The "Acqui-hire" Trend: Issues for Founders and Investors and Drafting Options

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> **"We have not once bought a company for the company. We buy companies to get excellent people."**
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> *— Mark Zuckerberg, Facebook CEO (speaking at Y-Combinator's Startup School)*

Despite a national economy struggling to recover from a crippling recession, the technology sector in the United States is experiencing arguably the most intensely competitive hiring market for software engineers since the collapse of the dot-com bubble of the early 2000s. Defying persistently high unemployment rates in other economic sectors, technology giants such as Google, Facebook and Twitter have found themselves embroiled in a war for talent, aggressively offering high salaries, generous equity incentives and lavish fringe benefits as inducements to hire and retain the best and brightest software engineers. This hiring frenzy has been driven by an apparent scarcity of engineering talent, one that has been exacerbated by many young engineers eschewing otherwise traditional career paths, electing instead to launch or participate in smaller start-up companies. This trend towards entrepreneurship has been spurred in part by the growing presence of business incubators and accelerators (and the resulting increased availability of early-stage investment capital) in traditional innovation hubs and the dramatic reduction in operating costs for companies made possible by the advent of cloud computing. Together, these developments have made launching, financing and staffing a technology start-up easier than ever before.

Faced with this competitive hiring landscape, many large technology companies have turned to a drastic — but increasingly common — method of recruiting engineering talent: buying start-up companies. While the notion of a large company acquiring a smaller, budding business is not in and of itself noteworthy, what makes this recent rush to acquire start-ups extraordinary is that in many cases the buyer has little or no interest in acquiring the company's products, customer relationships or intellectual property. Rather, the prized asset changing hands in the acquisition is people: namely, the start-up's engineering team. In fact, often in these transactions – popularly referred to as "acqui-hires" — the start-up is shut down shortly after the closing of the acquisition, resulting in discontinued products and services and pink slips for non-engineer employees. For faltering start-ups on the road to nowhere, the acqui-hire exit may simply be viewed as a hastening of the inevitable. Still, for other more promising business ventures, these transactions arguably stifle innovation, resulting in the premature abandonment of promising ideas and the undeserved loss of investor capital.

Acqui-hires raise several complex, interwoven issues for a start-up's founders, board of directors and investors. This article briefly summarizes these issues and provides suggestions for dealing with them prophylactically, both as a matter of process and through the drafting of start-up organizational and financing documents.

The Acqui-hire Enigma

Perhaps the most thought provoking question surrounding acqui-hires is why they exist in the first place. Put differently, why do larger companies go to the trouble and expense of buying start-ups when they could simply buy their desired, constituent parts — the engineers — for a relative pittance? Virtually all start-up employees are at-will employees with no written employment contracts obligating them to work for the start-up for an extended period of time. Employees working in jurisdictions such as California that do not enforce non-competition agreements have even less of a contractual attachment to their employers. Arguably, the multi-year vesting schedules associated with grants of start-up equity force employees to think twice before accepting job offers from larger companies. Still, in light of the sizeable compensation packages being offered by brand-name technology companies and the lack of legal impediments to switching jobs, one might conclude that acqui-hirers are addressing their HR needs with a hammer when a scalpel would suffice.

Technology company insiders have presented theories to shed light on this puzzling situation. Some argue that acqui-hires exist because it is more efficient for larger companies to hire a pre-assembled team in one fell swoop rather than piecing a team together individually (although, this theory is undermined somewhat by the reality that compensation packages must be negotiated for each member of the engineering team). Others theorize that larger companies use acqui-hires as a way to buy-off legal claims that could be brought against them by the start-up's investors. Despite the existence of these and other theories, recent commentary suggests that established but unwritten "norms" amongst technology entrepreneurs and investors prevent engineers from defecting from start-ups when presented with generous compensation packages from larger companies.

Investor Issues

Acqui-hires typically arise early in the life cycle of start-ups (between a seed and Series A round or a Series A and Series B round of financing) with purchase prices of less than $10,000,000. Often, acqui-hires involve start-ups that have failed to deliver on their early promise and are running out of money with grim prospects for raising additional capital from investors; in such cases, the transaction is effectively an alternative to turning off the lights and liquidating the company. In other cases, the start-up has performed well but the founders (often members of the targeted engineering team) determine that an acqui-hire is a more desirable outcome than the dilutive effect of an additional round of institutional financing.

