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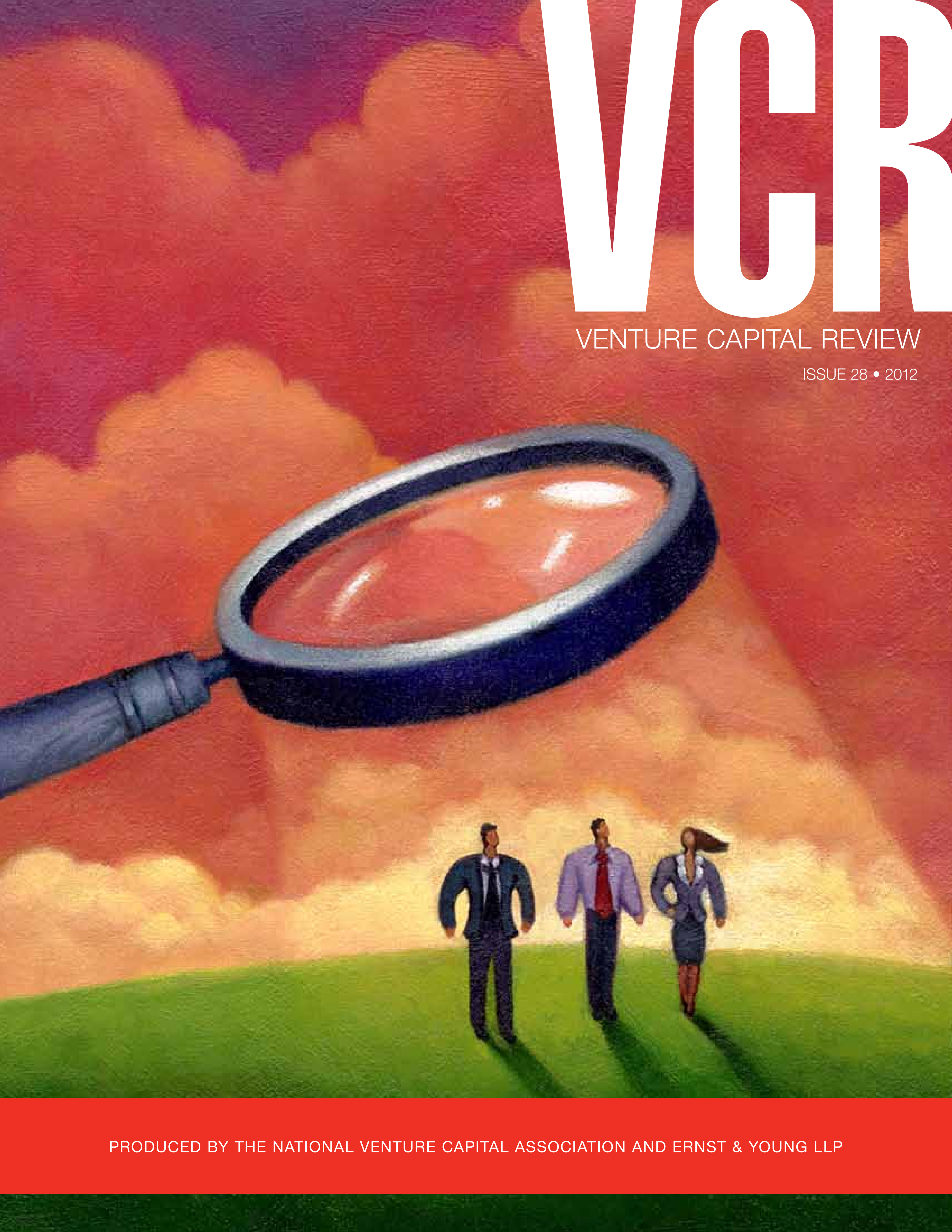

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Acqui-Hires for Growth: Planning for Success

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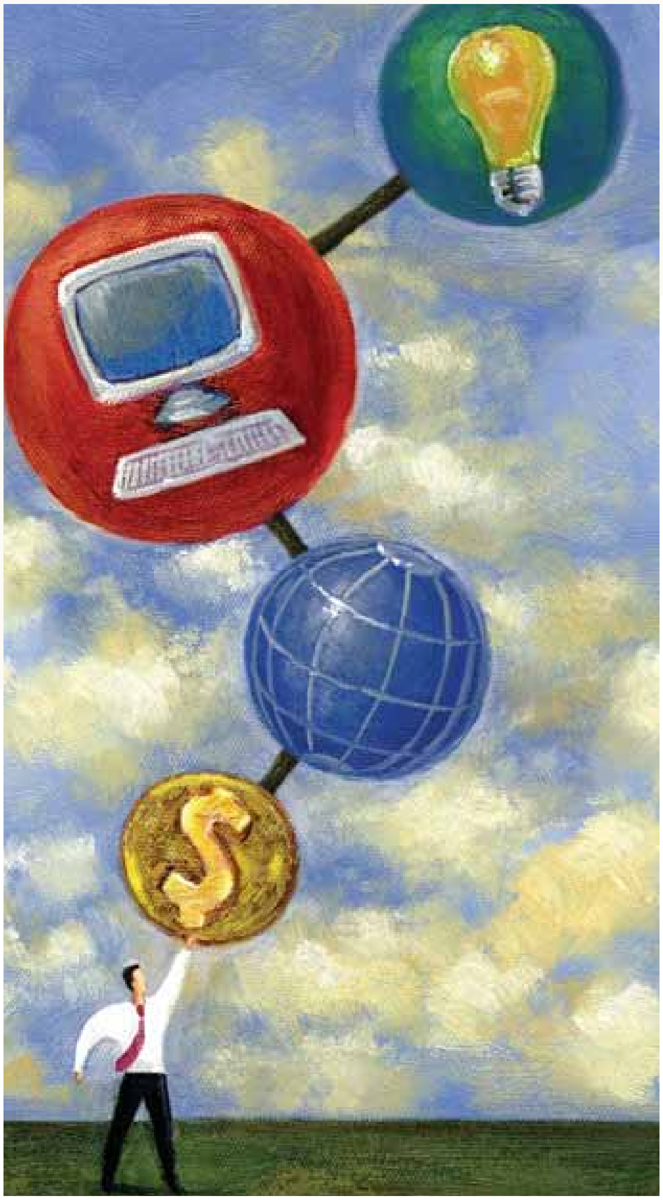

