terms of the deal in the LOI is also a common mistake founding shareholders make.
   In order avoid the above mistake, founding shareholders should have an LOI including but not limited to the following:

- The scope and length of any "no shop" clause or exclusivity provision, noting that the shorter its length the better it is for the founders.
- The price, mode of payment, type of stock, or part promissory notes.
- Any adjustments to the price and the method of calculation of these adjustments.
- The amount and length of any escrow.

3. Having incomplete books, records, and contracts.
   Before buying any company, the buyer will want to ensure that he knows what he is buying, his obligations, the nature and extent of the seller's contingent liabilities, problematic contracts, litigation risks, intellectual property issues, and much more.
   Due diligence investigations by buyers often find problems in the seller's historical documentation process, including some or all of the following:

- Missing or unsigned Board of Director or General Assembly's minutes or resolutions.
- Contracts missing a signature of either party.
- Contracts that have been amended but without the amendment terms signed.
- Incomplete employee-related documents.
- Absence of complete financial statements.
- Unregistered intellectual property rights.
- Terms of use agreements that aren't updated.
- Expired licenses.

Deficiencies as the ones stated above are so important to a buyer that the latter will require certain matters to be remedied as a condition to closing, which can be problematic, thus, breaking the whole deal.

4. Not taking into consideration the taxation
   The tax structuring implications of a transaction can have a substantial effect on the net economic return to the stockholders. On one hand, buyers tend to do asset purchase deals since they can provide a "step up" in tax basis and may alleviate the potential of taking on unknown liabilities of the seller. On the other hand, sellers should structure the sale of the company as a stock sale, since this will eliminate the risk of "double taxation" present in many asset deals, and enables the seller to avoid the burden and expense of winding up the company's remaining assets and liabilities. In addition, selling stocks instead of assets is simpler, requires less documentation and is less time consuming.

5. Neglecting the day-to-day operation of the business
   The procedure of selling a company will be tremendously distracting and time consuming. Nevertheless, the founders should not neglect the day-to-day operation of the business, hence, they should ensure that the business continues to grow and operate efficiently in line with projections given to the buyer. The founders should avoid the deterioration of the selling company's financial situation during the process. This may result in the buyer renegotiating the price and terms of the deal, or even kill the whole deal.

Conclusion:

The mistakes stated above, along with many other mistakes, *inter alia,* not executing a shareholders' agreement prior to any negotiation, not investing in proper Standard Operating Procedure module (SOP) and focusing on one individual to operate the whole business (a.k.a Key Person Risks) instead of a more dynamic approach, are all issues founding shareholders face and need to address prior to thinking of pitching any investor or prospective buyer.

Therefore, performing a due diligence on one's self along with proper corporate governance and proper counsel throughout the lifespan of a business will surely remedy any hiccup that might occur along the way.

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