

NEGOTIATION PRESSURE AND DEAL DEADLINES

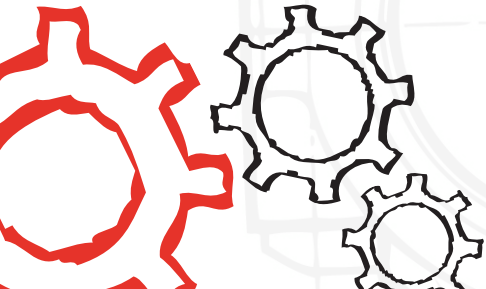
When an inventor builds a machine, he makes sure that he knows how each of the parts work and how they fit together. The more planning and preparation he puts into the machine, the more smoothly it operates when he switches it on. If the same kind of detailed planning and preparation are put into the legal administration of a company, then selling that company should be a much smoother process. The intention of this series of articles is to assist with that planning by looking at some of the cogs in the machine and providing some insight into what each one does.

Previous articles in this series have looked at cogs that are put in place earlier in a company's life. Although these provisions are all aimed at smoothing the process of a major fundraising or an exit sale, in many cases it will be some years between the time when such a cog is put in place and the time that it first turns. A drag-along right, for example, will be inserted into a company's articles of association at the time of a B or C round financing – and not be triggered until the investors and/or founders are selling out.

No less important, however, are the cogs in the machine that are put in last – the planning and preparation that management put into the major transactions in the life of their company. This article will consider a fundamental cog for the smooth running of a transaction – planning to deal with negotiation pressure.

REDBOX LTD.

Certain founders of RedBox Ltd. wanted to sell their shares, and located a buyer. Once the sale process was already moving, market rumours started to circulate that the government was planning to announce changes to the tax regime. If the rumours were accurate, the selling founders would receive markedly higher tax bills on the sale of their shares in RedBox. Accordingly the selling founders set out to ensure that the deal was concluded by midnight on the day before the rumoured announcement. All of the paperwork was close to being ready by around midday on that date, and so the parties duly assembled in a meeting room to finalise and sign the agreements.





It was at this point that negotiation pressure took effect. The selling founders were the only party in that room that faced adverse consequences if the deal was not signed that day, which meant that if any negotiations were opened they were the only party under any pressure to reach agreement quickly. Any other party could drag their heels over a change that was contrary to their interests, but the selling founders were strongly incentivised to conclude the negotiations – and the easiest way to do that is to accept the other party's position. More, the consequences that the selling founders expected to face were based on the price of their shares and the expected changes to the tax regime – and therefore easily calculable amounts.

Each of the other parties to the deal, recognising the negotiation pressure on the selling founders, requested last-minute changes to the documents that cost the selling founders value - but left enough of it on the table that it was still better to sign the deal that day rather than re-open negotiations. The selling founders duly conceded those points.

BURNRATE LTD. - TIMING


BurnRate Ltd. was a pre-revenue company, which had raised money from the founders and their contacts to develop its product. The directors of BurnRate intended to get the product

developed and tested, and on the basis of the tested product raise external capital to finance production and eventual sales.

Unfortunately for BurnRate the development and testing took longer than they had envisaged. By the time a suitable investor had been located, BurnRate was beginning to run out of cash. The founders and their contacts had already exhausted their funds in getting to this point, so BurnRate's options if they couldn't close the investment round in time were either to shed some of its staff or to take short-term financing on unfavourable terms.

BurnRate's directors and advisers could have recognised that there was an issue here for BurnRate's financing, and accordingly begun the process earlier to give themselves the best chance of finishing the transaction before their funding became an issue. With product testing in progress it is likely that any offers they received would have been conditional on that testing being completed satisfactorily, which may have created some additional work. By waiting, however, BurnRate was left in a position where they had to complete the deal quickly – negotiation pressure which would affect their terms.

Work does tend to spread out to fill the time available, and beginning a process earlier will lead to a longer process - with all of the cost and disruption that entails. This can be counteracted



by keeping up the momentum with the other parties to the transaction, which good advisers can help with. In any event the cost of a slightly longer process should be marginal, compared to the potential cost of ending up subject to substantial negotiation pressure.

BURNRATE LTD. - DEAL DEADLINE

One alternative technique to try to prevent negotiation pressure is to set a deadline by which the deal must be completed, so that the negotiations are concluded before the issue starts to arise. BurnRate's management, when they recognised the problem, did so - but the investor regularly took several days to review and respond to versions of the agreements.

When the deal deadline arrived with completion still some way off, BurnRate's management gave the investor a few days' grace - and another few days when that expired. A deal was eventually concluded shortly before BurnRate's money ran out, on terms that were well below the "worst acceptable case" that had been identified when BurnRate was planning its fundraising. On its face the imposition of a deal deadline should have prevented this occurring - but BurnRate's management were unable to convince the investor that the deadline was genuine.

Part of the issue was that, having started the process later than expected, the gap between the deal deadline and the date on

which funding was expected to run out was too small for BurnRate to close an alternative investment deal. The investor examined BurnRate's books as part of its due diligence, and likely knew this and rightly concluded that the deadline could therefore safely be ignored.

Trying to enforce a deadline when the company has no reasonable alternative, or the other party has no particular commitment to the deal, will rarely if ever be successful. BurnRate's management finalised the deal in the face of negotiation pressure and perhaps also reduced credibility with the investor.

INTHEROOM LTD.

InTheRoom Ltd. used a deal deadline to much better effect. InTheRoom was in a similar position to BurnRate - they had raised money from a number of funds and were looking to conclude a trade sale of the business. InTheRoom could have gone back to its investors for more funding, but the dilutive effect of that financing on management's value would have been significant.

InTheRoom began their process much earlier than BurnRate had done. This in itself is a good tactic to avoid negotiation pressure, but doubly so in the context of a deal deadline. Management were able to set a deadline far enough in advance of the date on which funding would have been exhausted that there would have been time to conduct an alternative process before the money ran out. This meant that the credibility of the deadline was not undermined.

InTheRoom's management also supported the deadline's credibility with interim deadlines for the completion of due diligence, signature of the termsheet and various other milestones in the process (and instructed their lawyers and other advisers to

work to them and highlight them to buyer's advisers). As well as emphasising the the time-critical nature of the deal, this also went some way to preventing work spreading out, and therefore mitigating the cost of the longer timetable.

Crucially, InTheRoom management's message to the buyer was consistent and cohesive – they were keen to do the deal, and would work exclusively on this sale process; but they needed a buyer within a limited timeframe and would look elsewhere if this process faltered. Management did occasionally grant small amounts of extra time on their interim deadlines during the process, but as they had established that they did have credible alternatives they could do this without undermining their overall position.

CONCLUSION

It will usually be the company, rather than the investor or buyer, that has a pressing need to complete a transaction by a certain date – and this leads to negotiation pressure, which can significantly affect the terms that are achieved in that deal. Beginning the process early, so as to allow time for the deal to proceed without getting too close to that real deadline, is the easiest and most common way of combating this.

Deal deadlines may be used effectively if the company believes that it has reasonable alternatives to the transaction and that the other party is relatively committed to the deal. If they intend to add this particular cog to their machine, management must ensure that their deadline is feasible and convincing – and, crucially, must be prepared to take action if it is not respected.