

The
STRATEGIC GUIDE
to
SELLING YOUR
SOFTWARE COMPANY:

Essential Advice from a
Veteran Deal Warrior

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GLOSSARY

“Leadership is thinking about the overview and the end result needed . . . and relies on competence, vision, and the leader’s inner strength to sustain the unit.”

Army Field Manual 22-600-20
1977

1. OVERVIEW

When I started this project, my friends asked me why I was writing a book about selling privately held *software* companies, as opposed to privately held companies in general. After all, I have assisted clients in selling and buying many different kinds of businesses, from industrial manufacturing and commercial service companies to wireless telecommunications businesses. But, I’ve been involved in more transactions involving software companies than anything else. Another reason to focus on software companies is that privately held software companies are very different from other kinds of privately held companies, and so I felt that software company owners would find a book like this one to be useful.

Because software companies are different from traditional businesses, the entire selling process is different. Typical valuation

methods are often inappropriate, in part because the economic characteristics of software companies are very different from traditional businesses. With software companies:

- Barriers to entry are low;
- Growth is rapid;
- Variable costs are virtually nonexistent;
- Sales are not confined to a particular geographic region;
- Competitors can emerge suddenly from out of nowhere;
- Margins are much higher;
- Intellectual property is fundamental to the business;
- Rapidly changing technology is a constant challenge that must be addressed; and
- Employee considerations are different, because the employees are often the company's most valuable asset.

Potential buyers who fail to understand how privately held software businesses differ from traditional businesses are difficult to deal with. And, inexperienced potential buyers can very quickly waste your time and money. Consequently, if you decide to sell your business, focus your efforts on potential buyers who understand how software companies are different.

The other question friends asked was: "Why the military angle?" Well, having spent four years at West Point, thirteen years as an active-duty Army officer, and twelve years as a Reserve officer, I've spent a lot of time working on, and thinking about, military operations. There's a lot to be said for the time-tested (and battle-tested) procedures that the Army uses to make decisions, develop plans, manage operations, and lead soldiers. I've found that these procedures work very well in analyzing the process of selling a business and efficiently managing the execution of that process.

U.S. Army Field Manual 5-0, *Army Planning and Orders Production*, is the Army's keystone manual for planning operations. It sets forth the Army's doctrine for problem solving, the military decision-making process (MDMP), troop leading procedures (TLP), and formats for Army plans and orders. This book will frequently make reference to FM 5-0, as well as its predecessor, FM 101-5, *Staff Organizations and Operations*.

Although references to military doctrine appear throughout this book, it is not intended to be a military book. It is, instead, a business book that borrows from the doctrine that the Army has developed to address the important, and extremely difficult, process that commanders must undertake as they make decisions that risk the lives of their soldiers. Although you might detect, in the examples given in this book, a bias toward the Army, it is certainly not intended as a slight to any other armed service: it's just where I come from.

The quotation from the Army Field Manual, reproduced at the beginning of this chapter, emphasizes how important it is for a leader to maintain an appreciation of the "big picture." The principal goal of this book is to give you the "big picture" of the process that will take place if you decide to sell your company. Although I have attempted to include all of the topics that I think you would need to consider, this book will not provide enough detail to make you an expert in every aspect of that process. You would need the help of an experienced team of professional advisors. The book will, however, provide you with the information you would need to enable you to lead your team and to manage the process effectively.

The organization of this book is somewhat linear. It attempts to present the material in the order in which you would consider it, if you

decide to sell, and then plan and execute the process of selling, your software company.

Chapter 2 presents the first, and most important, step of the process: deciding whether to sell your company. It describes the Army decision-making process and explains how you can apply that process to the task of deciding whether to sell your company. It directs you to consider several important initial issues: why you might want to sell, when you should sell, and how to organize the process of selling your company.

Chapter 3 addresses your reconnaissance of the marketplace and the pool of potential buyers and your assessment of specific potential buyers.

