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Overview

Buying Distressed Tech Start-ups

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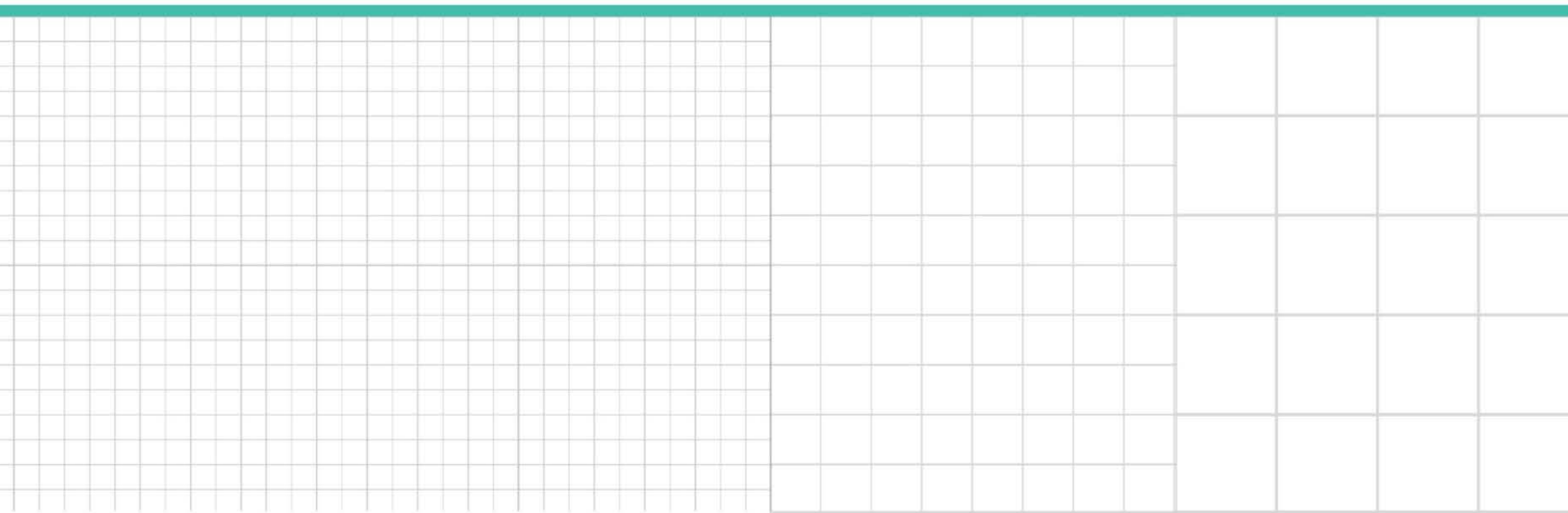

Buying Distressed Tech Start-ups

Contributed by C. Derek Liu, Baker McKenzie

For the past few years, Silicon Valley has anticipated a period where plentiful venture capital funding dries up and start-ups with not-yet-profitable businesses must make it on their own.

For many start-ups, this will mean having to sell at a discount or to accept money at significant discounts to the valuations of their prior financing rounds, or suffer the ultimate ignominy of shutting down the company. The expected coronavirus-induced recession may well be the start of that period. This article is the first of a two-part series for buyer and investors, on how to structure transactions for distressed start-ups. It will cover mergers and acquisitions transactions; the second part of this series will cover investments.

What History Tells Us

To frame the historical context, we can look at each of the two downturns since the new millennium—the dot-com crash in 2000-2001 and the Great Recession starting in 2007-2008. In the dot-com crash, while the number of M&A transactions involving U.S. venture-backed companies did not drop significantly from 2000 to 2001 (from 489 deals to 464 deals, or 5%), the median acquisition price plummeted from $100 million to $27 million (or 73%). In fact, the market would not regain the $100 million watermark until 2018.

