Negotiating for Better Stock in Equity-Funded Acquisitions

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For many founders, building and selling a successful venture-backed company for cash is the ultimate goal. However, the reality is that some companies will instead receive an equity-funded acquisition proposal in which equity of another private venture-backed company, rather than cash, represents all or a significant portion of the purchase price. Because all equity is not created equal, it is important for founders to understand how to negotiate for better equity in the context of such an acquisition proposal. This article explores what better equity looks like, and strategies founders can use to negotiate for that equity.

What Is "Better" Equity? To know what "better" equity is for the seller, it is necessary to understand what the "worst" and "best" stock is in the context an equity-funded acquisition by a private company buyer. The "worst" stock is plain common stock which does not enjoy any special rights and is subject to contractual restrictions which diminish its liquidity profile. Common stock sits at the bottom of the priority stack (after debt and preferred equity) in the event the company dissolves or is sold — thus, it is least valuable. Variations of transfer restrictions (*e.g.*, a prohibition on private secondary sales) may further diminish the desirability of common stock by making it difficult or impossible for the holder to achieve liquidity outside of an M&A event or initial public offering (IPO).

In contrast, the "best" stock is (1) the acquirer's most senior series of preferred stock, coupled with (2) additional contractual rights enhancing such stock's liquidity profile. For our purposes here, we'll call this "enhanced preferred stock". All things being equal, founders and VCs should have a strong preference for enhanced preferred stock in an equity-funded acquisition for several reasons:

- Usually, the most senior series of preferred stock will enjoy a liquidation preference ensuring that a certain amount of proceeds (commonly equal to invested capital) from a sale of the company flow to stockholders of that series before proceeds are distributed to junior preferred and common stockholders.
- Unique contractual rights not shared by common stockholders, like special voting rights with respect to major events and transactions, unique information rights, pro rata investment rights with respect to future financings, rights of first refusal and co-sale rights, increase the stock's relative value.
- Beyond the standard set of rights that are usually enjoyed by all preferred stockholders, additional contractual rights of and reduced restrictions on enhanced preferred stock make it more likely that the holder of such equity will achieve liquidity of some or all of its holdings prior to an M&A event or IPO. Such additional rights may include one or more of the following: time or event-based redemption rights (*i.e.*, the right to force the acquirer to redeem equity at a specified price in the future), other liquidity rights tied to future financings or commercial transactions (*e.g.*, the right to sell stock to the investors in the next equity financing), covenants of the acquirer to permit and support private secondary sales and registration rights (*i.e.*, the right to force the acquirer to register stock with the SEC, thereby allowing for unrestricted resale by the holder).

"Better" stock lies somewhere on the continuum between the common stock and enhanced preferred stock poles, with the type of stock and bundle of rights associated with such equity determining its precise location. Additional contractual rights and reduced restrictions may significantly improve the desirability of common stock and perhaps place the holder in a better position than it would have been as a preferred stockholder. For example, a seller able to negotiate the right to sell a certain amount of common stock to investors in the acquirer's next preferred stock equity financing could be more favorably positioned than the holder of senior preferred stock without any enhanced preferred rights.

Negotiating for Better Stock. With a framework for understanding what better stock means, below are several strategies sellers can employ in M&A negotiations to obtain better stock than that initially offered by the buyer.

Avoiding Dire Situations and Preserving Leverage. Leverage matters in every negotiation and any strategy that ignores this reality is doomed to fail. To state the obvious, the first strategy to negotiate for better stock in an equity-funded acquisition is the first strategy in preparing for *any* M&A event: companies should do all they can to avoid being in a dire fire sale situation when a buyer comes knocking on their door. If the seller is a failing company seeking a sale as a last ditch effort to avoid shutting its doors, even the best strategies may be useless in negotiation since as soon as the buyer says "no", the seller will likely fold its hand and agree to the deal offered.

Companies can maintain leverage for a future negotiation in many ways, including appropriately timing and sizing equity and debt financings, controlling burn rate, properly focusing the business and using key performance indicators for the business to drive action. For example, there is nothing worse than negotiating the sale of a company that runs out of cash in two weeks (it's not much of a negotiation). Thus, at least six to 12 months prior to that time, the company should set a course for additional funding or adjust the business model to preserve cash. No one knows a business like its founders, and if the founders realistically appraise the business over time, it will be easier for the company to stay ahead of bad trends and avoid abysmal situations.

Framing the Deal as an Investment. One foundational element in negotiating for preferred stock in an equity-funded acquisition is the psychological framing of the transaction by the seller. For the seller, it is critical to remember and to maintain throughout negotiation that the company being sold is worth a certain dollar amount (*e.g.*, $20 million) and that such dollar amount is being *invested* in the acquirer's equity. If the company has previously taken on invested capital (*e.g.*, $5 million in a Series A), it is also important to emphasize the fact that the company's investors certainly view the acquisition as an investment of those invested funds in the acquirer since they won't be achieving liquidity in the deal.

The investment perspective is important for the seller since investments in venture-backed companies, outside of some founder friendly, early-stage investors, are almost always made in exchange for preferred stock with a liquidation preference. This can be contrasted with common stock and securities like common stock options, which are usually used to compensate and incentivize a company's employees and service providers. While selling employees may be given restricted common stock or options by an acquirer as an incentive to work for the acquirer post-closing, that equity should be considered by sellers as wholly distinct from the equity being used by buyers to fund the acquisition.

Given the venture-capital investment ecosystem, verbally recasting the acquisition in terms of an investment (and encouraging selling VCs and the buyer to do the same) naturally lends itself to a discussion about preferred stock rather than common stock. From this perspective, it is easy to begin a conversation with the prospective buyer with something along the lines of: "We're excited to make an investment in XYZ Acquiror, but we're confused as to why we're being offered common stock when the market for venture investments is preferred?"

Deal Shopping. In the context of an equity financing, experienced founders know that the best way to negotiate optimal terms is to have multiple term sheets in hand and to pit investors against one another. The company's asymmetrical information and fear of loss by investors in such a scenario frequently results in improved results for the company. Fundamentally, M&A is no different: knowing that another buyer is also in discussion with the seller (or waiting in the wings to be contacted) is a powerful incentive for the buyer to offer preferred stock and favorable contractual rights if asked.

Accordingly, it is wise for the seller to keep a regularly updated list of the most likely acquirers of its business on hand and to have a financial advisor ready to approach such acquirers on short notice in the event of an acquisition proposal. Although it is likely that the type of acquirer that would propose an equity-funded acquisition is strategic (rather than financial) in nature, this list should include both financial and strategic buyers since any kind of additional buyers provide leverage to the seller.

Focus on Value Certainty. Sellers should also emphasize the need for deal value certainty and stress that preferred stock makes value realization more certain for the seller. Evaluating the desirability of an equity-funded acquisition proposal includes calculating the net present value of the consideration being offered and comparing it to other opportunities. However, such a calculation requires a certain level of certainty. Because of preferred stock liquidation preferences and the historical reality that many venture-backed companies fail or are sold for less than the aggregate liquidation preference, the value represented by preferred stock is more certain than value represented by common stock. For example, if the buyer has raised Series A, Series B and Series C funds with a combined non-participating liquidation preference of $50 million, this means that unless the buyer eventually sells for more than $50 million, the common stockholders will receive nothing in the deal. In that scenario, an equity-funded acquisition for common stock would have been "free" to the acquirer.

Investor Rights as a Negotiation Tool. Another tool for negotiation is using the rights of the seller's investors as leverage. In a venture-backed company, one or more investors will almost certainly have the right to approve (*i.e.*, block) an acquisition. This right to block a sale of the company can be an advantage in discussions with the buyer since it is certainly true that VCs will look much more favorably on an equity-funded acquisition offering enhanced preferred stock (or at least senior preferred stock or common stock with certain enhanced rights) as compared to plain common stock. The age of your investors' funds can also improve these discussions. Since VCs traditionally look to exit investments in three to seven years, a portfolio company investment that has been outstanding for over five years will make the VC more likely to demand better stock. If this is the case for the seller, it may be worth raising in discussions with the buyer within the more general context of obtaining investor approval of the deal.

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