Despite the existence of varying rationales for acqui-hires, they all share a common attribute which is a calculated allocation of financial consideration by the buyer for two distinct uses: one relatively small pool of consideration (made up of cash or shares of buyer stock) is used to acquire the start-up while another relatively large pool (made up of stock options or restricted stock of the buyer) is used to compensate and incentivize the start-up's engineering team as newly-hired employees of the buyer. Whereas the first pool of consideration is used to pay the start-up's creditors with the balance distributed amongst its stockholders in accordance with the waterfall provisions of the company's charter, the second pool is divided between a relatively small cohort of the start-up's employees.

The disparity between these two pools of consideration can leave start-up investors feeling as if the rug has been pulled out from under them. Jilted early-stage investors argue that, but for their initial willingness to take a risk on the start-up, the engineering team would have never been given the platform to build its reputation and be "discovered" by a larger company. Perhaps with justification, many investors feel that the two pools of consideration represent the true enterprise value of the start-up and they ought to be combined and split more evenly amongst the investors and the acqui-hired employees. For others, the complaints of these investors will fall on deaf ears. These parties maintain that investors will have lost little, if anything, to an acqui-hire in the case of a failing start-up (since the investors would have received pennies on the dollar upon liquidation of the company and the employees would have been free to work

elsewhere) and, in the case of a successful start-up, investors would have typically held contractual rights that could have been used to block the sale of the company. Both points of view in this emotional (and expensive) debate are valid and worthy of debate.

Employment Law Issues

Depending on the facts and circumstances, acqui-hires may violate employment/labor laws in certain jurisdictions and create resulting litigation risk for both the buyer and the acqui-hired engineering team. Arguably, this risk causes buyers to defensively "purchase" engineers from start-ups via acqui-hires rather than simply hiring them outright and causes founders to agree to being acqui-hired rather than simply walking away from the start-up for an opportunity with a larger company.

In situations where acqui-hired engineers have entered into written employment agreements or non-competition agreements with the start-up, finding these departing employees in breach of their legal obligations is fairly straightforward and injunctive relief may be awarded. In the case where a fixed-term employment agreement exists, the buyer could also be found liable for tortious interference with a contractual employment relationship. In practice, however, most engineers are at-will employees and have no contractual commitment to continue working for the start-up (just as the start-up has no legal obligation to continue employing the engineer). In addition, courts in certain jurisdictions (California, most famously) refuse to enforce non-competition agreements entered into in the employment context regardless of their scope and there is a growing trend in other jurisdictions (including Massachusetts) towards disfavoring these restrictive covenants. In other jurisdictions where non-competition agreements are in fact valid and enforceable, a start-up's legal claims may be undermined by the fact that buyers are often not direct competitors of the start-ups whose engineers they covet.

In cases where members of the acqui-hired engineering team are not parties to written employment or non-competition agreements, start-ups may alternatively consider turning to trade secret law for protection and redress. In addition to being able to obtain injunctive relief and/or damages as a result of the actual misappropriation of trade secrets, employers may also seek to prospectively enjoin a departed employee from engaging in activities (such as working for a competitor) that may result in the improper use or disclosure of trade secrets. Several jurisdictions have adopted the doctrine of "inevitable disclosure" which states that employees who have knowledge of their former employers' trade secrets can be held liable for the misuse of trade secrets merely by being employed by a competitor of the former employer, the idea being that even if an employee has good intentions vis-à-vis his former employer, he will "inevitably disclose" the trade secrets he knows from his former employment to the competitor while working for the competitor. To powerful effect, the inevitable disclosure doctrine can be used by employers in select jurisdictions to create a de facto non-competition agreement, even in the absence of an actual, written non-competition agreement with the departed employee. Of course, the outcomes of these cases are invariably fact specific; if the buyer in an acqui-hire is not a direct competitor of the start-up or the start-up did not have proper procedures in place to protect its confidential information (such that there was no protectable trade secret in the first place), then this avenue of redress may be unavailable.

Setting aside the viability (or lack thereof) of these potential legal claims, in reality there have been few (if any) reported lawsuits brought by investors against buyers or defecting employees in the context of acqui-hires and few have concluded that the threat of litigation is to blame for the acqui-hire trend. On the contrary, there is a pronounced reluctance amongst technology company investors to sue entrepreneurs. Whether based on informal word of mouth or the information posted on popular websites such as TechCrunch, an investor's reputation is viewed as an invaluable commodity and is integral to its ability to have access to a steady pipeline of attractive start-up investment opportunities. Indeed, gaining a reputation for suing entrepreneurs would be career suicide for a start-up investor. Of course, reputation matters to entrepreneurs as well, especially those of the serial variety that may well be knocking on the same investor doors in the future in search of financial support for their next business venture.

