



Choose Your Partner

Your not-so-little start-up is attracting several big suitors: To whom do you sell?

The Company: Tarian Software is an Ottawa-based company that makes software for managing electronic records. Its products allow companies to systematically manage the preservation and disposal of files, e-mails and other electronic documents. Thanks to stiffened post-Enron regulatory obligations, demand for its software is white hot.

The Situation: Several suitors, including IBM, are showing interest in buying Tarian. Its founders and investors are eager to sell. But Tarian's capitalization structure means the proceeds from a proposed sale could be eaten up by one investor, leaving its founders and other investors shut out. Co-founder Bruce Miller needs to choose a suitor — and work out a deal that satisfies the needs of both the entrepreneurs and other investors.

BRUCE MILLER PRESSED his mobile phone close to his ear, hoping to block out the noise from the "Days of Thunder" roller coaster that was screaming by in the background. With cellphone in hand and paperwork on his knee, Miller was an unusual figure among the vacationers at the Canada's Wonderland amusement park. Miller was CEO of Tarian Software, a records-management software firm headquartered in Ottawa — and the park was a rendezvous point for a singularly important meeting.

In four hours, Miller was to walk to the east end of the admission gates. There, he would surreptitiously meet with representatives of Documentum, a billion-dollar enterprise-content-management firm. Tarian's suddenly hot software had attracted three companies intent on buying the company, each of which wanted to keep their overtures away from the watchful eyes of their competitors.

But the caller on Miller's mobile phone confirmed that their secrecy had been for naught. It was IBM, another of Tarian's suitors. How they had sniffed out the covert meeting, Miller could only guess — but the tone from Big Blue had rapidly shifted from serious negotiation to an urgent need for exclusivity. IBM was a better fit for Tarian, the caller told Miller, but explained that IBM wouldn't proceed

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with negotiations while Tarian was chasing other deals. The solution, the caller said, was a standstill agreement.

Miller's heart raced as he furiously transcribed the key points. The standstill was a verbal, non-binding offer for the company. It allowed for 30 days to negotiate the details, contingent on Tarian signing a month-long "no-shop" clause that would prohibit them from courting any other potential acquirers.

In four hours, Miller would make a career-defining choice: Either he could meet with Documentum at the admission gates and turn his back on IBM, or he could walk to the information kiosk and use the fax machine to send a signed no-shop agreement to IBM.

OUTSIDER INTEREST in Tarian was first piqued in the spring of 2001, as investigators and officials dissected the collapse of energy firm Enron and accounting giant Arthur Andersen. The twin implosions would prompt a new array of tough legislation designed to prevent accounting fraud and restore investor trust. For this reason, Tarian's software had strong appeal among CEOs and CIOs, as it allowed large public companies to prove their regulatory compliance by tracking and managing every electronic document, even in organizations with tens of thousands of staff.

With the market for electronic records management predicted to swell to \$1 billion within a few short years, the time was ripe for acquisition. Over a series of dinners and phone calls, three companies expressed an interest in Tarian. The most serious potential buyers were IBM and Documentum. Negotiations with the two companies were flirtatious and veiled. Miller described the process to his confidantes as a "mating game," in which each suitor made subtle motions to gauge Tarian's interest.

But once IBM learned about Miller's amusement-park rendezvous, the style of negotiation

shifted dramatically. When Miller received the phone call at Canada's Wonderland, he was no longer hearing from marketers and managers from IBM's enterprise-content-management group, but rather a tough-talking former Green Beret who worked for IBM as an acquisitions specialist. Just over a year after it began, the mating game had clearly intensified.

AT CANADA'S WONDERLAND, Miller stared intently at IBM's terms on his notepad. In his head, he began to list the calls he needed to make: Tarian's three venture-capital (VC) backers and his co-founder would be his most important calls. But first, Miller needed an independent perspective on the no-shop clause. He dialled his lawyer in Ottawa.

The lawyer was less than enthused, particularly at the brinkmanship involved with the four-hour decision window. There were three major issues, he told Miller. First, the value of the deal failed to meet the threshold for Miller and his co-founder to receive any proceeds. Tarian's last round of financing had been closed during the lean years of the dot-com bust, and their third-round investor had demanded a multiple liquidation preference equal to three times its investment – not to mention interest and dividends. If Tarian accepted IBM's offer, the founders and first-round investors would be left almost entirely in the cold, while the VC who provided the last round of financing would swallow nearly every penny of the deal.

Secondly, IBM's proposed standstill agreement offered no "break fee," meaning that the suitor would not be charged any penalty should it fail to close the deal. Miller had asked for a break fee; IBM had refused. Over the phone, his lawyer's discomfort was evident: Miller would be working without a net, he warned. Under the terms of the no-shop proposal, Tarian couldn't negotiate, discuss or even take phone calls from

the company's other suitors. IBM, by contrast, could walk away without penalty. "They weren't bound to conclude the deal on the terms on the sheet. They weren't even really bound to do a deal," Miller recalls. "There was no legal obligation on IBM's part to close the deal."