A new M&A buzzword, the "acqui-hire," reflects competition for talent through acquisitions in today's hot technology market. In an "acqui-hire" the buyer is motivated primarily by the talent of the seller's employees rather than by its operating business or technology — which may still be under development.

Facebook CEO Mark Zuckerberg, in an often-repeated quote, told a 2010 audience that "Facebook has not once bought a company for the company itself. We buy companies to get excellent people."[1] During the past three years, which have been characterized by rapid change in the technology industry and the explosive growth of new household names in social media and cloud computing, large-cap public companies and venture-backed companies alike have competed to amass critical talent. Recent examples of talent-driven transactions include Twitter's acquisitions of Summify in January 2012 and Posterous in March 2012,[2] Google's acquisitions of Milk in March 2012 and RestEngine in May 2012,[3] Zynga's acquisitions of

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1 Nathaniel Cahners Hindman, *Mark Zuckerberg*: '*We Buy Companies To Get Excellent People*', THE HUFFINGTON POST, October 19, 2010 http://www.huffingtonpost.com/2010/10/19/mark-zuckerberg-we-buy-co_n_767338.html. Commenting on the Instagram acquisition, Mr. Zuckerberg posted "This is an important milestone for Facebook because it's the first time we've acquired a product and company with so many users".

2 Mike Issac, *Twitter Acquires Social-Aggregation Startup Summify*, WIRED, January 19, 2012 http://www.wired.com/business/2012/01/twitter-summify-acquisition/; Laurie Segall, *Why Twitter bought Tumblr's biggest rival, Posterous*, CNN MONEY, March 14, 2012, http://money.cnn.com/2012/03/14/technology/posterous_twitter/index.htm.

3 Alexia Tsotsis, *Winning a Bidding War With Facebook, Google Picks Up the Milk Product Team*, TECHCRUNCH, March 15, 2012, http://techcrunch.com/2012/03/15/winning-a-bidding-war-with-facebook-google-picks-up-the-entire-milk-team/; Josh Constine, *Twitter Buys Personalized Email Marketer RestEngine To Deliver Best Tweet Digests*, TECHCRUNCH, May 10, 2012, http://techcrunch.com/2012/05/10/twitter-acquires-restengine/.

In an "acqui-hire" the buyer is motivated primarily by the talent of the seller's employees rather than by its operating business or technology — which may still be under development.

area/code in January 2011 and Buzz Monkey in June 2012,[4] Groupon's acquisition of ditto.me in April 2012,[5] LinkedIn's acquisition of IndexTank in October 2011,[6] and Facebook's acquisitions of Lightbox and Glancee, both in May 2012.[7]

The term "acqui-hire" has been applied generously to describe acquisitions of companies with pre-existing businesses ranging from scant to significant. Facebook's acquisitions of Drop.io in October 2009 and Gowalla in December 2011 each made a splash in part due to the established user bases of the targets, which did not appear to impact the decision to terminate the services offered by the targets.[8] Perhaps weary of the disappearance of services and applications over the years, the community of early adopters has grumbled about the propensity of larger technology companies to buy and then discontinue innovative new offerings.[9] Time will tell whether acqui-hires will continue to be announced at a breakneck pace or if the maturity of several of the most prolific acquirors and slower market growth will slow this trend.

Acqui-hires present challenges for venture capital investors, who invest in start-up companies based on longer-term investment goals. Acqui-hires often represent a truncated company life, coupled with the promise of a payout and incentive rewards for the management team under a different umbrella. This situation can create conflicts between the interests of investors and the founder team. In our experience while an acqui-hire is generally a good result for all constituencies in failed or stalled venture-backed companies, investor experiences have been mixed in the case of acqui-hires for very early stage companies or successful post-financing companies.

This article will explore acqui-hires from a legal perspective. Motivations and concerns for key transaction constituencies, including buyers, venture capital firms and founders will be examined. Common legal issues in these talent-driven acquisitions, including the satisfaction of fiduciary duties, the negotiation of post-closing indemnification provisions and the evaluation of tax issues will be explored. Finally, we will include a practical checklist for venture capital investors who may find their portfolio company engaged in an acqui-hire.

Motivations and Concerns for Key Constituencies

A buyer uses an acqui-hire to grow technical staff in a more meaningful way than traditional hiring methods afford. The buyer might have a specific project or task in mind to be accomplished by the acquired team, which may or may not relate to the target's activities before closing. In any event, the buyer is looking for a cohesive group that has proven its ability to work together, combined with technical prowess and a good culture fit. In a pure acqui-hire, the business success of the target is secondary at best. A lack of revenue, market traction or other typical barometers of success

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4 Dean Takahashi, *Zynga dials Area/Code game studio for an acquisition*, VENTUREBEAT, January 21, 2011, http://venturebeat.com/2011/01/21/zynga-dials-areacode-game-studio-for-an-acquisition/; Kim Mai Cutler, *Zynga Adds 50 People Through Talent Acquisition of Video Game Marker Buzz Monkey*, TECHCRUNCH, June 4, 2012, http://techcrunch.com/2012/06/04/zynga-acquires-buzz-monkey/.

5 Colleen Taylor, *Groupon Acquires Recommendation App Ditto.me*, TECHCRUNCH, April 16, 2012, http://techcrunch.com/2012/04/16/groupon-acquires-ditto-me-the-social-recommendation-and-planning-app/.

6 Colleen Taylor, *LinkedIn acquires search engine startup IndexTank*, GIGAOM, October 11, 2011, http://gigaom.com/2011/10/11/linkedin-acquires-search-engine-startup-indextank/.

7 Josh Constine, *Facebook Hires Team From Android Photosharing App Dev Lightbox To Quiet Mobile Fears*, TECHCRUNCH, May 15, 2012, http://techcrunch.com/2012/05/15/facebook-lightbox/; Mike Isaac, *Ramping Up Mobile Discovery, Facebook Acquires Glancee*, ALLTHINGSD, May 4, 2012, http://allthingsd.com/20120504/ramping-up-mobile-discovery-facebook-acqhires-glancee/.

8 Anthony Ha, *Facebook hires Drop.io's Sam Lessin, calls it an acquisition*, VENTUREBEAT, October 29, 2010, http://venturebeat.com/2010/10/29/facebook-drop-io-sam-lessin/; Laurie Segall, *Facebook buys Gowalla*, CNNMONEY, December 2, 2011, http://money.cnn.com/2011/12/02/technology/gowalla_facebook/index.htm.

9 Dana Raam, *The Acqui-Hire: Rethinking the Trust We Place in Start-Ups*, SOCIALMEDIATODAY, May 8, 2012, http://socialmediatoday.com/danaraam/479653/acqui-hire-should-we-be-rethinking-trust-we-place-start-ups; Sarah Perez, *Insta-Backlash: Twitterverse Overreacts To Facebook's Instagram Acquisition, Users Delete Accounts*, TECHCRUNCH, April 9, 2012, http://techcrunch.com/2012/04/09/insta-backlash-twitterverse-overreacts-to-facebooks-instagram-acquisition-users-delete-accounts/

do not necessarily equate to a lack of creativity, intelligence or ability to design and build a product. The buyer's primary concerns are post-closing employee retention and the potential for contingent liabilities of the corporate entity that would have been avoided by simply hiring the target's employees.

For target company investors, the primary concerns in an acqui-hire are reputational and economic. The acquisition cuts short the expected life of the investment and might dramatically diminish the expected return to preferred stockholders if the deal consideration is cash or stock in a slower-growth public company. However, home runs for investors in acqui-hires can happen, particularly if the buyer is a hot private company paying in stock. Venture investors will not be disappointed with stock consideration issued by a rapidly growing company heading for a rich exit or IPO. For example, Facebook's August 2009 acquisition of venture-backed FriendFeed purportedly involved a significant stock component, which would now be worth several multiples of the deal value.[10] Investors holding convertible venture debt will have special economic concerns, discussed in more detail below.

On some occasions, the acqui-hire will result in less than a full return of invested capital. In these downside scenarios, investors will need to assess the likelihood that the target has a viable future and the potential for greater value realization at a later date. Difficult cases occur when the target may have a viable although less than certain future, while a current acqui-hire transaction would result in a disappointing return to investors. In these cases, board members are placed in a challenging situation and must carefully consider fiduciary duties to common stockholders, who may receive no consideration or only nominal consideration in an acqui-hire transaction. From the perspective of the target's board, a deal without any consideration to common stockholders may be a risky option in light of recent Delaware case law.

Reputational concerns of venture capital investors, including maintaining relationships with repeat founders and avoiding generating an impression of being difficult in the venture capital community generally, might create hurdles to blocking a founder's interest in pursuing an acqui-hire. We believe (and our experience over hundreds of venture deals has made clear) that most investors will agree that having a veto over an exit transaction does not easily, if ever, lead to exercising that veto.

The mindset of the founders being wooed in an acqui-hire is the most challenging to assess. The founders may be truly torn between continuing their entrepreneurial path and folding into a much larger organization with greater resources and presumed stability. Our friend Josh Kopelman, founder of First Round Capital, has explained this, metaphorically, by using the distinction between taking the train and deciding whether to ride local or express – venture investors like to take the express and lock in for the big outcome, while founders (especially younger, first-time founders) might want the optionality of riding local and exiting early. Founders also must balance their own self-interest against the interests of others who have placed their trust in them, including investors, company personnel, and customers. Often, as an acqui-hire progresses, this key tension receives a great deal of attention by venture capital investors and their attorneys.

Common Legal Issues in Acqui-hire Transactions

Duty of Care

A board of directors that considers an acqui-hire must be ever-mindful of its fiduciary duties to stockholders. Duties of care and loyalty apply to all board decisions, including in connection with a sale process. Under Delaware law, once a board has made a decision to pursue an exit transaction, fiduciary duties, commonly referred to as "Revlon" duties in this context, require the board to follow a reasonable process to achieve the best value reasonably attainable for stockholders.[11] Boards of private companies, large and small, are not

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10 Alyson Shontell, *If You Think The Word Acqui-Hire Really Means Failure, Take A Look At FriendFeed's ~ $330 Million Exit*, BUSINESS INSIDER SAI, February 5, 2012, http://articles.businessinsider.com/2012-02-05/tech/31026289_1_friendfeed-paul-buchheit-jim-norris.