Furthermore, investors and entrepreneurs alike appreciate the marketing value (and reputational benefit) of being able to trumpet the fact that one of their past ventures was acquired by Facebook (even if in reality the acquisition resulted in a disappointing return to the investor's limited partners). All told, it would seem that these informal, social norms of the tech community – not the threat of litigation – explain the prevalence and begrudging acceptance of acqui-hires.

Fiduciary Duty Issues

Acqui-hires also raise the spectre of investor claims for breaches of fiduciary duty against engineers who also serve as officers or directors of the start-up.

It is a central tenet of corporate law that officers and directors owe duties of loyalty to the corporation. Officers and directors must act in good faith and with the fairness and honesty that the law requires of fiduciaries, basing their decisions on the best interests of the corporation without regard for personal interests. Discharging this duty of loyalty in the context of a transaction where the post-closing equity and cash compensation packages being offered to the acqui-hired engineering team overshadow the acquisition price for the start-up can prove to be challenging.

In the case of a struggling start-up with meager prospects for additional injections of capital from existing or new investors, an engineer/director vote in favor of an acquisition by a larger company is perhaps justified and may withstand legal scrutiny since, in such instances, the start-up would typically cease operations and liquidate its assets, a scenario that would result in fewer proceeds being paid to stockholders than would have been paid in the context of an acqui-hire. However, given that most acqui-hires occur relatively early in the lifecycle of a start-up, director determinations regarding the future prospects of the start-up at such a nascent stage may be seen as premature or highly speculative.

In other cases where the start-up is performing well and meeting or exceeding investor expectations, an engineer/director vote in favor of an acquisition that includes lucrative compensation packages for the acqui-hired engineering team carries a more pronounced risk of scrutiny from a duty of loyalty perspective. This risk increases in situations where engineers have actively cooperated with the buyer in crafting the overall size and terms of the acqui-hired team's post-closing equity awards, bonuses and/or other compensation. This heightened risk also exists in scenarios where the engineer has actively encouraged other members of the engineering team to leave the start-up for the buyer while the engineer is still an employee of the start-up, behavior which has been found to breach the common law duty of loyalty in jurisdictions such as Massachusetts[1].

Engineer/directors are well advised to fully disclose the compensation packages that they have been offered by the buyer so that they can be properly vetted by the start-up's board. Recusal of "interested" engineer/directors from these board discussions is also recommended. In addition, it is important that all board-level discussion regarding the acqui-hire opportunity (including but not limited to the board's consideration of alternative exit scenarios) be properly documented in the start-up's corporate records.

A board of directors also owes a duty of care to the corporation. In the context of an acqui-hire (or any sale of a corporation, for that matter), this requires the board to act in an informed and deliberate manner in determining whether to approve the terms of the acquisition before presenting them for stockholder approval. To properly carry out this duty, the board must become well-informed regarding the proposed transaction while considering viable alternatives and taking into account the advice of outside experts and advisors as well as management. Despite this directive, the relatively low purchase prices of acqui-hires may make it difficult (or at least impractical) for boards to engage outside financial advisors or to conduct an auction process to ensure the maximization of value to investors.

Drafting/Structuring Options for Investors

Given the aforementioned normative pressures against litigating over acqui-hires, proactively addressing investor concerns in the drafting of financing and organizational documents would seem prudent. Despite the pervasiveness of acqui-hires, widely accepted drafting practices have yet to emerge. Notwithstanding this lack of consensus, investors have various protective measures at their disposal to protect their interests as stakeholders and to increase their leverage in acqui-hires, although some of these approaches may prove more efficacious than others.

First, preferred stock investors may attempt to increase the liquidation preference multiples that they receive on their shares of stock in connection with a liquidity event so as to shift the allocation of proceeds payable at exit in their favor. Similarly, early stage investors that are issued convertible promissory notes may consider including mandatory conversion and/or liquidation premium provisions in the terms of their notes (rather than simply accepting repayment of principal plus interest if the start-up is acquired prior to note maturity or conversion). Seed investors may also begin insisting upon priced equity rounds in lieu of accepting convertible debt if the prevalence of acqui-hires continues. Of course, investors do not have the benefit of foresight of knowing which of their start-up investments will ultimately result in acqui-hire transactions.