Similarly and less dramatically in the Great Recession, the number of transactions dropped moderately from 2007 to 2008 (519 deals to 427 deals, or 18%), and even recovered slightly in 2009 to 437 deals (up 2%). However, the median acquisition price more than halved, from $58 million in 2007 to $32 million in 2008 to $25 million in 2009 (total drop of 57%). Since then, however, deal activity has been markedly up in all of the 2010's. For example, 2018 saw 757 deals (up 55% compared to 2000, the height of the dot-com bubble) and 2019 saw an all-time high median exit value of $93 million. This is a dramatic upturn from the median exit value in 2010 of $38 million (total increase of 145%).

So while difficult to forecast the future based on the past, it should be fairly safe to say that if the coronavirus does induce a long-term recession, deals may still happen at a moderate pace, but one should expect valuations to fall significantly.

The Difference With Buying a Distressed Start-Up

Tech start-ups have characteristics that make the traditional tools of distressed M&A less relevant. First, start-ups often do not need the restructuring benefits of a bankruptcy process. They tend to be financed through preferred equity (or equity-like instruments such as convertible notes—SAFEs, or a "Simple Agreement for Future Equity," a simplified security that in economic terms approximates the result of a convertible note but without the debt features). These are commonly held by a close-knit group of insider investors, rather than complex debt structures secured by marketable assets.

And for many start-ups, there are not significant deferred commercial liabilities that need to be satisfied, as the primary expenses for start-ups are the employees themselves and a limited set of obligations like real estate leases and cloud-server contracts, which must be kept current to continue operations. As a result, the use of the bankruptcy process to restructure significant debt and other liabilities is often unnecessary.

Second, the primary value drivers of a tech start-up are often in the people and in the "soft" assets, such as source code or process know-how or network effects. As such, the negative connotations and the extended timing and expense of a bankruptcy or restructuring process makes preserving that value challenging. (The one notable exception being start-ups that have substantial patent portfolios.) As such, for the typical start-up acquisition, the traditional tools of conventional M&A, such as mergers and asset sales, remain commonly used.

The Primary Deal Structures

The primary choice to make in most start-up M&A, distressed or not, is between purchasing the equity of the company versus purchasing the assets directly.

Equity Purchases / Mergers. The primary benefits of purchasing equity, either via a stock purchase or a merger, is speed of execution and favourable tax treatment for the sellers. On speed, with the right internal shareholder approvals, and assuming that the transaction falls below the thresholds for antitrust filings, a merger can close on the same day that it signs

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(a so-called "sign-and-close"). This speed becomes an incredible advantage in the melting ice-cube situation of a distressed start-up: the management teams can negotiate without any publicity regarding the financial distress, and the transaction can be presented to the world as a fait accompli.

Employee and customer flight can both be minimized, because the buyer can take control of all communications rapidly (although for practical reasons the buyer will probably want the assurance of key stakeholders pre-signing). On the tax front, the sale of equity in a corporation is generally taxed only at the shareholder level, and at capital gains tax rates. If a shareholder's equity in a start-up qualifies as qualified small business stock, the shareholder may be allowed to exclude all of the capital gain from the sale (up to $10 million or 10 times the stock basis, whichever is greatest) from the shareholder's gross income. A stock purchase also tends to mitigate certain transfer taxes that could apply to an asset purchase.

The most significant downside of an equity purchase is inheriting all of the liabilities of the start-up. Of those, the more obvious liabilities are all of the ordinary course commercial liabilities, e.g., unpaid bills, taxes, and the contingent liabilities, e.g., possible lawsuits, regulatory fines (see below). The less obvious are the corporate-level liabilities created by the transaction itself (see below). And on the tax front, buyer does not get to step up the basis of the target's assets to reflect the purchase price, and so foregoes some future tax depreciation benefits.

Asset Purchases. An asset purchase has as its main advantage the flexibility to customize the assets and liabilities to be received. Notably, an asset purchaser can opt to only take the assets and leave behind all of the legacy liabilities of the target, with some limits as described below.