Chapter 4 explains how the Army technique of “task organizing” could be used to help you organize the team that would assist you with selling your company.

Chapter 5 deals with the often overlooked topic of preparing to sell your company. Failing to prepare properly would have a direct, adverse impact on the probability of concluding a successful sale.

Chapter 6 provides a detailed explanation of important responsibilities of the owners and the directors, as well as the basic alternative structures for the transaction.

Chapter 7 outlines the actual steps of the sale process: preliminary discussions with potential buyers, the letter of intent, the buyer’s examination of the company, negotiating the deal, the key provisions of the purchase agreement, and the closing of the transactions involved in the sale.

Chapter 8 provides some final thoughts on this complex and potentially life-changing process.

A word about gender. The goal of this book is to communicate useful information in a manner that is both efficient and memorable. I have not yet mastered the art of writing without reference to gender. This failure on my part should not be construed as an attempt to devalue the contributions of the female gender to the software industry or to the military. Instead, it is an attempt to communicate concisely. Thus, the use of masculine personal pronouns should be construed as nothing more than an economical use of words in the traditional manner. The reader will not see “he or she” or “his or her.” Suffice it to say, women are included in any reference to an anonymous “he.”

So, sit back, kick off your boots, take out your highlighter, and join me as we walk through the process of selling a privately held software company from the perspective of a veteran deal warrior.

Caveat emptor!

Before we proceed to examine the process of selling a software company, the lawyer in me compels me to say, “Caveat emptor!” (Let the buyer beware!) Much of what is contained in this book could be construed as legal or accounting advice. ***It is not!*** This book is intended to familiarize you with the issues that you would face if you decide to sell your software company. As we all know, every situation is different. Something as important as selling the company that you have put your blood, sweat, and tears into should not be undertaken without the assistance of experienced professional help. In particular, you would need an experienced accountant and attorney. Please note that the forms and documents in the back of this book are included for educational purposes only. ***They are no substitute for competent legal, tax, and accounting advice.***

“Nothing is more difficult, and therefore more precious, than to be able to decide.”

Napoleon Bonaparte

2. DECIDING

The decision to sell your software company is one of the biggest and most important decisions you will ever make. Obviously, it shouldn't be taken lightly. Moreover, the complexity of the decision means that you will probably need the assistance of others. Therefore, it will be extremely helpful if you use a structured decision-making process in order to keep things organized and coordinated.

Those readers who don't enjoy reading about something as theoretical as a process for making effective decisions can skip this chapter and move on to Chapter 3. But, beware! I've seen many transactions go off track, because the process degenerated into a disorganized mess. Accordingly, I strongly recommend that you continue on through Chapter 2. The process of selling your software company is one that will demand effective management and strong leadership from you and the other members of your team. I believe the

principles set forth in this chapter will be of great assistance to you in getting the job done.

2.1 The Army Decision-Making Process

Nowhere, in the process of selling a software company, is the value of the military analogy more apparent than in the very first step: making the decision to sell.

Army manuals contain many procedures that apply to the decision-making process involved in selling a software company as well as they do to problem solving and decision making in the Army. Consequently, I believe it is useful to see what the Army has to offer. The following discussion draws on several Army manuals, some of which will be quoted at length.

The Military Decision-Making Process

“Decision making is knowing *if* to decide, then *when* and *what* to decide. It includes understanding the consequence of decisions. Decisions are the means by which the commander translates his vision of the end state into action.”

“Decision making is both science and art. Many aspects of military operations—movement rates, fuel consumption, weapons effects—are quantifiable and, therefore, part of the *science* of war. Other aspects—the impact of leadership, complexity of operations, and uncertainty regarding enemy intentions—belong to the *art* of war.”

Chapter 5, FM 101-5
Staff Organizations and Operations

The italicized words in the first paragraph of the passage quoted in the box were italicized in the original and are worth emphasizing here. The first aspect of decision making is knowing whether *any* decision is necessary or appropriate. One entrepreneur who reviewed some early drafts of this book put it this way:

“Don’t forget to build value into your business by running it. Your business is not selling your business. The time you invest in your business builds value.”

