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Muddy employee incentive issues in a disappointing exit: 9 practical tips for public company acquirers

Mergers and Acquisitions Alert

1 APR 2014

By:

In mediocre payout situations, transaction proceeds are unlikely to give a substantial (if any) return to common stockholders, yet may be sufficient to at least return the initial investment, and perhaps a liquidation premium, to preferred stockholders. In such a scenario, the practical implementation of fiduciary duties for privately held boards has historically been somewhat murky.

Prior to 2013, many issues generally surrounded liquidation payouts to preferred investors when allocated among various series of preferred investments, whether structured as bridge notes that attached large additional preferences, or as a pay-to-play, which immediately diluted non-participating legacy stockholders at the time of a bridge financing.

The 2013 *In Re: Trados, Incorporated Shareholders Litigation* case in Delaware renewed attention on this area by applying the rigorous "entire fairness" legal review standard to a board's actions when it was unclear that a board was zealously evaluating the impact of decisions on all stockholders, as opposed to just preferred stockholders. The entire fairness standard, first set forth in the decision in *Weinberger v. UOP, Inc.* in 1983, requires the board (and not the plaintiffs) to prove that both a fair process and fair price were obtained for the stockholders. Although the *Trados* board happened to prevail on its particular facts, this rigorous standard highlights Delaware's ongoing concerns in this context.

Despite the often-mandated acquisition of directors and officers liability insurance "tail policies," public company acquirers are advised to more closely scrutinize the circumstances of a liquidation where the proceeds are unlikely to materially benefit all stockholders either by class (common/preferred) or series within a class (such as Series A or Series B). Retrospective reallocation of pieces of the pie among stockholders may cause unwanted negative publicity, management distraction and turbulence with continuing employees who are vital to making an acquisition work within the buyer's organization.

The quandary of a "so-so" exit

Not all startups exit with values akin to Facebook's acquisitions of WhatsApp, Oculus VR or Instagram. For startups that do not hit it out of the park − which is the majority of them − the fact pattern resembles in the following:

- The startup began with an interesting idea. It took in three or four rounds of funding but no firm market emerges and **venture capital backers are no longer willing to fund the target** and want to quickly and quietly sell it (and thus avoid an outright shutdown) and recoup as much of their investment as possible through their liquidation preference.
- There is, however, **value in the underlying technology** – and the price is likely right, if not downright cheap, to

perhaps save a buyer six to twelve months of development time or turnover customer lists or patent advantages.

- Equally important, **the engineering team** itself is an asset – and neither target nor any buyer will want that asset to simply walk out the door.
- As the target's cash dwindles, the current investors **extend a cash lifeline** – using bridge financing notes that require a 2X or 3X principal payout to the lenders upon a sale of the target.

Prior to 2013, the answer was relatively simple. A target's board of directors is usually 'packed' with members from investing venture capital funds and current members of management but rarely includes former CEO founder types or other former employees who vested on common stock prior to their departure). This mashup of VC investors and current management, with an occasional outsider thrown in, seeks the best price. In a lukewarm valuation scenario, that price may not be enough to pay off the liquidation preference overhanging the target – leaving little or perhaps nothing for holders of common stock. Yet employees hold common stock, meaning there is little incentive for those employees to hang around.

Alternative #1: The target's board adopts a carveout or management incentive plan, reallocating some proceeds from a stockholder payout to employees to encourage them to remain. However, that results in lower proceeds for common stock holders, or even earlier preferred stock investors who must wait in line for the last-in investors to be paid their liquidation preference.

Alternative #2: The buyer embraces identified target employees and a promises a post-closing retention plan – but it then turns around and reduces the proposed purchase price to account for the post-closing retention value.

Historical focus on preferred stock payouts: The complicated issues in this situation historically revolved around circumstances where either the deal value was insufficient to pay the liquidation preferences for various early-stage venture investors even though a later stage preferred round may be paid in full – and even more thorny situations such as the infamous pay-to-play, where equity holders who do not participate in the bridge lifeline extension of cash either do not receive the 2X-5X preference in paying off such notes (thereby cramming them down further on the chain in a liquidation payoff when/if it occurs), or, in a true pay-to-play, the non-participating investors are massively diluted (crammed down) at the time of the new fundraising.

Management carveouts were routine: However, until 2013, "management carveouts" were an ordinary course feature of deals where venture capital investors wanted to retain employees in order to preserve some sort of saleable enterprise. The major downside of a carveout plan is that the proceeds to an employee would be tax characterized as ordinary income rather than capital gains on holding stock, since the extra money was not linked to their stockholdings but rather than their continued employment services to the company.

