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Navigating the Challenges of Private Fintech M&A

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Lee advises U.S. and international strategic clients on a wide variety of complex matters, including mergers and acquisitions, joint ventures, restructurings and corporate governance matters.

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Earn-outs

Bridging the value gap

- When there is a meaningful disagreement between seller and buyer on future prospects of target, a potential way to bridge the gap is to provide for an earn-out, i.e., a contingent payment of additional purchase price based on agreed milestone(s)
- However, earn-outs add significant complexity, and the face value of earn-outs tends to be heavily discounted by sellers

Key negotiation terms to consider

- Targets and milestones
  - Financial – revenue, gross profit, EBITDA or adjusted EBITDA, cash flow
  - Non-financial – completion of product launch or project or receipt of regulatory approvals
  - Whatever metric is utilized, parties will need to agree on a set of accounting policies that will be used for measurement purposes – which can also be a complicated exercise
    - Involving accountants early is very important and being clear on these metrics at LOI stage avoids later disconnects
- Installments and time periods
- Impact of subsequent events (e.g., change of control, M&A, termination of key employees of the business)
- Operational restrictions on buyer (e.g., undertaking by buyer to achieve the payment trigger) and consent rights for the seller
- Control/ring-fence business of target (e.g., buyer to hold the business separate as an operational and accounting matter, which may impede the buyer's integration plans, and accordingly, its ability to realize value)
- Right to access information to assess performance of target and audit payments
- Right to offset indemnity payments against earn-out

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Earn-outs (cont.)

Other issues

- Conflicts can become a significant issue if management team has an interest in the earn-out
- To avoid the earn-out being deemed a “security” for SEC purposes (which can create legal complications), earn-outs are generally illiquid, i.e., they may only be transferred by operation of law
- Earn-outs are one of the largest sources of post-closing disputes and litigation
  - Disputes center both on whether the target was achieved and whether the buyer complied with its covenants (e.g., its obligation to try to achieve the target)

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Equity financing

Key negotiation considerations

Valuation

- Use of equity financing requires valuation for both companies (fundamentally no different than a typical company price negotiation, but the process must be undertaken twice)
- Use of valuation from prior equity financing rounds less likely to be relevant given the significant market dislocations
- Investors in recent equity financing rounds may be resistant to decreased valuations (or have down-round protection which will impact dilution)

Capital structure / distribution waterfall

- Distribution waterfall must be able to appropriately allocate the deal consideration among the target equityholders; however, the governing documents for many fintech companies do not clearly address how non-cash consideration will be treated, particularly where there are multiple classes of equity with different liquidation preferences, anti-dilution protections and pre-negotiated consent / governance rights
- Deals at depressed valuations may leave some layers of the capital structure without meaningful proceeds, which may give such equityholders a right to block the deal
- Parties are subject to risk of litigation if the common equity will not receive consideration and/or if management will receive value that arguably takes away from the equityholders

Pro forma capital structure

- Consider whether the combined company will have a single class of common stock, or whether the combined company will also have one or more classes of preferred stock; if the latter, can require complicated negotiations with the holders of each class of existing preferred stock at each of the two companies

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Equity financing (cont.)

Other issues

- In a merger of equals, significant focus on initial board and management composition
- For a public company buyer, will need to consider any relevant exchange rules by the issuance of new securities (e.g., buyer shareholder vote is required before a NYSE- or Nasdaq-listed company can issue 20% or more of its outstanding common stock or voting power, which may delay closing timeline and create interloper risk)
- Shareholder rights will depend on whether there are significant shareholders (or shareholder groups) who will insist on governance and other rights
- Shareholders are typically reluctant to give up the governance rights they currently have, and will want to benefit from governance rights held by other investors

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Debt financing

Key trends and considerations

- Private debt is generally a more natural option for growth stage companies and has gained popularity over the years, which can be traced to, among other things:
  - *Speed of execution*: Direct lenders are able to close transactions on more compressed timeframes as there is no need to market the debt facilities (which can be a time-consuming process, which involves presentations to third parties such as rating agencies and marketing to prospective lenders)
  - *Flexibility*: Direct lenders are not limited by restrictions applicable to regulated banks and can lend into structures and circumstances that might be more challenging in a syndicated environment, including where EBITDA may not be an available or useful metric, borrowers lack customary financials for syndicated deals, or there is a more complex capitalization or organizational structure
  - *Pricing*: In recent years, private debt has been priced slightly higher than what could potentially be achieved in the syndicated market (which may still be preferable to an issuer because it eliminates "market flex" risk), but this is largely a function of what has been, until recently, a very issuer favorable market. In recent months, new syndicated loans have generally been quoted at steep discounts (e.g. 92-93 vs 99 issue price), meaning private debt has become even more attractive as a way of avoiding the broadly syndicated market
- Financing for fintech companies will often need to address issues that are not typically contemplated in cookie-cutter credit agreements, such as:
  - Perfecting security over crypto-based assets
  - In the case of the lending industry, other asset-level financing arrangements that are more complicated than other industries (warehouses, repos, securitizations or dealings with GSEs)
  - Regulatory overlay and constraints that impose on the security package

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Regulatory considerations

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Overview

– The extent of regulatory requirements in fintech transactions generally depends on the activities engaged by the fintech entity, although some states have also introduced licensing / chartering regimes

