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OPPORTUNITIES IN A DOWNTURN:
THE PRIVATE M&A PLAY FOR
DISTRESSED TECH COMPANIES IN THE US

Foreword

The tech sector has had a tumultuous year. Rising inflation and corresponding interest rate hikes have had a sobering effect on the economy and battered the tech sector. Tech IPOs on US stock markets are down 83% compared to 2021 and late-stage investments in tech companies have dropped by 63% over the past year.

Fundamentals have changed in other ways. The sky-high valuations once imputed to tech giants are being reappraised in some cases, and companies once focused on growth at-all-costs are being forced to transition to a more cashflow-centric operating model. Cost cuts are being made across the industry, with redundancies have become all too common at some of the largest names in Silicon Valley. In this shifted economic reality, some tech companies are increasingly struggling to manage their liabilities. Beyond the global household names, there are tech companies which may be in breach of their debt covenants -- unable to pay off their trade credit and lacking the cash flow to meet their debt payments as they come due.

In this environment, while the investment thesis of some strategic buyers and financial investors will preclude them from deploying capital in such “distressed situations”, other investors will have the mandate and risk appetite to acquire promising tech companies at a substantial discount. This article overviews key considerations for such buyers in the context of acquisitions of private companies under US laws. After first assessing the strategic benefits of the different deal structures used in distressed tech acquisitions, we highlight some of the unique risks inherent in distressed tech investments and offer some practical strategies that buyers can use to circumvent these risks.

Your Team

Neil Barlow
Partner
New York
T: +1 212 878 4912
E: neil.barlow@cliffordchance.com

Matt Bergerud
Associate
Washington DC
T: +1 202 912 5532
E: matt.bergerud@cliffordchance.com

Sam Clinton-Davis
Law Clerk
New York
T: +1 212 878 4903
E: sam.clintondavis@cliffordchance.com

Cristina Rice
Trainee
New York
T: +1 212 878 8035
E: cristina.rice@cliffordchance.com

Susan Trepekli
Law Clerk
New York
T: +1 212 878 8020
E: susan.trepekli@cliffordchance.com

Sara Brown
Law Clerk
New York
T: +1 212 880 5752
E: sara.brown@cliffordchance.com

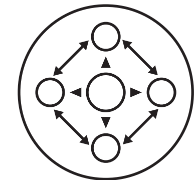
The Sale Process: In Court vs. Out-of-Court?

Once a prospective buyer has identified a target, one of their first considerations will be how the sale process is to be conducted. If the distressed target, for example, has already filed for bankruptcy, then any sale it conducts will be overseen by the bankruptcy court where it is filed and will also be subject to Title 11 of the United States Code, which will generally require, among other things, a formal marketing process and public auction.

A potential purchaser may find a sale through the bankruptcy process attractive because the assets can generally be acquired free and clear of liens and claims. Despite this, such "in-court" sales are rare in the tech sector. Tech start-ups, for example, are likely to have little need for an automatic stay against creditor action, one of the primary benefits of the bankruptcy process. Such start-ups are often financed by preferred equity, convertible notes or some variation thereof and rarely take on substantial external bank debt that could benefit from a balance sheet restructuring. Moreover, since their main expenses are typically employee wages, cloud-server contracts and real estate leases, there are often more efficient ways to restructure their liabilities outside of the public eye. However, one benefit to pursuing the acquisition of tech businesses that are in bankruptcy is that often the complex rights afforded to existing stockholders enabling them to block a sale are not enforceable, enabling a buyer to execute on an acquisition unfettered by the stockholder base.

Even larger tech companies that have taken on significant third-party debt that could be restructured in a bankruptcy are generally wary of the bankruptcy process. In addition to potentially harming their reputation and brand value, the "in-court" procedure can be costly and may significantly constrain their ability to dictate their own timeline and to structure the deal on their own terms. As a result, distressed tech companies are far more likely to turn to the tools of traditional M&A as they look to negotiate a deal outside the walls of the courtroom. Accordingly, the following discussion assumes an out-of-court sale transaction.