11 See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986), *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 37 (Del. Supr. 1994) and their progeny. We note that certain mergers involving public companies in which a substantial portion of the consideration consists of stock in the buyer will not implicate Revlon duties. *See In Re Smurfit-Stone Container Corp. Shareholder Litigation*, 2011 Del. Ch. LEXIS 79, 2011 WL 2028076.

exempt from these requirements.[12] California courts have not expressly adopted Revlon-type requirements in connection with exit transactions involving California corporations. However, directors of California corporations would be served well by understanding Delaware case law, which is based on the same basic duties of care and loyalty as clearly apply to California corporations.

The duty of care requires directors "to act in an informed and deliberate manner in determining whether to approve an agreement of merger before submitting the proposal to the stockholders."[13] The duty of care, in the context of an acquisition, requires a board to become well-informed regarding transaction terms and process, consider viable alternatives, retain and consider the advice of outside experts and advisors, consider the views of management, and engage in meaningful discussions with advisors and management. The Delaware courts have stated repeatedly that "There is no single path that a Board must follow in order to maximize stockholder value, but directors must follow a path of reasonableness which leads toward that end."[14] However, the Delaware courts have cautioned that "if a Board fails to employ any traditional value maximization tool, such as an auction, a broad market check, or a go-shop provision, that Board must possess an impeccable knowledge of the company's business for the court to determine it acted reasonably."[15]

In most acqui-hires, an auction process is not conducted before approval of a sale. In addition, private company exit agreements rarely include a "fiduciary out" or go-shop provision that would allow a market check post-signing. These factors can place stress on the board's exercise of the duty of care in the context of approving an acqui-hire. Case law interpreting fiduciary duties in connection with a sale process is very fact-specific and almost always involves public companies. The *In re OPENLANE, Inc.* case, which involved a small-cap bulletin board company, may be instructive. In *OPENLANE*, the Court stated that "The fact that a company is small… does not modify core fiduciary duties… In other words, small companies do not get a pass just for being small. Where, however, a small company is managed by a board with an impeccable knowledge of the company's business, the Court may consider the size of the company in determining what is reasonable and appropriate."[16] The *OPENLANE* court found that the company's board, consisting of founders and key investors who had an active role in the company's business for years, was one of the "few boards that possess an impeccable knowledge of the company's business" and accordingly could reasonably approve a sale of the company without a broad market check, a financial advisor's fairness opinion or a "fiduciary out" termination right.[17] Despite the potential for deference to a board consisting of founders and hands-on professional investors, and the lower risk of stockholder claims involving closely-held companies, boards involved in the consideration of acqui-hires must strive to fulfill their duties of care in evaluating and approving such transactions. Even without the benefit of a full market check process, the board should carefully review potential alternative buyers, market and competitive factors, and company projections and financing prospects. The transaction process and board deliberations should be carefully documented with the assistance of counsel familiar with exit transactions in order to support a finding that the board has satisfied its duty of care.

The *OPENLANE* case underscores one of the core difficulties small venture-backed corporations have when trying to follow Delaware law – the courts in Delaware interpret law as it is made on the backs of larger, better-capitalized corporations. In other words, Delaware case law is replete with well-funded companies hiring seasoned financial advisors to hold banker-run auctions and provide fairness opinions under conditions that more clearly check the boxes needed for a determination that the board has satisfied its fiduciary duties. Hiring well-connected and attentive bankers is much easier when selling a company for $500 million or more, and an exit in that price range would easily allow a board to fund separate advisors for a special committee. Acqui-hires inhabit precisely the opposite universe. Bankers rarely undertake engagements to sell a start-up for $9 million, which

12 See *Cirrus Holding Co. Ltd. v. Cirrus Industries, Inc.*, 794 A.2d 1191 (Del. Ch. 2001).
13 *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985).
14 *In re OPENLANE, Inc. Shareholders Litigation*, 2011 Del. Ch. LEXIS 156, at *17-18 (Del. Ch. 2011) (quoting *In Re Smurfit-Stone Container Corp.*, at *16, which was citing *QVC Network Inc.*, 637 A.2d at 45).
15 In *re OPENLANE, Inc.* at *18.

16 *Id* at *24.
17 *Id* at *21-22.

may well be the deal size for an acqui-hire. Further, because acqui-hire consideration may consist largely of illiquid stock (for tax, employee incentive and other reasons), and cash consideration will usually be reduced by transaction expenses, it is difficult for investors to rally behind paying advisors what appears to be a disproportionate fee on a small deal. Unfortunately, boards facing an acqui-hire are left to grapple with a set of laws written by and for an entirely different class of businesses.

Duty of Loyalty

Boards considering acqui-hires must be familiar with the duty of loyalty. The duty of loyalty requires that each director make decisions based on the best interests of the corporation, without regard for personal interest. Both management and representatives of venture capital investors must fully disclose and carefully evaluate any conflicts of interest in connection with acqui-hires, particularly when transactions involve substantial management carve-out plans and/or result in a disappointing amount of consideration (if any) to common stockholders. As described below, in reaction to the *Trados* decision, common stock carve-outs may be prudent in transactions in which the common stockholders would otherwise receive no consideration.