As a result, investors that push for the aforementioned favorable investment terms run the risk of presenting start-ups with uncompetitive term sheets and losing out on their fair share of investment opportunities. Furthermore, these protective measures fail to address the main issue raised by acqui-hires which is the buyer's imbalanced allocation of deal consideration to the acqui-hired engineering team rather than the start-up itself. Sky-high liquidation preferences/premiums do nothing to address the cut-rate prices that are the hallmarks of many acqui-hire transactions.

In light of the deficiencies of the above approach, investors may opt instead to insert terms in financing documents that mandate that all consideration related to an acqui-hire transaction – both the purchase price for the start-up and the compensation packages provided to the engineering team – be pooled together and distributed to the investors in accordance with the waterfall provisions of the start-up's charter. A creative lawyer might draft these terms in such a way that the compensation allocated to the acqui-hired engineers would only be deemed pooled consideration in situations where the return on investment to seed/preferred investors falls below a prescribed percentage rate so as to differentiate between acqui-hires where investors are treated "fairly" and bottom-dollar deals.

Still, drafting such provisions may ultimately prove difficult and the administration of enforcing them may prove costly, especially in light of the fact that much of the compensation paid to the engineering team will consist of stock options, restricted stock awards and other consideration subject to vesting that the engineers will be "earning" over time and, in many cases, may be performance-based. Putting aside the challenges of accurately and fairly valuing this consideration for purposes of sharing it with the investors, investors may also take pause at the thought of having a significant percentage of their total deal consideration being tied to engineers remaining employed by the buyer for 3-4 years post-closing and/or attaining prescribed performance targets. Moreover, such a pooling of deal consideration will likely make acqui-hires more expensive for buyers since the equity compensation portion of acqui-hires is normally treated as a deductible compensation expense of the buyer for tax purposes, a benefit that will be lost if this compensation is instead shared with outside investors.

Finally, as a twist on the above approach, financing documents may be drafted so that a minimum percentage of the total amount of a buyer's total payments made in connection with an acqui-hire transaction is allocated to the start-up's investors. Added flexibility could be achieved by making this percentage subject to a sliding scale based on the actual size of the buyer's payments. While this approach would partially address the tax issues mentioned above, it would

remain a challenge to accurately and fairly value the equity incentive compensation being offered to the engineering team. In addition, buyers will likely fear that the incentivization effects of granting stock options and restricted stock awards to the engineering team will be undermined by having to share that consideration with investors.

While no common drafting practice has surfaced to address the issues raised by acqui-hires, rest assured that the options discussed above and others are on the minds of start-up investors and their lawyers. No less of an authority than the National Venture Capital Association has discussed incorporating drafting provisions for acqui-hires into their model legal documents although changes have yet to be made as of the date of this article.

Conclusion

Acqui-hires have far-reaching ramifications for the relationships between start-ups and their investors. Provided that the dearth of engineering talent and the pressures against fighting acqui-hires in court endure, one can anticipate that these transactions are here to stay. Given this likelihood, founders, investors and boards of directors should bear in mind the following matters in connection with their involvement with start-ups.

- Early-stage investors investing in convertible notes should consider implementing an "early-exit" multiplier (i.e. payment of a liquidation premium rather than just repayment of principal plus interest) that is payable upon an exit transaction that occurs prior to conversion. Such provisions are already not uncommon but, given the prevalence of acqui-hires, investors may be justified in insisting upon their inclusion.
- Early-stage investors investing in preferred stock should consider including specific protective provisions in the start-up's organizational and financing documents (such as a mechanism that would cause the deal consideration and employee consideration paid in an acqui-hire to be pooled together and split amongst the investors and the departing engineering team). Investors choosing this approach will need to be mindful of the market's appetite for such protections.
- The start-up's board of directors should consider retaining an outside financial advisor to "bless" the acqui-hire from a valuation standpoint. In cases where this is not possible or practical, the board should at a minimum consider establishing a sub-committee of independent directors to assist in the negotiation of the terms of the acqui-hire.
- The recusal of directors that are interested in the outcome of the acqui-hire (namely, those directors that are part of the engineering team that will be working for the buyer post-closing) should be considered.
- Steps should be taken to confirm that all post-closing compensatory arrangements with management are disclosed and discussed by the board. Boards should maintain meticulous written records of their deliberations and discussions related to proposed acqui-hires.

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Footnotes.

1. *Augat, Inc. v. Aegis, Inc.*, 409 Mass. 165.