Thus, it is important to know whether *any* decision regarding the sale of your software company is called for. If you lose sight of managing your core business, because you are preoccupied with selling it, or making some other major strategic decision that is unrelated to running the company, the results could be disastrous. The quoted passage of FM 101-5 also stresses the importance of knowing *when* to decide, which is discussed in detail in Section 2.5. Finally, the passage emphasizes the importance of knowing *what* to decide. Never allow yourself to become enamored with any particular course of action, such as an IPO, a sale to a strategic purchaser, or an investment by a venture capitalist or other private equity firm. Section 2.3 discusses the planning process in detail, including the development and evaluation of alternative courses of action. Knowing what needs to be decided is a key aspect of the decision-making process.

The second paragraph of the passage quoted in the box emphasizes the dual nature of the decision-making process: it is part science and part art. This dual nature is present in most decisions of any magnitude, and so it is not surprising that this dual nature is also apparent in the process of deciding to sell a software company.

Some aspects of selling a software company are quantifiable and, therefore, part of the science of the process. Quantitative analysis seeks to define and evaluate relevant factors or variables that can be measured or counted. It can be useful in identifying trends in data sets, as well as sharp departures from expected norms or measurements. Thorough quantitative analysis looks for correlations between variables, so that you

can predict the effects on the dependent variable when changes occur in the value of the independent variable. For example, are your sales revenues affected by interest rates or the sales of other products, such as computer hardware? If so, what is the lag time between a change in the sales of the computer hardware and the resulting change in your revenues? What factors cause the biggest impact on your profits? Is it possible to predict the future performance of your company with a reasonable level of certainty? Army doctrine recommends that you organize and display the results of quantitative analysis in the form of charts and graphs.

In theory, if one considers only quantitative analysis, a software company should be sold whenever that course of action would be in the best interest of the shareholders. In other words, attempt to sell your software company whenever the discounted rate of return on the capital you have invested in the company is projected to be less if the company remains independent than it would be if the company were sold.

The quantitative perspective on the decision-making process views the decision as a straightforward investment decision, based on the software company's projected growth rate, cost of additional financing that may be required, appropriate discount rate, market receptivity, and so forth—all of which an analyst would be happy to collect for you on a spreadsheet.

Unfortunately, theory is not the real world. The decision to sell a software company is rarely a simple exercise in financial analysis, although such an analysis may be an important part of the overall decision. If, as a shareholder, you are considering your company's situation solely from the perspective of an investor, then your focus would be on assessing whether the management team can achieve the

projections that are part of the assumptions on which your financial analysis is based. There are, however, many non-quantitative factors that can dramatically affect that analysis as well. If, for example, your company has recently developed a new software product that has attracted the attention of other companies with greater resources (in the form of financial capital, human capital, access to markets through an elaborate sales and distribution network, etc.), then your company might be in store for some serious competition that necessitates a significant revision of the financial analysis. Your managers might be concerned about such potential competition; they might be unaware of it; or some or all of them might be contemplating leaving your company altogether. Non-quantitative factors like these can have a dramatic effect on the analysis, though they never appear on a spreadsheet.

Addressing these non-quantitative aspects of the decision-making process is part of the art of the decision-making process. You will need to make subjective assessments of such variables based on facts and assumptions and their likely effects on the outcome. Your judgment in this regard can be greatly enhanced by availing yourself of the assistance of professional advisors with significant experience in such matters. In the end, however, you know your company best. You are in the best position to make such judgment calls.

2.2 Skills and Techniques of Decision Making

Before addressing the specifics of deciding whether to sell your software company, let's take a look at some general principles of decision-making. In particular, let's examine the Skills and Techniques of Decision Making as described in Army FM 5-0. Although the Army

refers to this process as “problem solving,” the procedure is more often referred to in business literature as a decision-making process.