And finally, the lawyer warned, Miller and his partner would both need to be unreservedly committed to the integration process. Employment agreements would require the founders and key staff to stay with IBM and surrender their stock options. If they left after that, a non-compete clause would preclude them from competing with IBM in any area of electronic records management, and a no-hire clause would keep them from hiring any of their Tarian employees. Even the proceeds of the deal would be subject to a "holdback clause," which would reserve a substantial portion of the founders' proceeds from the deal, with payback contingent on meeting ambitious performance goals for the two years after the acquisition.

After talking to his lawyer, Miller called his co-founder, Steve Saunders. Relaying the details of the offer from his hastily scrawled notes, Miller could tell Saunders was seething. Saunders did not like the offer – at all. His suspicion stemmed from the nature of IBM's last-minute offer. "And it was pretty well-founded," Miller admits. "We had a potential acquisition deal on a plane four hours away, and then IBM tells us to turn them away on a wing and a prayer."

Saunders listened impatiently as Miller argued the merits of pursuing the IBM deal. IBM, Miller noted, had more products into which Tarian's software could be integrated. "They could make broader and better use of the technology," Miller explained. Tarian's other suitors, including Documentum, were limited single-product companies by comparison.

But for Saunders, the issue was less a question of managing integration and more an emo-

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tional response to IBM's hardball tactics. "We have a huge bargaining chip in the fact that there are several companies interested in acquiring us," he argued. "IBM's trying to pressure us to abandon that advantage." In Saunders' view, IBM was playing dirty – and their tactics boded poorly for their relationship with Tarian. That's not the kind of company I want to work for," Saunders said.

In response, Miller stressed the size and reputation of Big Blue: "A lot of people [there] would have egg on their face if we failed to close the deal," Miller told his partner. "Besides,

right suitor and it's the right deal," he stated. "We can make it work. If you want to stop it from proceeding, you'll have to scuttle the company." On the end of the line, Miller could hear a resigned sigh. When they ended the call, Saunders had agreed to trust Miller's judgment about whether to pursue the deal.

Snapping a spare battery into his mobile phone, Miller then braced himself for a string of phone calls to the three VC companies that had financed Tarian's formation and growth. His first call was to Axis Capital of Toronto, Tarian's first-round investor. Its response was reserved and

slumps in all areas. Even without a home-run return, BDC was enthusiastic about an exit; earlier, it had already indicated it was looking to divest its position in Tarian altogether.

Miller's last call was to VentureLink, a labour-sponsored investment fund with total assets of \$36.8 million. Focussed on Canadian technology companies, the fund had weathered a year of poor performance, dampened by a weak IPO market and a considerable decline in technology mergers and acquisitions. Miller knew that Tarian's acquisition potential was a bright spot in a dark year for the fund. But to

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Saunders grumbled. Even if he could overlook IBM's heavy-handed negotiation style, he was still concerned about the cultural fit between monolithic IBM and their young firm. Tarian was small and nimble, and deliberately gave its employees a great deal of leeway and responsibility. At IBM, they'd be "cogs in a huge wheel," Saunders complained. Documentum had fewer than 750 global employees, compared to IBM's 300,000.

Miller interpreted IBM's sudden aggressiveness far more favourably than his partner. "I was glad that we were finally moving forward, that we got beyond the mating game," he says. Miller also saw IBM as a natural fit for Tarian's product. He forced Saunders's hand: "It's the

skeptical. At the purchase price mentioned on the phone in the morning, they would receive almost none of the proceeds, due to the pecking order among the company's VC investors. Over the phone, Axis made no promises to allow a sale if it meant sacrificing a chance for a return on investment. But Miller knew Axis was in a bind: The alternative to an exit by acquisition would be finding another group of investors, further diluting Axis's stake. "We knew we could do another round, but few of us really wanted that," Miller reflects.

Tarian's second VC was the Business Development Bank of Canada (BDC). High returns from its VC wing tended to buoy loan and consulting operations. But in the aftermath of the 2000-2001 market collapse, BDC was facing

make the IBM offer work, he needed VentureLink to relent on its right to a multiple liquidation preference – and he was willing to scuttle the purchase entirely if VentureLink wasn't ready to negotiate a fair distribution of the proceeds.

Miller needed VentureLink's approval to pursue any sale, but he knew that the VCs couldn't easily exit without the founders' co-operation. "Remember, the IBM deal requires that the founders stay on, and any Documentum deal would demand the same thing," he reminded the VC. "Steve and I can make or break any deal. And this is what we're telling you: This is an honest deal. It's a reasonable deal. We need to find a way to work within the basket of money, give everyone a fair return and make this deal work."