What had been the most controversial aspect of acqui-hires in the minds of investors – the presence of management carve-out plans which at times appear disproportionate to payments for the target's equity securities – has become commonplace. Management carve-outs were heavily used during the nuclear winter of the dot com bust when companies were sold, if at all, below the liquidation preference and both sellers and buyers needed to create incentives for continuing management. As the market thawed, and some would say overheated, buyers sought to win the hearts and minds of the management team by overriding the capitalization table and providing hefty incentive or retention pools for management. In the acqui-hire context, the need to create incentives and relatively modest transaction sizes conspire to shift the capitalization so that 40% or even half the deal consideration may consist of incentive pool payments and equity grant rolls overs, each of which are contingent on key employees staying with the buyer post-closing. The constituencies who do not partake in retention incentive packages will certainly ponder the fairness of this shift, particularly if they are being paid pennies on the dollar relative to original investments.

Management carve-out plans created by a target's disinterested board of directors differ from buyer-created management carve-out plans. The former often signal that a company has become ripe for an exit transaction and are frequently created when a target's preferred stock liquidation preference has overtaken the value of common equity held by continuing management. These plans may consist of cash bonuses or retention plans to provide employees with equity if they stay through a sale and for some period post-sale and are intended to create conditions which will lead to the highest exit price possible for all stockholders. Buyer-created management carve-out plans typically take the form of retention plans or equity grants that vest over time based on continued employment with the buyer. These plans can become significant in size as the buyer attempts to shift value to its desired pool of employees (in the view of buyer, the true value of the business may in fact be attributable to these employees rather than the company itself). In either case, larger carve-out plans may heighten the risk of fiduciary duty claims against the board and increase the likelihood that stockholders will vote against the transaction with the intent of bringing a State law appraisal rights suit thereafter.

Nowhere is that risk higher than when the "management has hijacked the process" – in other words, a carve-out is created by a management team in cooperation with a buyer and forced upon the company due to the management's control of the process. Involving the board – not just management – is key in even the early stages of negotiations surrounding an exit, especially if there will be a disproportionate stay pool or carve-out for management. The law requires that management prioritize the interests of the stockholders above and beyond those of the employees. The process is at least as important as the outcome in determining fairness, so a process in which independent board members provide input that affects the outcome of the negotiations is desirable. Filling the unfilled "independent" board seat can become virtually impossible as a company moves into a transaction, especially if the exit is valued flat to or below the last financing. Accordingly, ensuring that as the company moves into potential exit or financing scenarios the board is full and engaged is very helpful, although often overlooked.

If a management board member will benefit from accelerated incentive award vesting, a post-closing employment arrangement, buyer stock incentives or other retention programs, these additional financial interests will lead to enhanced scrutiny of the transaction process in the event of any stockholder dispute. The value of compensation or other benefits above the per share deal price to be received by a management board member should be specifically disclosed to the board and stockholders in advance of soliciting a vote on an acqui-hire. Depending on the situation and the nature of the conflicts, the board and its legal advisors may also consider whether the founder board member should recuse himself or herself from all or a portion of board deliberations relating to a transaction. If possible, the board members should be in the habit of having any member whose compensation is discussed exit the room for that discussion, whether in the financing or at any other point in the life of the company. Too often, we have seen board members state "I'm comfortable speaking in front of" the conflicted board member so she or he "need not leave the room." We believe that doing this sets the wrong culture for the boardroom and characterizes any desire to have someone step out as a negative. Boards are better served by being in the habit of having someone exit the discussion to avoid stigmatizing a discussion without the interested party and to pave the way for a clean process. In cases where several board members hold special interests in a transaction, the board may choose to form a special committee of disinterested directors to approve the transaction.

Both management and representatives of venture capital investors must fully disclose and carefully evaluate any conflicts of interest in connection with acqui-hires, particularly when transactions involve substantial management carve-out plans and/or result in a disappointing amount of consideration (if any) to common stockholders.

Duty of loyalty concerns in approving an acqui-hire also exist for directors designated by preferred stockholders, particularly when the consideration flowing to equity is not sufficient to result in a payment to common stockholders after satisfying the liquidation preference. Many venture capital lawyers are aware of the 2009 Delaware Chancery Court decision in *In re Trados Inc. Stockholder Litigation*.[18] *Trados* involved the sale of a venture-backed company for $60 million, of which preferred stockholders received approximately $52 million (on a liquidation preference of $57.9 million), management received $8 million under a management carve-out plan and the holders of common stock received no payments in respect of their common shares. A common stockholder alleged that the directors breached their fiduciary duties in approving the transaction because at least a majority of the directors were unable to exercise disinterested business judgment and favored the interests of the preferred stockholders at the expense of the common stockholders. The seven-member board included four designees of the preferred stockholders and two members of management. The plaintiff alleged that the preferred stockholders were eager to pursue an exit transaction, despite the fact that the company was well-financed and showing improved financial performance, and that the members of management had an interest in the transaction through their participation in a seller-created carve-out plan.

The *Trados* Court noted that "in circumstances where the interests of the common stockholders diverge from those of the preferred stockholders, it is possible that a director could breach her duty by improperly favoring the interests of the preferred stockholders over those of the common stockholders."[19] In denying defendant's motion to dismiss the fiduciary duty claims, the Court found it reasonable to infer that the common stockholders would have been able to receive some consideration for their shares in the future had the merger not occurred, and accordingly the interests of the preferred and common stockholders may have diverged as to the decision of whether to pursue the merger.