The Army has graphically described the elements of its Seven Step Problem-Solving Model in the following diagram, the components of which we’ll examine in detail in Section 2.3.

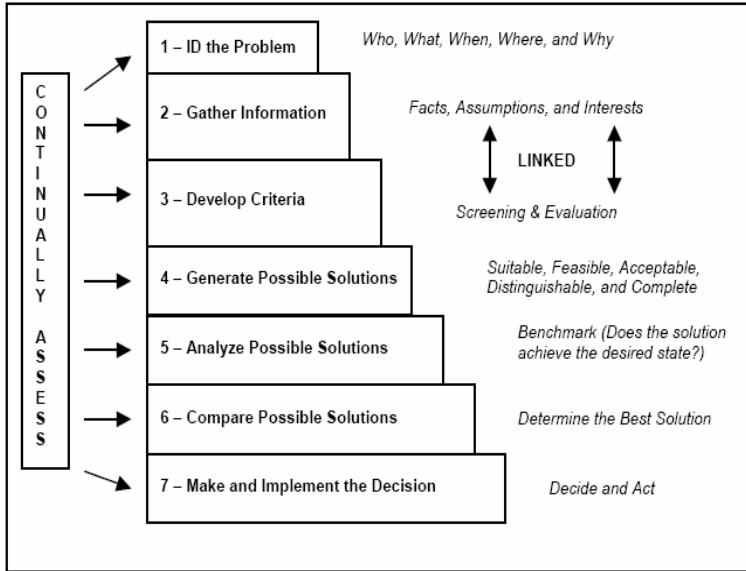


Figure 2-1. Seven Step Problem-Solving Model

Decision making is basically a systematic approach to defining a problem, developing possible courses of action to accomplish the goal, arriving at the best course of action, and implementing it. For a decision as big as selling your software company, which would involve a variety of factors, a systematic decision-making process is essential. It would help you ensure that you consider all of the important relevant factors and that you anticipate, and account for, the relationships among these factors as you develop your final decision. In short, the use of an approach like the Army’s systematic decision-making process ensures that the desired objective is achieved in the most effective and efficient manner.

ANNEX A
SAMPLE LETTER OF INTENT
*[for educational purposes only; must be conformed to state law
and the needs of the company]*

PURCHASER CORPORATION LETTERHEAD

_____, 200__

Shareholders of Company

[See Schedule A]

Re: Letter of Intent

Dear Sellers:

This letter of intent (this “**Letter**”) is intended to summarize the principal terms of a proposal being considered by ABC Corporation, a California corporation (“**Purchaser**”) regarding its possible acquisition of all of the outstanding capital stock of XYZ Systems, Inc., a Delaware corporation (“**Company**”) from the shareholders listed on **Schedule A**, attached hereto and incorporated by this reference. The persons listed on Schedule A are all of Company’s shareholders (“**Sellers**”). In this Letter, Purchaser and Sellers are sometimes called the “**Parties**,” and Purchaser’s possible acquisition of the stock of Company is sometimes called the “**Possible Acquisition**.”

PART ONE

The Parties wish to commence negotiating a definitive written purchase agreement providing for the Possible Acquisition (a “**Definitive Agreement**”). To facilitate the negotiation of a Definitive Agreement, the Parties request that Sellers’ counsel prepare an initial draft. *[As Seller, try to include this provision, although the Purchaser will probably insist on having its counsel draft the Definitive Agreement.]* The execution of any such Definitive Agreement would be subject to the satisfactory completion of Purchaser’s ongoing investigation of Company’s business and would also be subject to approval by Purchaser’s board of directors.

The following numbered paragraphs of this Part One reflect our understanding of the matters described in them, but do not constitute a complete statement of, or a legally binding or enforceable agreement or commitment on the part of, Seller or Purchaser with respect to the matters described therein, nor do they impose on either Seller or Purchaser an enforceable duty or obligation to conclude any such agreement or commitment.