On the speed dimension, asset purchases are slower to negotiate and execute. First, buyer and target need to parse the individual assets and liabilities, to determine what should transfer. Second, the transfer of those assets over to the buyer will often times require additional third party consent (e.g., contracts and employee arrangements). These disadvantages are somewhat counterbalanced by not having to heavily diligence the liabilities of the target entity, which are usually left behind.

On the tax dimension, asset purchases can be less efficient than stock acquisitions as there are ultimately two levels of taxation. The target corporation will generally be subject to income tax on the net taxable gain from the asset sale, which may be offset, in part or in whole, if the target entity has significant net operating losses. Then, if the target wishes to distribute the sale proceeds to its shareholders, the amount distributed to each shareholder will generally be subject to income tax, which may be at the capital gains tax rates or the ordinary income tax rates depending on the type of distribution made.

Because distressed sales by definition tend to have lower purchase prices and a history of operating losses, the ability to offset purchase proceeds with historical net operating losses increases the appeal of asset sales. Furthermore, buyer does get to step up the basis of the target's assets to reflect the purchase price in an asset purchase, and may generally deduct depreciation and amortization based on the stepped-up asset basis.

The flexibility to customize the transaction is not bulletproof, because of two doctrines. First, under fraudulent conveyance (or fraudulent transfer) laws, creditors can claw back assets or unwind transfers, if they can prove that the assets were transferred for less than fair value at a time where the target was insolvent or near insolvent, with the effect of unfairly depriving creditors of assets of the entity. In assessing such risk, for the average start-up that has only ordinary commercial liabilities (e.g., lease payments, ordinary accounts payable), there is a reasonable risk assessment that ordinary commercial creditors would likely not initiate litigation to unwind a sale over smaller amounts. The concern is substantially heightened for start-ups with substantial debt. In such cases, it will likely make sense to include lenders in the negotiation in any case to ensure that any claims on the assets are properly released, or to explore the ABC or 363 options described below.

Second, successor liability laws can also offset some of the benefits of leaving legacy liabilities behind. Under such laws, under certain circumstances, if a buyer acquires the entirety of a target's business, the liabilities of target will follow the assets notwithstanding the contractual agreement between the two parties for the seller to retain such assets. Such risk can be mitigated, for certain constituents such as employees, by obtaining releases as part of the closing process.

However, careful thought should be given to the issue if the target is in a business where there is a high magnitude of risk of contingent claims: e.g., hardware companies with product liability claims, or big data companies with consumer privacy claims. The unfortunate aspect of both fraudulent conveyance and successor liability laws is that their application may be subjective and often litigated in hindsight (e.g., when the eventual bankruptcy has actually happened, or when a plaintiff

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is looking for a deep pocket after the target entity itself has already dissolved), such that it is often difficult to conclusively avoid such risks by contractual drafting.

Acquihires. To take an extreme form of an asset sale, for many small target companies, one common acquisition structure is a so-called "acquihire," where the buyer simply hires the employees from the start-up. Acquihire structures are useful where the target company's actual products did not gain significant traction and thus are not of great value. Though there is no universal legal structure for acquihires, in one common acquihire structure, the buyer makes offers of employment to the target's employees that it wants, and simultaneously pays a relatively nominal amount of consideration to the target entity itself (usually an amount sufficient to satisfy some portion of debt and pay for the liquidation itself), in exchange for which it receives a release of claims.

The key benefit of this particular acquihire structure is an almost complete insulation from the liabilities of the target: because neither assets nor liabilities were transferred, the risk of a fraudulent conveyance claim or a successor liability claim are minimized. And execution time can be minimal, as the buyer need not diligence the target's assets and liabilities or negotiate a full purchase agreement. As a note, it will be helpful, even where the intellectual property is not desired, to obtain a non-exclusive, perpetual license to the intellectual property to avoid future owners of those assets making infringement claims.

