MERGERS & ACQUISITIONS ***Q&A***

Q: I'm buying (or investing in) a company, but I haven't done the Intellectual Property (IP) due diligence. What should I do?

A: Getting the IP due diligence right in an M&A transaction is a challenge, but doing so will help with the valuation, lock in the intangible assets, and reduce risk. Consider these tips:

• Conduct an IP Audit. Investigate what you think you're buying and confirm that you want it. Patents, trademarks, copyrights, and trade secrets are what most people consider. Don't stop there. Dig deeper to identify other intangibles (computer code, formulations, design concepts, testing data, invention disclosures). This IP audit results in a robust IP Asset List.

• Confirm that the seller owns the IP. Investigate the title to the intangibles on your IP Asset List. Patent, trademark, and copyright laws treat ownership differently, so while the seller may claim they own everything, you'd be surprised to learn the opposite. Once you identify any problem areas, you can negotiate with the owner to resolve them.

• Confirm that the items driving revenue don't infringe. The last thing you want to do is buy a lawsuit. Analyze the balance sheet and investigate the items driving revenue to determine whether they infringe on third-party IP. Your investors will be upset if a competitor sues, gets an injunction, and then stops the sales of those things driving revenue.

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Q: Does an earn-out make sense in the sale of my business?

A: It depends on the circumstances.

There are numerous ways to structure the sale. Few transactions are all cash. Many times there can be a gap between the value the seller is willing to accept and what the buyer is willing to pay. A well-drafted earn-out can be used to bridge that gap while satisfying the concerns of both parties.

An earn-out is a contractual provision in a purchase agreement that provides for the seller to obtain additional further compensation contingent on future financial performance of the business post-closing. Amounts paid pursuant to an earn-out are in addition to the amounts paid at closing.

With tremendous upside for a seller in an earn-out, it's imperative a seller consider the following in such a transaction:

• Be realistic about the future growth of the company being sold.

• Acknowledge that the seller will, in all likelihood, be working as hard or harder after the sale, in an effort to maximize the amount of the earn-out.

• Know about the person or persons you're selling your business to.

• Try to retain as much control as possible while allowing the buyer the flexibility to grow (both sales and earnings) during the earn-out term.

In considering an earn-out, get professionals involved as early as possible. Their experience can be invaluable.

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Q: What is rollover equity and why is it an important deal term?

A: As private equity funds are structured to invest in businesses, rather than manage businesses, a target company with a strong management team is a highly desirable prospect. Thus, it's common for a buyer to insist that the company's owners (or at least those owners who are actively involved in management) remain involved after closing. This promotes a smooth transition.

To incentivize owners to remain active, buyers generally require them to exchange (roll over) existing equity for equity in the new company. As a result, the existing owners would hold a minority equity interest in the new company. The amount of rolled equity varies, with the target's owner(s) generally retaining a 5 percent to 40 percent interest. With such a potentially large investment, the existing owners must carefully consider and negotiate the proposed rollover package.

The most important point is to start negotiating these terms up front, not after getting deep into the sales process. By doing so, existing owners can often minimize tax liability, gain favorable positions to control future sales, and minimize requirements to make additional capital contributions.

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