ANNEX B

SAMPLE NON-DISCLOSURE AGREEMENT

[for educational purposes only; must be conformed to state law and the needs of the company]

THIS NON-DISCLOSURE AGREEMENT (this “**Agreement**”) is made and entered into, effective as of the ___ day of _____, 2006, by and between XYZ, Inc., a Delaware corporation (“**XYZ**”), and ABC Corporation, a California corporation (together with any affiliates of ABC, “**ABC**”). XYZ and ABC may be individually referred to as a “**Party**” or collectively as the “**Parties**.”

WITNESSETH:

WHEREAS, representatives of XYZ have already disclosed, or will hereafter disclose, to ABC certain confidential and proprietary information relating to the ___ business (the “**Business**”) and the operations of XYZ, in connection with ABC’s evaluation of the Business and prospective negotiations to sell the Business to ABC; and

WHEREAS, XYZ agrees to provide such information to ABC, subject to the terms and conditions of this Agreement.

NOW, THEREFORE, for and in consideration of the mutual covenants and agreements contained in this Agreement and other good and valuable consideration, the receipt and sufficiency of which the Parties hereby acknowledge, the Parties agree as follows:

1. CONFIDENTIAL INFORMATION.

(a) In connection with discussions between the Parties relating to the sale of the Business to ABC and for the purpose of evaluating the propriety of such transaction (the “**Transaction**”), XYZ may provide ABC with information concerning systems designs; systems documentation; computer programs; machine-readable information; processing flowcharts; reports; drawings; discoveries; inventions; improvements; concepts; ideas; models; patented and copyrighted materials and information; proprietary equipment designs; and information concerning XYZ’s operations, customers, suppliers, productivity, revenues, costs, profit margins, and other financial information regarding XYZ.

(b) In addition, XYZ may provide ABC with other information, defined as “**Trade Secrets**” under the _____ Trade Secrets Act. *[Note that not all states have a Trade Secrets Statute. Some rely on common law established by judicial decisions.]* Trade Secrets include all technical and nontechnical data, compilations, programs,

ANNEX C (Part 1)

SAMPLE DUE DILIGENCE CHECKLIST

[for educational purposes only; must be conformed to state law and the needs of the company]

I. ORGANIZATION AND GENERAL CORPORATE MATTERS

- A. Articles of Incorporation and Bylaws of the Company. Check for procedural and substantive compliance with corporation statute and corporate law applicable at the time of each corporate action. Depending on the transaction, such review could include the matters noted below.
1. Review for preemptive rights, rights of first refusal, registration rights, or any other rights relating to the issuance or registration of securities.
 2. If the transaction involves the issuance of stock (including convertible securities), are there sufficient authorized shares for the offering, including any conversion rights, taking into account any shares reserved for issuance pursuant to outstanding options, warrants, convertible securities and employee benefit plans?
 3. As to any amendments to the Articles of Incorporation and other significant corporate action, review corporate minutes for compliance with corporation law in effect at the time of the amendment.
 4. Review the Bylaws for any unusual provisions affecting shareholder rights or restrictions on ownership, transfer or voting of shares.
- B. Certificates of Good Standing; Qualification to do Business.
1. Obtain current certificates of good standing for the company in state of organization and wherever qualified to do business.
 2. Obtain list of all states in which the company is qualified to do business and list of states in which it has significant operations. Determine if there is any state where the company is not qualified but should be qualified.
- C. Minutes. Minutes of meetings of the company's shareholders and Board of Directors during the preceding five years. To the extent possible, check whether the minutes of all meetings are in the minute books. Review for matters that

ANNEX C (Part 2)

INTELLECTUAL PROPERTY DUE DILIGENCE CHECKLIST

I. INTRODUCTION. No due diligence checklist can possibly anticipate all of the issues that might arise in a particular transaction. At best, a checklist is but a starting point. The parties involved in the transaction must consider what intellectual property is involved in the transaction and how important it is to the transaction. Typically, intellectual property due diligence will involve a review of all of the following.