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There was a pause on the other end of the line as the VentureLink partner digested Miller's argument. The reply was diplomatic, in carefully measured words: VentureLink was being asked for a leap of faith and could not blindly commit to forfeiting the proceeds to which it was entitled. But it did offer its good faith in coming to a resolution, and promised that it was not giving a "hard red light" to IBM's offer.

As Miller watched the park-goers queue for rides, he tried to digest the situation. He knew rationally and emotionally that IBM was the right partner. But his co-founder was reluctant, VentureLink wasn't committed to renegotiation and his first-round VCs wanted some return on their original investment. Each partner seemed willing to let Tarian sit at the table with IBM, but it remained unclear what concessions the VCs would be willing to accept. A quick glance at his watch showed he had less than an hour left to decide.

The Outcome

When the deadline came, Miller accepted IBM's no-shop offer. He felt that the dollar value was sufficiently large that, reasonably divided, each of the investors could walk away with a decent return. He also knew that he and Saunders had leverage over their investors by virtue of the fact that their human and intellectual capital would be a necessary part of any acquisition. While he had no guarantee of their co-operation, he knew that each of the investors would improve its odds of a return by co-operating.

Tarian successfully increased the deal's value somewhat during the negotiations, but the final purchase price still remained lower than the threshold needed for the founders and first-round investors to receive any proceeds if VentureLink's multiple liquidation preference remained intact. So to work through the distribution, the founders met with each of the investors and participated in an exercise: "We got everyone to write down a number that they'd be happy to walk away from the deal with," Miller explains. "When we added up those numbers, it wasn't dramatically higher than the deal value. Everyone had made sensible guesses about each other's needs, and made reasonable demands themselves." It took only a few hours of negotiation before the partners had a deal they could each take to their boards.

The deal, completed in November 2002,

was that year's largest Canadian software-industry acquisition. Though the culture was different, Tarian's founders handily met and exceeded the sales and performance milestones for the integration. "We blew the earn-out targets out of the water," Miller laughs. He and Saunders subsequently left IBM to return to entrepreneurial careers. Today, he remains satisfied with his decision: "Everyone walked away feeling that they had done very well."

The Expert View

By Paul N. Hyde

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Before he agreed to IBM's offer, Bruce Miller was in a tough spot. He had a reluctant partner and a group of prior investors with conflicting objectives. His powerful suitor, meanwhile, was offering a now-or-never deal at a price that could have left the founders and early-round investors empty-handed.

Before assessing the results, it's instructive to ask: How did Tarian end up in this position? The answer seems to be in the "triple-dip" liquidation preference in its last round of financing. Since it was negotiated in a period of economic uncertainty, we can probably assume that the terms were dictated rather than discussed. When the economic climate tightens or business slows, sometimes the best (and only) deal is simply the one that keeps the doors open another day. This can often come at a high cost to the founders and the early-stage investors.

So, the first lesson for entrepreneurs is this: It's very common to have to raise future funds in a different economic and business climate from the one you face at start-up, so it pays to "future-proof" your financing strategy. This means considering multiple options for follow-on financing. Starting with a consortium of first-

round investors rather than a single backer is one way to gain this flexibility. Another is to seek out investors that have expertise in your business, product and industry. When the chips are down, investors will more likely put follow-on rounds into companies they believe in and intimately understand.

Investors can draw a lesson from Tarian's story: Deal structure drives entrepreneurial behaviour. If entrepreneurs see a winning conclusion, they stay hungry and ambitious. If you strangle their prospects to benefit financially from their exit (and multiple liquidation preferences do just that for anything but a home run), their incentive can be dulled. Companies are rarely led with lasting drive when founders lack the potential for a profitable payout.

As for the deal itself, my intuition about IBM's demands tells me that their same-day no-shop deadline was artificial and highly strategic. The standstill agreement was designed to prevent Tarian from driving up the purchase price. And without a break fee, the company would be crippled if the deal failed, placing Tarian in a weak bargaining position. In spite of legal advice, Tarian chose to accept those terms. Miller clearly believed that the odds of a clean exit lay with a sale to IBM. The specifics of IBM's offer gave him the leverage he needed to extract concessions from his third VC. That said, it still surprises me that the VCs and founders did not call IBM's bluff and elect to create a horse race among Tarian's suitors.

This leads me to my final thought for entrepreneurs: Don't go it alone. In every acquisition I've been involved with, I've enlisted the help of a reputable investment banker with proven merger and acquisition experience. In Tarian's case, the founders and VCs could have benefited from an experienced hand. They would have had greater insight into IBM's actions and motivations, and the expertise to confidently seek serious and competitive counter-offers.

IBM turned their side of the negotiations over to an acquisitions expert with a proven transaction record. In my view, Tarian would have been wise to fight fire with fire.

Note: The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The views represented here are solely those of the case authors and are based on their own professional judgment. Certain names, scenarios or identifying information may have been disguised to protect confidentiality.