***Trados* reaffirms board duties to all stockholders**: The 2013 *In Re: Trados, Incorporated Shareholders Litigation* emphasized that a board owes fiduciary duties to all stockholders – and using a management carveout to strip money from stockholders lower in the liquidation food chain than the venture capital funds affiliated with board members in order to give that money to people who would otherwise have no right to such money upon a liquidation invites great scrutiny from Delaware courts. While there are cogent business reasons to institute a management carveout, and Delaware is open to reasonable arguments, as shown in the eventual substantive outcome of *Trados*, there also is the outward danger of self-interest in venture capital funds and current **management manipulating a carveout** to deny the financial benefit of a liquidation to ousted founders, former employees or disillusioned prior investors. It is that very potential for abuse, even if most in Silicon Valley would posit it is far from the norm, that creates judicial review.

After-effects of *Trados*: Some commentators have suggested writing into a company's certificate of incorporation that individual board members owe a duty more to their nominating entities (i.e. venture capital firms) than to all stockholders. There has been informal Delaware guidance that this would at least put other stockholders on notice. Left unsaid, however, is that savvy founders will likely become nervous and perhaps lurch even further towards dual class control plans (à la Facebook, Broadcom and others) to retain governance control.

The awkward position of a buyer: Leaving aside prospective machinations in startups, the implications of *Trados* leave an incoming buyer in an awkward position. By definition, a target will be loath to share details of the sale process with a buyer, lest it reveal how much leverage a buyer has in the process. However, in a management carveout situation – in which the sale may become subject to having to prove a "fair process/fair price" – a buyer needs to ask process questions of a target to at least get to the "fair process" prong. Although it is highly unlikely that Delaware would seek to unwind a deal post-closing, it is entirely foreseeable that a post-closing judicial quarrel between classes of stockholders would likely disaffect target employees who continue with the buyer. Those are the very people whom the buyer would like to completely focus on executing in the present, rather than struggling with post-facto examinations of value. Although the buyer's liability is somewhat limited, in that Delaware courts scowl upon any indemnification of directors who are found to have breached their duty of loyalty, the uncertainty and publicity of ongoing litigation should be sufficient downsides to persuade a buyer to spend time on this subject with a target.

Nine practical remedies for acquirers

Among the **practical remedies for acquirers** in the prototypical "mediocre" deal, where payouts to common stockholders appear meager and/or a management carveout plan exists, are these:

- Ask about and **understand management carveout plans** and any similar bonus plans that either are transaction-based or may be business-based but may appear unusually lucrative and de facto transactionally linked.
- **Review any other arrangement that re-allocates the transaction proceeds** from a traditional liquidation payout, with particular focus on the terms, and equally importantly, the target's governance and notice procedures, **for any bridge financing** with a change-of-control preference, **or any pay-to-play investment round**.
- **Skeptically probe and ask questions about both "price" and "process."** Board minutes are likely over-generalized and uninformative. Even if a target demurs to discuss its specific price situation, emphasize the whitewater created by *Trados* and push a target that has adopted a management carveout plan or other reallocation of liquidation proceeds to justify its sale from a process standpoint.
- How does the target justify not having a **special committee of board members** who are entirely unaffiliated from preferred stockholders? A target should avoid sale deliberations involving board members who are conflicted, either directly as partners of a VC firm, or, as the facts in *Trados* demonstrate, indirectly through other business relationships with preferred stockholders. Such a special committee can be formed using third parties specifically hired for such a task.
- How does the target justify not having **a "majority of the minority" stockholder vote** – that is to say, a vote of a majority of the stockholders who are not affiliated with the "advantaged" stockholders? Delaware courts have specifically indicated that having a special committee and a majority of the minority vote would serve to prevent an "entire fairness" shift in the burden of proof from any plaintiff to director defendants.
- **Consider additional specific representations and warranties** as part of uncapped/zero basket fundamental representations related to the board having fulfilled its fiduciary duties, and **consider personal certification by board members**. Realize that this latter part may be viewed as insulting and as untenable legal risk – but the discussion at least forces the issue.
- **Mandate D&O tail coverage** and diligence on the exact policy that is obtained to evaluate its coverage, including Side A coverage for directors. Confirm with the target that **no side agreements exist** to reimburse directors who are found to have breached their duty of loyalty.
- **Evaluate keeping some valuation powder dry** by holding back a percentage of expected valuation from preliminary valuation discussions with a target, understanding that a certain additional percentage of value may be necessary for post-closing to incent employees who may not receive significant management carveout/bonus arrangements if a board is wary of creating increased *Trados*-like scrutiny.
- **Focus any post-closing employee incentives as forward looking**: Understand that rich post-closing equity or bonus plan incentives for continuing target employees may create the appearance of colluding with a target's board to deny common stockholders merger consideration. Structure such incentives to be forward looking, either through time-based vesting or use of performance goals that are measured from post-closing and thus do not appear to reward pre-closing service (at the expense of money that would otherwise go to common stockholders).

For more information about practical remedies for acquirers in a disappointing exit, please contact: