In this section we're going to talk about the other type of term sheet that you might have to negotiate, which is a letter of intent in an acquisition scenario where your company is being acquired. We're going to spend time on a relatively simple case all the way throughout which is a two party transaction where there is an explicit buyer of your company.

There are more complicated transactions, but for the purposes of the LOI that we're going to be talking about here, we're assuming that your company is being acquired by another company.

Clint: Let's talk about the structure of an LOI. How do I understand what I'm going to get out of it?

Brad: The LOI, like the term sheet, is a document that can be a couple of pages long, sometimes more. It has lots of different sections in it. A lot of time when your company is being acquired you're focused on, "What price am I getting?"

The problem is that, like in the economics of a term sheet, the price isn't always a simple straight forward number. There can be multiple components to what the price actually is. We'll talk about a number of these components in this section.

For example, in addition to the base consideration you're getting there could be an earn out, which is extra consideration that you earn over time. There could be an incentive carve out for the management team that's either part of the overall price or in addition to the overall price. There will often be an escrow, which is some amount of the consideration that's held back for a period of time to make sure that reps and warranties, which we'll talk about, get satisfied.

There are multiple components to the actual price, notwithstanding that fact that in some companied you might be being acquired for cash, and in other companies you might be being acquired for stock in their company. If it's a public company it's relatively easy to understand what the value of that stock is. If it's a private company it's a lot harder to understand the value of the stock.

The actual price is not as simple as just understanding a simple number.

Clint: Put this all in context for us. What is a typical acquisition process look like? How does start? Where does the LOI fit in? How does it end?

Brad: It's probably important to recognize that there's not really a typical process. Companies acquire other companies for lots of different reasons. Sometimes you're in a situation where the dance and the process evolves over a very long period of time. Sometimes it's very sudden.

Sometimes it's a situation that's incredibly competitive between lots of different companies that are trying to buy yours, and others where there is one single buyer that's been interested in buying your company for a while.

There are situations where you might shop the company actively trying to find other people who are interested to try and drive up the value of the acquisition. There are other situations where you might be delighted with only working with the one company that's approached you.

You could be in a situation where you have to sell the company because you're running out of cash and your investors are pushing you to sell the business. There could be another situation where you're cash flow positive.

There really isn't a typical case. I would break down the long arch of these different scenarios into the following stages. The first stage is essentially the dance leading up to the point at which you start negotiating with one or more parties. The second stage is negotiating and agreeing to the letter of intent.

Those two stages, by the way, are not too dissimilar to the process that you go through in terms of raising financing, although the timeframe can be different and the activities can be very different. The last is then going from a letter of intent to definitive agreement. The process there is again a very heavy lawyer driven process, although it tends to be much heavier weight than a term sheet to a financing versus what you're used to in that context.

Student: What activities should an early stage company, prior to you've been entering or thinking about these negotiations, take to prepare itself to be a good acquisition target? Because it is very likely successful outcome relative to the point of [inaudible 0:04:16].

Brad: That's right. Most of the success outcomes for an early stage company will be to be acquired. I think that most important is to recognize that you're likely on a path to be acquired. I think a lot of people advise entrepreneurs to never think about the exit and just focus on building a great company.

I believe you shouldn't worry about the exit and should focus on building a great company, but you should also recognize that it's likely that you're going to get acquired. You should be working on developing those relationships and be open to any inquiry from anyone who might look like a potential inquirer.

I also encourage entrepreneurs, as their companies start to mature and take shape, to start to think about who those potential inquirers are and to actively develop relationships with them. That way, it's not just a case of random happening, but if random does happen, you at least know who you should reach out to because something is going on.

By the way, a lot of times relationships that turn into business relationships of some sort often lead to acquisition discussions. The process of completely ignoring it is a mistake.

The other thing, which is part of the essence of getting your capital structure right and being serious and deliberate about your corporate records, it may seem like a nuisance as an entrepreneur to have to deal with all of this stuff. In the context of a venture financing, you'll start doing annual audits. You'll do 409a valuations.

There are all these things that you'll end up doing that are part of the overhead of being a growing startup company. Many of those things are in place because at the time at which an acquisition happens, you have to get that stuff organized and put together. It's much easier to put it together along the way than just at that last moment when you're getting acquired.