Common Transaction Structures



Most investments in distressed tech companies will be structured as either (i) stock acquisitions, (ii) mergers, (iii) asset purchases, or (iv) so-called "acquihires". Although the suitability of each transaction structure will be contingent on the deal specifics, here are some of the key considerations that parties must work through when considering the choice of deal structure.

(i) Stock Acquisitions

In a stock acquisition, the buyer acquires the target company's stock directly from the selling stockholders. There are various reasons why the buyer of a distressed tech company might want to structure the transaction in this way. One of the principal appeals of a stock purchase, for example, is the potential for speedy execution. Given that the buyer obtains all the target's assets and liabilities by buying the target's stock, no time is lost negotiating which assets and liabilities will be sold to the buyer. Moreover, if the value of the business has dipped so greatly that the purchase price falls below the thresholds for antitrust filings, and relevant stockholder approvals have been obtained, the deal can close on the same day of signing. Alternatively, the investment could potentially be initially structured in the form of convertible debt to provide immediate liquidity to the business while third-party approvals for the sale are secured. This is of considerable use when the target in question is haemorrhaging money, and where the target's hopes for a successful turnaround diminish by the day.

In addition, from a tax perspective, a stock sale might also appeal to the selling stockholders. Not only is the sale usually taxed at just the stockholder level (as opposed to also being taxed at the company level) but such sales are also often taxed as capital gains rather than income, thereby reducing the selling stockholders' tax liabilities. If the target is an active domestic C corporation whose gross assets (valued at the original cost) do not exceed $50 million, then the stockholder equity could constitute "Qualified Small Business Stock", allowing the stockholder to exclude up to $10 million of capital gains from their gross income.

Structuring a distressed tech deal as stock purchase, however, is not without its downsides. The buyer, after all, will inherit all the target's liabilities, which may be significant given that the company is in distress. Moreover, the need for stockholder consensus to sell could constitute a significant roadblock if certain classes of stockholder face losing their entire investment. It is not uncommon for VC-backed tech companies to have issued preferred stock to the VC investor and common stock to other stockholders. Should the VC lack the requisite drag rights (i.e. the ability to deliver a 100% sale of all stock), then in the event sale proceeds would only be sufficient to pay out the preferred stockholders, the common stockholders would have no incentive to support the deal. While this article is focused on buyouts of private companies, there are alternative growth equity structures that allow for an investor to make a significant minority investment in distressed tech companies, which may more readily engender the support of the existing stockholder base – we do not discuss these here.

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(ii) Mergers

Another common deal structure used in private M&A is the merger. In a merger, two companies combine into one legal entity with the surviving entity assuming all the assets, rights and liabilities of the extinguished entity. Mergers in the US often make use of a triangular structure, where a newly formed subsidiary of the buyer either merges into the target company (a "reverse triangular merger") or where the target merges into the buyer's subsidiary (a "forward triangular merger").

Triangular merger structures can prove popular in distressed acquisitions as the acquiring company does not directly assume the target's obligations. Instead, these liabilities remain in either the target or the buyer's subsidiary, allowing the acquirer to obtain the benefit of the target's assets without bearing direct responsibility for their liabilities. A further advantage of triangular mergers is the fact that they typically only require the consent of a majority of the target's stockholders. Mergers can therefore be useful in situations where the target company has a contingent of stockholders who oppose the transaction. Such opposition may be motivated amongst the stockholders of a distressed company who may incur a loss on their initial investment as a result of the sale.

Buyers contemplating a merger structure must nevertheless be aware that target stockholders who are opposed to the merger may have the right to petition the court to force the buyer to pay them "fair value" for their stock. Although these "appraisal" claims are rare in practice, they can prove costly to litigate, providing a time-consuming distraction for buyers who want to execute their deals with speed and certainty on the expenses they will incur.

