www.ocbj.com $1.50 VOL. 33 NO. 2 • January 11-17, 2010

ORANGE COUNTY BUSINESS JOURNAL

Keeping (Or Getting) Your Corporate House in Order

Simple steps to avoid unnecessary and costly headache and delay for M&A target companies to facilitate a smooth exit strategy

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I. Introduction

Owners and management of target companies in merger and acquisition (M&A) transactions are often surprised to learn that, in addition to whatever business, operational and financial due diligence may be undertaken by the acquiror and its financial and accounting representatives, an entirely separate and distinct parallel due diligence review of the target's corporate governance, contracts and other material legal documents will be conducted by the acquiror's internal legal team and/or outside law firm.

In many transactions, particularly those involving private-company targets, the company's owners, management team and M&A counsel expend unnecessary time and attention addressing deficiencies discovered during the legal due diligence process. Resolving these deficiencies typically results in significantly increased legal fees for the target company (which is money out of the owners' pockets), a delayed closing and, in some cases, the acquiror altogether walking away from the deal. The good news is that most, if not all, of these costs and delays can be reduced or perhaps avoided by taking some simple steps to properly maintain the company's corporate governance and legal matters and, where necessary, consulting with experienced corporate or M&A counsel.

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Whether an exit event is around the corner or years away, it is much simpler and more cost-effective to implement and maintain sound corporate governance and legal practices than it is to correct problems after the fact. To the extent a company already has problems, it is better to discover and resolve them now than to have them emerge weeks or days prior to the anticipated closing date.

The following is a summary of some of the more common legal due diligence issues selling companies encounter when engaging in an M&A transaction, along with some suggestions on how to avoid them. While some of the examples below refer to corporations organized under the laws of California or Delaware, the principles generally hold true regardless of the state of incorporation and, for the most part, also apply to other business entities such as partnerships and limited liability companies.

II. Articles and bylaws

A corporation's articles of incorporation and bylaws are the basic documents that govern the corporation's operation. Take an hour or so to read them. Yes, it can be a boring read – particularly for the creative, entrepreneurial personality – but the average business owner should be able to understand most if not all of their contents. These documents contain important information such as the authorized number of shares that may be issued; the authorized number of directors; quorum requirements for board and shareholder meetings; and whether board or shareholder action can be taken by written consent (as opposed to actually holding a meeting). Becoming familiar with the foregoing provisions of the articles and bylaws can help avoid some frequent and problematic corporate governance violations such as issuing too many shares, operating with the wrong number of directors, failing to have a quorum when matters are approved by the board or shareholders, and taking action by written consent when it is not authorized.

III. Meetings and minutes; board and shareholder approvals

The corporate laws of both California and Delaware require that a corporation hold a meeting of shareholders at least annually. Similarly, most bylaws require that the board of directors meet at least annually. Corporate law generally also requires that a corporation keep accurate minutes of all shareholder, board and board committee proceedings. These rules apply even if a corporation has just a single shareholder and/or director.

While the owners and directors of a private company may often see these as insignificant formalities, there are compelling reasons to take the time to comply with these requirements. For example, a potential acquiror may become dissuaded by poorly-kept or missing minutes, as it may call into question whether the company's activities have been conducted with proper board and shareholder authorization or whether inattention to detail is pervasive throughout the company, thus diminishing its valuation. More generally, failure to maintain proper books and records is a violation of general corporate law and can be a factor in holding shareholders personally liable for the acts of the corporation (a legal concept commonly known as "piercing the corporate veil" or "alter-ego liability").

A non-exclusive list of matters typically requiring board approval includes: electing officers annually; adoption of employee benefit plans (401(k) plans, stock option plans, etc.); executive-level employment agreements, salary and bonuses; the purchase, sale or lease of real property; credit facilities and other significant debt (other than ordinary course debt such as trade payables); and the issuance of stock, stock options and warrants to purchase stock.

Shareholders should elect directors on an annual basis and approve any fundamental transactions, such as a merger or the sale or transfer of all or substantially all of a corporation's assets. Shareholder approval may also be required for other transactions under applicable corporate law and to gain the advantage of certain tax treatment for a corporation's stock option or similar incentive-based plans.

A corporation that conducts these and other transactions at the direction of its management without obtaining board and/or shareholder approval may find that the conduct transpired without proper corporate authorization. The consequences of failing to obtain appropriate corporate authorization include the conduct being void or subject to rescission and may expose the company to various claims and liabilities. Trying to correct these failures after the fact can be difficult and costly, particularly if the shareholders or board members existing at the time of the conduct are no longer in the picture or have become hostile to management or each other.

IV. Compliance with governing corporate laws

The corporate law of a corporation's state of organization, as well as court decisions interpreting those laws, are filled with nuances that can cause the most well-intending board members and shareholders to trip up on corporate governance matters. Here are just a few examples:

- A California corporation must have two or more board members if it has two or more shareholders; and must have three or more board members if it has three or more shareholders.
- Except in limited circumstances, shareholders of a California corporation may not appoint directors by written consent – the holding of an actual shareholders' meeting is required.
- Action taken by written consent of the stockholders of a Delaware corporation is invalid unless each stockholder individually dates his or her signature to the consent.

Failure to comply with these and other technicalities can result in corporate actions that are not properly authorized. Again, improper authorization can be a substantial deterrent to potential acquirors and often require significant time and legal fees to correct.

V. Contracts

A potential buyer will want to know that a company has the right to enforce the terms of its contractual relationships. A company should appoint someone (ideally someone familiar with negotiating or drafting agreements) to review the company's contracts at least annually to ensure they have not expired. If the company has numerous contracts and it proves too burdensome to review them all, apply a Pareto-principled review – focusing on those contracts that are most material to the business. Contracts that have expired should be extended in writing or a new contract entered into. Also, check to make sure the terms of the contract match the current terms of the relationship and amend nonconforming provisions as necessary.

Oral contracts present similar problems. While a business owner may be comfortable with its ten-year oral arrangement with a certain customer or supplier, a potential buyer will like-

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ly require the certainty that comes with a written agreement.

Another contract issue that arises in the M&A context, particularly in deals structured as an asset sale, are provisions that prohibit assignment of the contract without the consent of the other party. Check under the "Miscellaneous," "General Provisions" or similar heading near the end of a contract and you will often find a provision that sets forth the conditions under which the contract may be assigned. More likely than not, in well crafted contracts, the provision will state that either one or both parties is prohibited from assigning the contract without the written consent of the other party. The task of trying to track down written consents to assign contracts from uncooperative or hostile third parties is notorious for delaying deal closings.

To reduce the number of consents that will be required to close an M&A transaction, management should review the assignment provisions prior to executing an agreement and try to negotiate out any requirement that the company obtain the consent of the other party prior to assignment. Be aware, however, that this may be met with some resistance (the other party may want to have control over whom they are bound to in the contract) or result in the other party asking for reciprocal language with respect to its ability to assign the contact without the company's consent (which the company may not be comfortable with for the same reason).

If a company has its own form of contract that it regularly enters into with customers or clients, it should consider drafting the assignment provision so that the company can assign the contract without the consent of the other party (whether the company wants to grant a reciprocal right to the other party or, alternatively, require that the other party seek the company's consent prior to assignment depends on multiple factors, including the type of the contract and the nature of the company's business). A would-be seller can quickly become frustrated upon learning that the form of contract it has been using requires that it seek the written consent of each of its customers that signed the contract before the company can close its M&A transaction.

A final word on assignment provisions: although they often appear straightforward, they can be entwined with legal nuance. Those that aren't sophisticated in the drafting or interpretation of these provisions should consult with someone familiar with contract law to ensure the language results in the intended consequences.

VI. Stock option and other incentive plans

Companies typically have the best of intentions when implementing a stock option or similar incentive plan – the owners value their employees and want them to have the opportunity to participate in the upside of the business. However, some of the most well-intended incentive plans have been the downfall of the very exit event from which the owners had hoped the plan's participants would benefit.

The procedure for adopting and implementing a stock option or similar incentive plan is filled with traps for the inexperienced. Generally, the plan, and in most cases, each grant under the plan, must be approved by the company's board of directors; the plan must contain certain provisions to take advantage of certain laws and to not violate others; the granting of options or similar awards are typically subject to compliance with state and federal securities laws; and establishing an improper fair-value exercise price can wreak havoc on a later valuation of the company or a subsequent audit.

VII. The perfect storm – a real-life example

A recent transaction where the founder and majority owner was seeking to sell his technology company illustrates the potential impact of failing to properly maintain some of the corporate governance and other legal matters discussed above. In this particular case, the founder had acted as the company's sole director since the inception of the California corporation (even though there were three shareholders), widely distributed a memorandum purporting to allow every employee of the company to earn stock options based on the company's sales volume (without obtaining board approval or adopting a formal stock option plan) and had minutes and material contracts that were unsigned or altogether missing.

These deficiencies called into question the validity of much of the corporation's historical activities and left more than 40 current and former employees with potential claims for undefined stock options. The result: two potential private-equity suitors that had signed letters of intent and progressed toward closing eventually backed out of the deal due to concerns related to these problems. While the deal did eventually close nearly a year later with a third buyer, the founder incurred significant legal fees correcting these problems, paid a significant price to obtain releases from potential option holders and had a substantial portion of the purchase price held back in escrow at closing to provide security to the buyer.

VIII. Conclusion

An exit event is a pivotal moment for the owners of a privately-held company – often representing the culmination of years, if not decades, of proverbial blood, sweat and tears. While an exciting transition, it is frequently accompanied by frustration, stress and anxiety – particularly for those not familiar with the process. Implementing the suggestions described in this article can significantly reduce the risk of being ensnared by some of the more common legal due diligence problems and help facilitate a smooth path toward a successful consummation of the exit event.

If you have any questions or would like any assistance regarding the matters discussed in this article, please contact the author, Garett Sleichter 714.641.3495 gsleichter@rutan.com or your regular Rutan & Tucker contact.