The *Trados* issue should be explored in each acqui-hire involving a loss on investment at any level of the capital structure. The *Trados* risk may diminish if the only common stockholders who do not receive deal proceeds are management team members who otherwise receive post-closing employment incentives, but those are rarely the facts. When a group of common stockholders not connected to the current venture capital investors or management of the company receives no deal proceeds, the risks increase. In such cases, a common stock carve-out may be needed in order to obtain requisite votes and to mitigate the risk of breach of duty claims and state law appraisal actions. Other areas of conflict between stockholders may arise and should be addressed in connection with acqui-hire transactions, including when some investors have a special need for liquidity not shared by other stockholders.[20]

In addition to exposing directors to potential breach of fiduciary duty claims, a transaction in which directors or officers of a corporation have personal interests could be voidable under state common law. Both Delaware and California provide statutory safe harbors under which no transaction will be voidable solely for the reason that directors or officers have a financial interest. The safe harbors require the interested directors to fully disclose their interests and either the corporation must receive the affirmative approval of the transaction from a majority of the disinterested directors or of the disinterested stockholders, or the corporation must show that the transaction satisfies an entire fairness standard when it is approved by the board.[21] Entire fairness means that the transaction was arrived at through fair dealing and resulted in a fair price.[22] To avoid the burden of proof that a transaction meets the exacting standards of "entire fairness" review, informed approvals from the disinterested constituencies should be obtained when possible. In other words, having at least a majority of disinterested directors or a "majority of the minority" stockholders vote to approve (on an informed basis) the transaction helps insulate it from challenge. In our experience, with earlier stage acqui-hire targets, disinterested directors are often lacking. In addition, obtaining the consent of a majority of the disinterested stockholders can be difficult as there may be few disinterested stockholders. Nonetheless, parties should assess the landscape to understand in advance whether there will be a disinterested group and, if so, whether consent is likely obtainable.

18 *In re Trados Incorporation Shareholder Litigation*, 2009 Del. Ch. LEXIS 128 (Del. Ch. 2009).

19 *Id* at *28 (emphasis in original).

20 See *In re Answers Corp. Shareholder Litigation*, 2011 Del. Ch. LEXIS 57 (Del. Ch. 2011).

21 8 DEL. C. § 144 (Lexis 2012); CAL CORP CODE §§ 310(a)(1)-(3) (Lexis 2012). California also requires the transaction must be just and reasonable to the corporation if board rather than stockholder approval is relied on.

22 See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983). Entire fairness review can also apply to the evaluation of fiduciary duty claims in the absence of an independent process that passes muster under applicable state law.

Non-stockholder Constituencies

Delaware law has established that fiduciary duties run only to those presently holding stock rather than to holders of options, warrants and, except in special cases including insolvency, convertible notes.[23] Without the benefit of fiduciary duties in most cases, investors in convertible notes must be very aware of the potential treatment of their securities in the event of an early-stage acqui-hire transaction.

In the last five years, we've seen an uptick in convertible notes as the mechanism for first funding in early-stage tech companies. These convertible notes typically convert into preferred stock in connection with the first true equity financing of the company. Customarily, the principal and accrued interest of the debt will purchase shares of preferred stock in that first financing at a discount of 15% or 20% below the issuance price to other investors. To illustrate, a note holder, upon converting her or his note, will typically pay about $0.80 for a $1 share of preferred stock (and will pay even less when interest is factored in, though in our experience, interest rates in these note deals are low), which means an automatic up-round for note holders when the company gets equity financing. To further enhance the return of the convertible note investor, the valuation in the equity financing round is typically subject to a negotiated cap, meaning that the note investor may buy at a lower valuation than other investors in the equity round (if the conversion price obtained by applying the cap is lower than the conversion price obtained by applying the discount). Because an acqui-hire might precede a company's first equity financing, care should be taken to document what becomes of the convertible note in a change of control event.

Absent an expressly negotiated contractual right, the consent of a debt holder would not be required to consummate an acqui-hire. The consummation of a transaction will almost certainly accelerate required payments of indebtedness incurred under a convertible note. However, unlike a bank lender, the holder of convertible note issued by a venture-backed company typically is more interested in the conversion feature than the repayment terms — and the structure of the conversion feature may dramatically affect the economic result in an acqui-hire scenario. The

23 See *Simons v. Cogan*, 549 A. 2d 300, 304 (Del. 1988).

payment of principal and interest under the note offers no upside to the note holder, and the typical interest rate would not be risk adjusted. In our experience, contractual veto rights as alluded to above are rare. Rather, a premium on the repayment of the debt is a more common form of protection. For example, the principal and interest could become repayable at a multiplier (e.g., 2x outstanding indebtedness), which offers some upside to the note holder.[24] The note could be convertible into equity upon a change in control at a prescribed valuation, which offers upside protection to the note holder but might be viewed by the founders as a windfall depending on the exit transaction price. Finally, the note could have a combination of the last two methods, giving the holder the best of both worlds, depending on which method provides a greater payout at a given exit size.

Indemnification and Escrow Issues Common to Acqui-hire Transactions

While post-closing indemnification obligations remain a key issue for venture investors, buyer concerns are heightened in acqui-hires where the immediate return on investment is often near the amount invested and where the transaction price rarely supports the cost of full diligence and risk assessment. Venture investors, rather than acting as the "deep pocket" for the indemnity escrow, have incentives to make sure that all transaction constituencies receiving consideration in an M&A transaction share the risk of escrow and indemnification on a *pro rata* basis.