(iii) Asset Purchases

An alternative deal structure that the parties might also consider is an asset sale. Buyers can find asset sales attractive because they have the ability to cherry pick the assets and liabilities that are bought or left behind. Under Delaware law, as long as the transaction does not constitute a sale of "substantially all" of the target's assets, then no stockholder vote is required – a significant advantage if there are different classes of stockholder whose interests have diverged as a result of the company being in distress. This becomes acutely relevant where certain assets, in particular intellectual property, are of interest to an investor because of potential synergies with their existing tech companies – but if the value of the distressed business itself is substantially weighted in that particular asset, a stockholder vote may still be required.

From a tax perspective, because distressed companies are likely to have a history of operating losses, those losses can be subsequently used to offset future taxable gains, enhancing the investment profile for the buyer.

Asset sales, however, have certain drawbacks. The trade-off for the flexibility to negotiate which assets and liabilities are bought and sold is a far more complex set of negotiations which are often drawn out over longer periods of time. Moreover, for all the tax benefits afforded to the buyer on purchasing a distressed company's assets, these transactions can create tax inefficiencies for the target stockholders. Since the distressed company often distributes the proceeds of the asset sale to its stockholders (whether through a liquidating or non-liquidating distribution), asset sales can result in taxation being imposed at both the level of the target and at the level of the stockholders.

(iv) Acquihires

A fourth transaction structure is the "acquihire". In these transactions, the business is acquired predominately as a means of hiring the target's employees. The target business, which can be bought either through a stock or asset purchase is often shut down after the transaction closes, with the employees being re-integrated (and often re-purposed) within the buyer's own business. This can be particularly accretive to an existing investor's tech business(es) where they have been previously reliant on outsourcing software engineer support for example, and the risk of losing that support through the provider in question going into bankruptcy means an acquihire of certain of their employee base makes business sense – both because it retains institutional knowledge and efficiencies and because it avoids having to enter into new and potentially more costly contractual arrangements with different providers.

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Navigating the Risks

Acquisitions of distressed tech companies pose a unique variety of challenges that buyers must be able to navigate. In the next section of this article, we consider some of the most significant risks to the successful purchase of a distressed tech company and set out pragmatic steps that buyers can take to circumvent these obstacles.

(i) Disagreements over Valuation

In negotiating the details of the acquisition, sellers may be anchored by the elevated valuations achieved by industry peers in comparable transactions in recent years. For buyers, on the other hand, the "distressed tech" opportunity is attractive precisely because the market value of tech companies has plummeted in recent months. The result is a potential impasse, with the founders struggling to accept the depressed valuation of the company they built and invested in.

There are, however, ways to mitigate these standoffs over valuation. Transaction structures which split the buyer's consideration into an initial, fixed cash outlay and a subsequent, contingent payment, can break the deadlock. "Earn-out" mechanics, for example, can be incorporated into the acquisition agreement, making a portion of the purchase price contingent on the target meeting certain performance milestones after the transaction closes, for example these may be EBITDA or revenue based and assessed annually and paid out over a period of three years. Sellers agreeing to a deferred consideration structure are typically concerned that buyers will not do their upmost to enable the business to meet the performance criteria in question. As a result, they often seek to impose restrictions on how the buyer will operate the business post-closing, all of which need to strike the right balance between the commercial freedom to operate the business in its best interests and remaining true to the guardrails of the earn-out structure. Although the nature and extent of these restrictions are often heavily negotiated, earn-outs remain a crucial mechanism to help parties navigate the deadlock over questions of valuation.

(ii) Limited Indemnity Protection

A second challenge in any distressed sale is the fact that the seller might lack the means to satisfy any post-closing claims brought by the buyer. While the seller might have agreed to a generous suite of indemnities in the purchase agreement, if the seller is in a position of financial distress themselves, then those indemnities may turn out to be of little help to the buyer.