ABCs and 363's. In truly distressed situations, a so-called "ABC," or assignment for the benefit of creditors, or a 363 pre-packaged bankruptcy sale, are also potential tools. Such structures are primarily useful where the deal proceeds are unable to clear the debt of the target, or there exists substantial concern about fraudulent conveyance or successor liability, and buyer wants fuller protection from such claims.

An "ABC" is available in certain states, including notably California. In an ABC, the target entity agrees to transfer all of its assets to a liquidator (called an assignee), which is typically a private-sector service provider. The assignee conducts a solicitation process for such assets (unless a satisfactory one was done pre-ABC), and if it finds no better bids, then sells the assets to the buyer and remits the proceeds to the target's creditors.

An ABC can be appropriate in situations where the buyer values the ability to cleanse historical liability but still wants a relatively predictable and fast deal execution process. Because the assignee is a private company, it is able to move fairly quickly and, if the target has already engaged in a fulsome solicitation process prior to entering into the ABC, the assignee may also be willing to waive an additional solicitation process.

The downside is that because the technical sale occurs between the assignee and the buyer, the buyer is often stuck with very limited representations to the assets and little if no post-closing recourse. As such, ABCs are likely best reserved for extreme situations where the purchase price is so low as to be unable to satisfy a fairly large number of lenders and/or trade creditors.

Similar to an ABC, a 363 sale refers to a procedure in bankruptcy whereby a buyer and seller can pre-negotiate a purchase agreement, which is then submitted to approval by the bankruptcy court. Much like in an ABC, but this time in the context of a formal judicial process, the court will oversee an auction process. The winning bidder will buy the assets free and clear of unwanted liabilities. The primary downsides of a 363 sale in the context of most start-ups is the time and expense necessary to navigate the bankruptcy process, and for the buyer, the attendant uncertainties of the court-governed auction process.

For most buyers, both structures have downsides that make them viable only in truly distressed cases. Both structures offer little mitigation of the key concerns of employee retention and customer flight, though ABCs are incrementally better than 363s because the process is less visibly publicized.

Mitigating Liability Risks

It is probably obvious that a distressed start-up likely has more potential for liability than average. As such, the normal tools of risk mitigation for M&A should be amplified.

To start, it is much more likely that distressed start-ups will have above-average amounts of unpaid bills. Sufficient financial due diligence should be performed to ensure that known liabilities are accounted for in the upfront purchase price. Buyers should generally use purchase price adjustment mechanisms (e.g., cash-free, debt-free, with a target level of working capital), rather than opting for fixed price or lock-box approaches.

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Further, they should ensure that such concepts are appropriately defined to cover the potential financial risk areas: for instance, the definition of debt should ideally not be limited to debt for borrowed money, and should instead cover a wider range of financial or quasi-financial liabilities such as past-due accounts payable, unpaid taxes, employee accruals, and the like. And backstopping that adjustment mechanism should be a sufficiently robust separate escrow for purchase price adjustments, to ensure that any unexpectedly large swings in debt or current liabilities do not deplete the main escrow.

The caveat here is that setting the appropriate target working capital and debt levels may be particularly difficult because historical levels may not be adequate guides in a deteriorating situation. It may be appropriate to pursue more creative approaches such as opting for a one-way adjustment with a reasonable floor, which would protect against dramatic downswings.

Similarly, buyers may be tempted to insist on larger-than-normal main indemnity escrows. Distressed transactions have more potential for discovery for post-closing liability. First, the timeline for upfront due diligence may be compressed because of the exigencies of the financial situation of the target.

Second, the target itself may have neglected (whether knowingly or not) areas of legal compliance in the spirit of cost-savings, which in turn makes it more likely that there will be a contingent liability (e.g., a future litigation or regulatory action) that springs up. Third, the management team itself may have less of a stake in the escrow (because their own common equity may be wiped out), so the ordinary care taken to respond to diligence and to prepare disclosure schedules may be lessened.

However, counterbalancing the desire for additional security are the practical realities of securing target shareholder approval. Because there are less proceeds to go around, asking for substantial escrows becomes a difficult topic of negotiation. Further, the burden of such escrows —under many modern start-up charters—is allocated to the bottom of the liquidation waterfall (e.g., the common shares fund up to their entire proceeds, before any preferred shares contribute), which means that the founders / employees are disproportionately affected.

Finally, many venture investors will insist that they not have liability above the proceeds that they receive, which could be problematic in situations where a substantial portion of proceeds are used to clear debt and/or transaction expenses, and the buyer wants recourse up to the actual amount that it paid for fundamental representations and other like claims.

Representations and warranties insurance in such distressed situations may be appropriate due to the above tension. However, a few notes are important. First, R&W insurance will generally not cover purchase price adjustment items, so at minimum a purchase price adjustment escrow is still appropriate. Second, R&W insurers will still want to ensure that a sufficient level of due diligence was performed by buyer (and will exclude wide swaths of risk areas if they detect weakness), which makes it challenging to execute a deal quickly to lock in a lower purchase price or save an imploding asset.

Third, separate escrows may still be needed for individual risk areas since R&W insurance will not cover any liabilities known at the time of signing, so the post-closing liability negotiation is not completely avoided. Finally, R&W insurance will not cover occurrences between signing and closing absent a separate rider, so buyer may not have protection for further deteriorations in the business (e.g., via the major customers / suppliers rep, or the undisclosed liabilities rep).

Closing Risk

Buyers will also be inclined to negotiate for more flexibility to not close the transaction if the target's condition deteriorates more quickly than expected. Buyers should not expect much from traditional concepts of "material adverse effect", as courts may view the buyer as having made an informed decision to buy a distressed company in the first place, absent a dramatic worsening of the existing trend of deterioration. And notably, as parties are discovering during the Covid-19 crisis, the market practice has historically been to exclude out macro-conditions such as broad industry or economic, unless they disproportionally affect the target.

Closing conditions such as retaining key customers or key employees could be negotiated for, or bringing the representations down at closing at a lower standard of accuracy so that a material breach of a representation can be the basis for the refusal to close. However, expect targets to contest such terms vigorously, since targets will (rightly) perceive that if the transaction fails to close, they may be driven into further distress or even insolvency.

Similarly, because of the dire consequences of a failed closing, regulatory risk will be another area of focus. In normal times, antitrust laws are more permissive with transactions involving distressed targets. However, during the current Covid-19

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crisis, regulatory scrutiny—particularly in the foreign investment regimes such as the Committee on Foreign Investment in the United States—has considerably heightened.

Shareholder Issues

Another source of substantial difficulty in acquiring distressed start-ups is navigating the multiple constituencies on the target's side. In the typical capital structure of a Silicon-Valley style start-up, the employees (including the founders) receive common stock (or options/restricted stock units for common stock), while the outside venture investors typically invest via preferred stock. And between the various tranches of preferred stock, there are likely different valuations, different levels of seniority and different class-specific consent rights. In a distressed situation, depending on the amount of proceeds relative to the rights of the individual classes of preferred, common shareholders and junior preferred holders may receive little to no proceeds.

As a result, on the target side is usually a highly contentious set of internal negotiations among the various stakeholders over how to divide the slices of a smaller-than-expected pie. And it is common for a deal that is generally supported by the shareholders to be held up because of a class-specific consent right by one class of shareholders. Notably, in certain start-ups that meet the requirements of California's long-arm statute, a class vote of the common shareholders may be required, which becomes very challenging if the common is being allocated none of the proceeds.