Once the economics of equity incentive roll-overs or new grants and retention packages are known, investors should seek to align their post-closing interests with those of management. One mechanism for investors to consider is subjecting roll-over options and the retention package to the escrow and indemnification provisions of the acquisition document. Treating the incentive and retention package the same as the proceeds otherwise payable to the common and preferred stock properly allocates the risk of post-closing purchase price adjustments among the investors who took the capital risk and the management team who operated the business and are in a better position to make representations, warranties and disclosures regarding the company. In the 2011 SRS M&A Deal Terms Study, SRS noted that use of management carve-out plans has increased in recent years, raising issues of how they participate in escrows and earn-outs. We have not seen published reporting regarding the frequency or method of that participation. Companies adopting seller-sponsored carve-out plans should consider whether to expressly provide that those plans will participate in future indemnity and escrow obligations on a pro rata basis. In our experience, obtaining indemnity and escrow participation from buyer-created carve-out plans is difficult, as the buyer will not wish to have its retention incentives diluted by the prospect of indemnity claim claw-backs.[25]

Tax Issues

Acqui-hires require careful review of the tax treatment of different categories of transaction and employee incentive consideration. If the parties structured the deal as a shutdown of the target's business followed by the buyer's hiring of the target's stockholder/employees, those stockholder/employees would be taxed on any payments they receive as ordinary compensation income. Currently, ordinary compensation income is subject to a federal income tax rate as high as 35%. By contrast, to the extent that any payments to stockholder/employees constitute purchase price in exchange for target company stock, a long-term capital gain rate (currently 15%) would apply for stockholders who have held their shares for at least one year. In addition, if the buyer's stock will be the predominant form of consideration, the transaction, if structured as a purchase, might be eligible for treatment as a "tax-free reorganization," which would mean no immediate taxation with respect to stock of the buyer received and capital gain treatment when that stock is later sold.

If the transaction is structured as a purchase of the target company, but the business of the target is not continued after the transaction, a risk exists that

24 Note, however, that the parties ought to consider (preferably, before signing the note deal) the governing State's usury laws to determine if the conversion discount, exit premium or other features might be considered additional interest. Usury laws vary significantly from state to state and often are subject to any number of specific exceptions that must be carefully navigated. A "savings clause", whereby the rate is said to be the specified amount unless the maximum lawful rate is lower, in which case such lawful rate applies, is prudent to include as a backstop in jurisdictions that may respect such a clause.

25 Moreover, placing compensatory options in escrow may raise deferred compensation issues under Section 409A of the Internal Revenue Code. Careful consideration should be made of the facts and circumstances before any options are subject to escrow.

the Internal Revenue Service might not respect the transaction structure as a purchase (whether or not structured to qualify as a tax-free reorganization). In this event, the consideration received by the stockholder/employee would be recharacterized as ordinary compensation income. Analysis of these structures is nuanced and will require involving tax lawyers early in the deal. While we understand that parties may perceive tax counsel as a disproportionate expense in the case of smaller deals, we have found all too often that parties suggest and even agree upon tax inefficient structures only to realize that halfway through the deal and have to start from scratch, wasting more time and money.

While management carve-out payments in the form of a buyer retention plan are clearly intended as compensation and taxable at ordinary income rates, contingent deal consideration for equity needs close tax scrutiny. Consideration payable after the transaction that is tied to performance of the company might be treated as compensation rather than purchase price if the right to receive payment hinges upon an individual's continued employment with the buyer. Those arrangements may also implicate the deferred compensation penalty rules of Section 409A of the Internal Revenue Code. In practice, many acqui-hire deals are structured so that retention milestone goals are measured by group rather than individual retention in order to mitigate the risk of payments for equity being characterized as compensation. However, a buyer might want to characterize the payments as compensation because compensation payments are generally deductible to the buyer (though from an accounting perspective, compensation is an expense, and some buyers might not want the earnings charge). Whether any payments should be characterized as compensation rather than as purchase price is based on all the relevant facts and circumstances, and a tax expert should be involved to advise in these situations.

Venture capital investors should note that indemnification for tax matters is frequently not capped by the indemnification escrow. The 2011 SRS M&A Deal Terms Survey provided that tax matters are subject to a stand-alone indemnity in 69% of the reported transactions. In addition, SRS reports that 77% of reported transactions exclude tax representations from the cap on indemnification and general survival periods. The 2011 ABA Private Target Mergers & Acquisitions Deal Points Study indicated that tax matters are subject to a stand-alone indemnity in 61% of the reported transactions and are carved out of the indemnification cap in 53% of the reported transactions. The SRS survey included more recent data, so a trend of increased incidence of stand-alone tax indemnity and carve-out of tax from caps may be developing. In any event, we believe that the SRS survey is more heavily weighted toward transactions involving venture-backed companies and, thus, is more instructive in the acqui-hire context. The prevalence of indemnification above the escrow for tax issues, coupled with the special structuring issues in acqui-hire transactions, which could give rise to post-closing liability for improper withholding, call for careful attention to be focused on who bears the post-closing risk of "getting it wrong."