II. PATENTS.

- A. The following items, both domestic and foreign, in connection with the target company's business, including, but not limited to, copies of the supporting documentation with respect to each item:
 - 1. issued patents (patents);
 - 2. patent applications;
 - 3. abandoned patent applications; and
 - 4. invention disclosures not covered by patents or patent applications. (File history and additional information may be requested upon review of these materials.)
- B. All prior art searches, conclusions, reports, and opinions, whether internal or external, that the target company possesses, concerning
 - 1. the validity of the patents;
 - 2. any infringement of its patents by others;
 - 3. the infringement of third-party patents by the target company's products; and
 - 4. the validity of such third-party patents.
- C. Documents related to the payment of maintenance fees for all patent applications and patents.
- D. Cooperative research agreements, license agreements, and merchandising agreements involving the patents, regardless of whether the target company was the licensee or licensor.
- E. Threatened or pending interferences involving the target company's patent applications or patents.

ANNEX D
SAMPLE DATA ROOM POLICIES

Introduction

In the interest of facilitating your due diligence of “**Project Zachary**” we have established certain processes regarding the manner in which visitors may use the facilities made available to them.

The documents contained in the data room (the “**Information**”) in connection with and relating to Project Zachary (the “**Proposed Transaction**”) are made available subject to and on the terms of the Non-Disclosure Agreement signed by you previously. Please note that this Non-Disclosure Agreement applies equally to the representatives of your company and to the representatives of your advisors.

Location, Hours and Appointments

The data room is located at the following address:

Contact persons at _____:

| | <u>Name</u> | <u>Telephone Number</u> |
|----|-------------|-------------------------|
| 1. | _____ | _____ |
| 2. | _____ | _____ |
| 3. | _____ | _____ |

The data room will be opened Monday–Friday, 9:30 to 5:00 p.m. Any request related to the data room should be addressed to XYZ Corp. representatives.

Prior to the beginning of the data room procedure, please provide or XYZ Corp. with a list of all attendees, including the company/firm they

ANNEX E

*[for educational purposes only; must be conformed to state law
and the needs of the company]*

SAMPLE EMPLOYMENT AGREEMENT

In consideration of my continued employment by _____, Inc., a _____ corporation ("**Company**"), having office at _____ (the "**Office**"), as an employee, the compensation paid to me, and the disclosure to me of any Confidential Information and Trade Secrets by Company in connection with my employment, I execute this Employment Agreement (this "**Agreement**") and in so doing agree as follows:

1. DEFINITIONS.

"**Competitive Products or Services**" shall mean the business of executive search and placement in the non-profit sector, including but not limited to presidents and other executives of public and private colleges and universities.

"**Confidential Information**" means information (in any form or media) regarding Company's Customers or Potential Customers as defined below (including lists of Customers or Potential Customers), or Company's methods of operation, programs and databases, patents and designs, pricing, billing rates, billing procedures, vendors and suppliers, business methods, finances, management, or any other non-public business information relating to Company (including but not limited to information constituting a trade secret under the _____ Trade Secrets Act of (the "**Trade Secret Act**") as addressed below) that has value to Company and is treated by Company as being confidential; **provided, however**, that Confidential Information does not include any information that has been voluntarily disclosed to the public by Company (except where such public disclosure has been made by me without authorization) or that has been independently developed and disclosed by others, or that otherwise enters the public domain through lawful means.

"**Customer**" shall mean any person or entity with whom Company had business dealings of any kind within the last two years prior to my separation from employment with Company.

"**Material Contact**" shall mean contact between me and each Customer: (i) with whom I dealt directly for business purposes; (ii) whose dealings with Company were coordinated or supervised by me; (iii) about whom I obtained Confidential Information or Trade Secrets in the ordinary course of business as a result of my