Buyers, however, have a number of options at their disposal when negotiating against a cash-strapped seller. One effective strategy is to place a portion of the purchase price into an "escrow" account that will be held by a neutral third-party. Should the seller's indemnity obligations be triggered, the buyer can be compensated with funds from the escrow account rather than going through the more cumbersome and fraught process of seeking payment from the seller directly. The escrow route, of course, is not without its limitations. There are likely to be disagreements over the amount of money that should be held back in escrow and the length of the escrow arrangement. Given these considerations, buyers are increasingly choosing to supplement their post-closing indemnity protections with representations and warranties insurance ("RWI"). RWI policies cover losses resulting from breaches of a seller's representations and warranties which were unknown to the buyer at the time the agreement was executed.

Therefore, even if a seller is unable to stand behind the representations and warranties they have provided to the buyer, RWI provides buyers with additional comfort to proceed with deals that might otherwise be unviable. Note, pricing and availability of RWI in a distressed sale scenario become more challenging but is usually achievable in due course.

(iii) Due Diligence Considerations

Another challenge present in many distressed sales are unique due diligence considerations which a buyer may face. Buyers may be accustomed to a formalized process and will need to shift their normal diligence process to accommodate the shortened diligence timeline and a paucity of information being made available. Where the asset is competitive in terms of outside investor interest, often the buyer that can move most expeditiously will have the upper hand in reaching alignment with the sellers more quickly.

In fact, distressed businesses are often unprepared for a sale and as such the management team are not able to hand over the plethora of customary due diligence materials that would typically be made available in a traditional sale process. In these instances, a focused and meaningful due diligence exercise may be accomplished by focusing exclusively on issues that go straight to value, such as the state of play regarding those customer contracts that make up the majority of key business revenues, liabilities such as material debtor claims, investigations or litigations and confirmation around ownership of the stock and the intellectual property of the business. It may be the case that the buyer will need to balance the discounted cost of the acquisition versus the potential cost of remediation matters that need to be addressed post-closing. In a transaction with a gap period between signing and closing, it may be possible to negotiate a due diligence condition that will ensure a flow of information and materials to the buyer prior to closing but give the sellers some comfort that they have a buyer ready to close on the purchase, provided they have represented the business correctly in advance of the release of the confirmatory diligence materials.

(iv) Retaining Talent

One common issue for prospective buyers to navigate is engaging with and retaining the target's talent throughout the transaction and post transaction close. Even in adverse economic conditions, highly skilled tech employees remain in demand. In distressed situations, these employees, many of whom are holders of equity or incentive interests in the business, will have their equity either become worthless (as discussed above) or these employees' stock options will be "under water" because their interests are worth less than the relevant strike price (i.e. the initial value at which they were granted). The risk is high, therefore, that such talented employees may explore other employment opportunities. To mitigate this risk, buyers may choose to apportion part of the deal proceeds to fund a retention pool for employees (potentially with the sellers also funding a segment of that), proactively prepare new employment offers for employees (pre-signing if necessary), or enable equity rollovers to entice these employees to stay employed with the target company and with a real possibility for their equity interests to rebound in value over a period of time.

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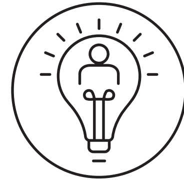
Conclusion



By most accounts, after the rise of tech company valuations throughout 2020 and 2021, 2022 saw an about turn for the industry. This has been most publicly demonstrated through the sharp fall in stock prices of tech companies listed on the Nasdaq. Clearly there are tech companies with strong business fundamentals and a path to profitability, which are nonetheless running out of cash and approaching financial distress. Investors who are alive to the unique challenges of distressed tech acquisitions, who can protect themselves through sensible contractual mechanisms, targeted diligence and creative planning, can seize the opportunity from the midst of a disrupted market.

Notes

C L I F F O R D

C H A N C E

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

www.cliffordchance.com

Clifford Chance, 31 West 52nd Street, New York, NY 10019-6131, USA

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