Another consideration is the potential applicability of Section 280G of the Internal Revenue Code, which imposes a 20% excise tax (and disallows deductions) for so-called "golden parachute" payments made to executives on a change of control of a company. Any compensatory payment, which can include acceleration of vesting, should be examined early on to determine whether stockholder approval needs to be obtained to eliminate the application of the excise tax.[26]

The Viability of Prophylactic Provisions

What can be done to better align the interests of founders and investors in connection with acqui-hires? Although the acqui-hire phenomenon has been growing over the past several years, the market has not answered by placing specific protections in investment financing documents. The board already has the ability to adopt, or decline to adopt, seller-created management carve-out plans. From an investor's perspective, the acqui-hire outcome focuses attention on the consent rights of investor-designated directors and brings new issues to bear on often utilized provisions. For example, investors often require the company to have a compensation committee and for the investor-designated director to serve on that committee. Taking it one step further, investors may

26 Stockholder approval will not suffice to eliminate the 280G excise tax in the case of companies with equity securities that are publicly traded. See Edward M. Zimmerman, Jason Mendelson and Brian A. Silikovitz, *Golden Parachute Tax Rules In A Venture Capital Context: Early Stage Structures Can Create Tax Hits Upon Exit*, MEALEY'S LITIGATION REPORT, July 2006.

Venture investors, rather than acting as the "deep pocket" for the indemnity escrow, have incentives to make sure that all transaction constituencies receiving consideration in an M&A transaction share the risk of escrow and indemnification on a pro rata basis.

desire to expressly require any management carve-out or other change in control plan be approved by the compensation committee, including the affirmative consent of the investor-designated director. Also, the affirmative consent of the investor-designated director is commonly required to approve the compensation of executive officers — and this right can be used to influence the outcome of a seller-created management carve-out plan.

Nevertheless, target-side protective provisions cannot shield against an aggressive management carve-out plan contained in a buyer term sheet. A more aggressive option would be to deem any buyer retention package part of the proceeds to be split among all parties pursuant to the charter allocation provisions. The lack of a trend concerning investor protections to address the acqui-hire scenario could be indicative of entrepreneurs holding enough leverage in a hot market to resist them but could also be indicative of the fact that developing "new" protective provisions in the standard venture investment documents may not be meaningful.

We believe the best protective mechanisms are planning and communication. Investors should level-set with their portfolio companies ahead of time. The first step in this process is often at the investment term sheet stage when investor-designated director consent requirements are negotiated. Specific discussions should occur concerning expectations if a buy-out term sheet were to arrive, including that the investors should be made aware of the possibility of a term sheet early in the process. Once a buy-out term sheet arrives, what steps can be taken to protect the investors' interests and anticipate conflict issues? The directors and investors should determine whether a retention package is being offered to the founders or other key personnel and, if so, whether there is enough detail to understand its impact relative to the rest of the deal package. A full understanding of the entire economics of the transaction is essential to the process of fiduciary duty compliance.

Acqui-hire Transactions – an Investor's Checklist

Below is a suggested checklist of items that all venture capital investors should consider when their portfolio company is engaged in an acqui-hire. We do not predict that acqui-hires will warrant wholesale changes to the way venture financing transactions are structured or give rise to a new playbook for the acquisition transactions themselves. However, these transactions do have sweeping ramifications to the relationships between investors and founders, if for no other reason than the vastly different objectives they may have in any given acqui-hire.

Pre-Term Sheet

- When investing in convertible notes, expressly provide for a conversion feature of notes (not just payment of principal plus interest) upon an exit transaction prior to conversion. Be aware of the applicable State usury laws and build in a "savings clause" to protect repayment of the loan at a premium.
- Consider the viability of, and current market for, express protections for preferred stock in organizational documents.
- When adopting any seller-side management carve-out plan, openly discuss and address indemnification, escrow and earn-out issues with management.
- Have a periodic M&A "rules of the road" discussion with management to encourage early investor involvement prior to initiating sale discussions with potential buyers.

Term Sheet Stage

- Before moving into exclusivity, consider whether the company has identified and adequately considered other M&A or financing alternatives that might be attainable.
- Consider whether a financial advisor should be retained (and ensure that any retention is approved by the board).
- Consider whether the board is receiving advice from experienced M&A counsel and make sure there's a seasoned tax lawyer involved…early!
- Confirm that all potential interests of management and board representatives in the potential transaction have been expressly disclosed and that board minutes reflect that disclosure.
- Involve counsel in determining who is and is not an "interested director" as the determination is very nuanced under Delaware law.
- Have recusals been considered for directors who may be considered "interested" in a transaction? Ensure that a director leaves the room when his or her compensation is discussed.
- Has the board discussed the need for an independent committee with counsel, and is an independent committee practical under the circumstances?
- Consider forming a negotiating committee including representatives of investors to participate in deal negotiations or to receive more frequent updates from management.
- Carefully review the term sheet's provisions relating to treatment of unvested seller incentive awards, creation of management carve-out plans, post-transaction equity awards or other bonuses or compensation, and participation of equity incentive holders and management carve-out plans in escrow and indemnity. If the term sheet is silent as to any of these items, ask questions now to avoid surprises later.

Definitive Agreements Stage

- In most cases the board should meet to consider approval of the transaction, more than once, rather than act by written consent, to create a record of discussion and deliberation. That record should be roughly contemporaneous as courts have frowned upon minutes done months after the facts.
- Confirm that the board process is sufficiently documented through minutes and preservation of presentation materials to show that the board has fulfilled its duty of care.
- Confirm that all final post-closing management arrangements have been disclosed.
- Confirm that the tax treatment of compensatory payments as opposed to payments for equity is clear and properly structured.
- Know your *Trados* profile and consider whether a disinterested stockholder approval is feasible and could be prudent. Also under *Trados*, consider creating a common stock carve-out to provide more value to the common holders.

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