To further complicate matters, buyers opting to use an equity purchase structure should be aware that distressed purchases generate heighted potential for liability from target shareholders. Notably, under a line of cases under following *In re Trados*, the Delaware courts have heavily scrutinized the conduct of the target entity's board of directors in approving any sale in which the preferred payout and common payout substantially diverge (e.g., the common getting wiped out).

Because most start-ups' board of directors are heavily weighted towards representatives of venture funds and management, the Delaware courts consider such directors to be conflicted, from a fiduciary duty perspective, when considering the question of whether or not to sell the company. For venture investors' representatives, the courts view such directors are more incentivized towards recovering some or all of their preferred investments, rather than holding out for a possibility of a recovery of the enterprise and obtaining some value for the common.

And for management, the courts view such directors as also incentivized to approve so as to secure future employment. As a result of *Trados*, a buyer that acquires a distressed start-up may find itself indemnifying the target entity's former directors and officers in a drawn out litigation over whether the ex-directors reviewed and approved the transaction appropriately.

Similarly, almost all U.S. states offer so-called "appraisal" or "dissenters" claims, whereby a disgruntled shareholder may seek a judicial appraisal of the value of its equity. Though courts often will respect a negotiated arm's-length deal price as an appropriate measure of value, in situations where the courts detect concerns regarding the fairness of the solicitation or approval process for the deal, the courts may be inclined to second-guess the negotiated value and give greater weight to valuation experts' appraisals.

Appraisal claims can be expensive to litigate, because they require having to hire outside valuation firms. And they are particularly harmful in situations where the negotiated deal consideration is all or partly stock, since appraisal awards are always paid out in cash. So, even a judgment declaring that the dollar value of the price was fair could result in an unexpected cash payout.

As a result of the above two risks, in any equity purchase transaction, the buyer should carefully monitor the target entity's process for board and shareholder approval. Where possible, the target entity should be using an independent committee of disinterested directors. Also, because the risk is from the shareholders themselves, getting consents and releases from as many shareholders as possible is helpful.

Note in particular that for Delaware companies, such releases cannot simply be contained in a letter of transmittal and should instead be separately signed preferably coincident with the signing of the acquisition agreement. And in situations where the holders of common shares and/or junior preferred shares receive nothing (and thus are unlikely to sign a release), buyers should carefully weigh the need for additional protection, be it an enhanced escrow or insisting on a re-allocation of proceeds to those classes.

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Treatment of Debt/Interim Financing

Most Silicon-Valley start-ups are more heavily funded with equity and lighter on debt, since most start-ups are not profitable and cannot sustain substantial debt loads. As a result, except in extraordinary situations, the deal proceeds should be sufficient to repay at least the debt, with some amount left over for the venture investors. This is particularly true given that the preferred investors usually control the board, and in a situation where there is nothing left over for the preferred, there is little incentive for them to approve the sale, relative to continuing to run the company (or handing it over to the lenders). Consequently, with respect to debt, the key concern for buyers is ensuring that the debt is appropriately repaid with deal proceeds and an appropriate release of liens obtained.

One exception is the target with convertible notes outstanding, which are common in two contexts. The first is in start-ups that have not yet raised venture financing, or that are in between venture rounds, where the convertible note is meant to be a way to finance the company without the full complexities of determining valuation or governance. The second is in distressed investment situations, where start-ups will be forced to offer investors very attractive terms, such as a 2x or 3x return on a change-of-control. Such high premiums are often required because investors would otherwise refuse to invest in a distressed start-up with little to no tangible assets to recover if a sale does not occur. Such debt is commonly subscribed by the existing venture investors of the start-up, who are best able to assess the possibility of an eventual sale.

Targets with immediate liquidity needs may ask buyers to step in and provide bridge financing during the deal negotiation period or between signing and closing. Such financing comes with several advantages for the buyer. First, relative to the insiders' bridge financing, the buyer may be able to offer more attractive terms and thus preserve more value for the common shareholders, who are often the company's management team and employees.

Second, the financing places the buyer firmly in control over the negotiation process, since an eventual failure to consummate the deal will usually result in such debt either quickly maturing or becoming longer-term debt on onerous terms. Third, the buyer is best placed to assess its ultimate willingness to do the deal and may be able to act more quickly than trying to raise from target's investor base, who may have some degree of wariness of continuing to fund a dying start-up.

Balanced against that are the obvious downsides that buyer may be stuck with an illiquid and undesirable debt instrument if the deal fails. For instance, if the deal requires antitrust or other regulatory clearance, it is possible that a regulator may block the transaction. Further, many buyers may have internal limitations, either from a financial reporting perspective, a treasury perspective or otherwise, from holding onto a bespoke debt instrument.

Whether funded by investors or buyer, it is generally preferable for buyer not to allow the target company to fall into actual insolvency during the pendency of the deal. For instance, if a target is unable to meet its payroll obligations, it will typically be obligated to terminate its employees as a matter of law, and target directors tend to take this obligation very seriously given the potential for personal liability. Further, failure to pay suppliers tends to result in termination of supply in addition to the financial liabilities created, which complicates the ability to preserve the enterprise.

Employees and Commercial Relationships

On the non-legal front, buyers should pay attention to managing all of the melting ice-cube risks of a degrading business.

Highly skilled tech employees are highly sought after (at least during non-recessionary times) and the spectre of either a failing company or a disappointing exit transaction may cause many to look at other opportunities. Competitors monitor these situations closely and will actively recruit the best employees of failing businesses. In distressed situations, the target equity held by the employees is commonly worthless, either, in the case of options, because the common shares are receiving less than the applicable strike price, or for common shares or RSUs, because common shares receive nothing.

To counterbalance that risk, buyer may set aside a portion of the deal proceeds to fund a retention pool for employees. Note that particularly in a distressed situation, from a fiduciary duty perspective, it is much easier for the buyer to structure its offer this way, rather than allowing the target company to adopt employee retention on its end. Target companies do frequently adopt so-called management incentive plans, or management carve-out plans, where a percentage of the deal proceeds are allocated to management, in order to incentivize an eventual sale.

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However, such "MIPs" are problematic to adopt on the eve of a transaction from a fiduciary perspective, because they deprive proceeds that would otherwise go to the common stock holders. Further, buyers often have little control over the allocation of the retention under such MIPs, which are typically negotiated between management and the target board. In any case, buyer should minimize uncertainty by acting quickly to prepare employment offers for employees (pre-signing if necessary) and communicating with employees proactively and transparently.

With respect to commercial relationships, the same principles regarding proactive and transparent communication apply. Closing conditions with respect to key contracts may be appropriate, though targets may heavily resist them. As such, it may be appropriate to communicate pre-announcement with key counterparties. Note that many commercial contracts have termination provisions tied to liquidation- or bankruptcy- related actions, so a combination of due diligence to understand such parameters and liquidity support (see above) to ensure that such clauses are not triggered may be appropriate.

Further, if the period between signing and closing is prolonged, negotiations regarding restrictions on the target's ability to operate its business, including making adjustments to its contracts, may be contentious, particularly as targets may argue for the need to act quickly in the face of the existential risks that Covid-19 and its ensuing consequences may present.

Conclusion

Acquiring distressed start-ups is frequently an exercise in scooping up a slippery, melting ice cube. Buyers should be prepared to be agile and to make decisions quickly. Though the target's distress gives buyer significant negotiating leverage, both buyer and target are racing against the time of a degrading business and outside parties like creditors or disgruntled shareholders that have differing incentives.

Buyers may be forced to settle for imperfect protections, either limited due diligence or limited recourse or otherwise, simply as a matter of trade-off for being able to win a strategic asset at a compelling price. Keeping focus on what are the key assets driving the purchase—be it a core team of key employees, or a collection of valuable patents—is essential in guiding the decision of which trade-offs are acceptable.

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