Activity-based regimes

Non-bank* money transmitters

– Federal Money Services Business (**MSB**) registration with FinCEN required
– Subject to reporting and recordkeeping requirements under the Bank Secrecy Act (**BSA**)
– State by state money transmission license (**MTL**) requirements, which typically require change in control approval at 15-25% control thresholds or if buyer has a “controlling influence” over the target

Non-bank lenders

– State by state lending licenses required (if not operating through a funding bank)
– Subject to various state laws (e.g. Usury laws) and consumer protection and anti-discrimination-focused federal laws; active enforcement by Consumer Financial Protection Bureau (CFPB)
– Some states require change in control approval, generally either at 10% or 25% control thresholds, and/or other filings (e.g., for a change in name)

Non-bank “fintech banks”

– Regulated based on the services they provide -- If lending, subject to lending laws; if transmitting money, MTL and BSA
– In the absence of a specific regulatory regime, threshold for change in control approval will depend on the activities of the fintech “bank” and what licensing regime (if any), they fall into

Other fintech companies

– Generally some combination of MTL / BSA and lending requirements, as well as CFPB, but also depends on the activity (e.g., card payments network rules for payment activity; registration with the SEC and with FINRA for trading activity)
– Threshold for change in control approval depends on the exact activity and thus what registrations are required

Entity-based regimes

State licenses / charters

– Some states have introduced novel licensing or chartering regimes, some of which are bank charters that avoid the parent being subject to the BHCA (e.g., South Dakota Trust Charter and the Wyoming Special Purpose Depository Institution Bank Charter (Wyoming SPDI))
– These licensing regimes are generally stricter than activity-based regimes and may include capital requirements, pre-approval before introducing new products or services and ongoing examination and supervision
– Thresholds for change in control approval vary by license or charter (e.g., 10% for NY BitLicense, 25% for Wyoming SPDI if the purchaser is not a bank or bank holding company, or 5% if the purchaser is a bank or bank holding company)
– Licenses or charters may or may not replace other licensing requirements within a certain state (e.g., a BitLicensee engaging in activities constituting money transmission in NY would also need to obtain a NY MTL)

Regulatory considerations (cont.)

Other issues

- When transactions involve state-licensed fintech entities, it is important to engage with state regulators directly, as guidance from state regulators about how they regulate and supervise fintech entities or their parent entities may not always be publicly available
- Satisfaction of one state's requirements typically will not pre-empt other state requirements, although there may be opportunities for efficiencies because much of the information that will be required by various state regulators will be similar
- For all transactions including fintechs, other generally-applicable regulatory requirements may apply, such as HSR filings (which may be implicated if the transaction is valued at more than $101 million)

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Representation & warranty insurance

Overview

– The number of deals involving M&A rep and warranty insurance remains very high
  - Trend driven primarily by private equity sellers that are reluctant to agree to post-closing liability or escrows so as to ensure a "clean exit" and maximize certainty and quantum of upfront proceeds, and strategic sellers who, having agreed to rep and warranty insurance on buy side transactions, are looking to benefit from the structure on the sell side as well
– Alleviates issues when dealing with multiple sellers or sellers who will be part of post-closing management team
– Increased use has led to significant streamlining of the process
– Product range constantly developing, with specific insurance policies available to cover known risks or interim breaches, in addition to standard R&W insurance
– Current trends on recoverability in claims against R&W insurance are promising, though ability to recover based on a multiple of damages has been under some pressure, with certain insurers imposing caps on the multiple that can be used
  - Anecdotally, insurance brokers say that insurers understand that in order to validate the product, they will need to maintain a track record for paying out on claims
  - Policies have become somewhat less expansive in the last 12 months, and exclusions are harder to remove

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Representation & warranty insurance (cont.)

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Key terms

- Policy limit vary between around 10% to 20% of enterprise value
- Deductible (the “retention”) of between 1% and 2% of target enterprise value
  - Purchase agreement may also include a deductible; the delta (if any) can be covered from seller, typically through an escrow
  - Policies typically include a retention step-down after the first 12-18 months, before which is when the vast majority of claims are typically made
  - Insurers will agree to a materiality scrape for most reps
- Premium generally 4-6% of the policy limit
  - Responsibility for cost of policy generally a point of negotiation
- Can incept at signing by paying non-refundable deposit equal to 10% of premium
  - Inception at signing is recommended in order to ensure coverage is available for pre-signing breaches that become known after signing, but before closing
- Possible to cover consequential damages (to the extent reasonably foreseeable)
- Survival period ~3 years for general business reps and ~6 years for fundamental reps (including tax and employee benefits reps)
- Coverage limitations may apply if the period between signing and closing is more than 12 months

Representation & warranty insurance (cont.)

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Limitations and exclusions

– No coverage for
  - known issues, including "interim breaches" (i.e., breaches that result from developments post-signing)
  - other sources of liability (e.g., breach of covenant, pre-closing taxes, appraisal claims)
  - representations regarding NOLs, transfer pricing, FLSA and wage and hour claims and asbestos
  - other specific exclusions added as the insurer conducts due diligence (areas of known risk; areas where insufficient diligence conducted; areas where reps were added or indemnities were sought to address specific concern)
– All matters subject to retention, including breaches of "fundamental" reps
– Coverage may be modified (or unavailable) where period between signing and closing is > 90-120 days
– If rollover sellers will account for a meaningful percentage of buyer's equity post-transaction (e.g., 25%), insurers will typically seek to reduce insurance proceeds paid to insureds by rollover sellers' ownership (e.g., 25%) if rollover sellers had actual knowledge of breach
  - May result in buyer seeking to obtain coverage at a buyer-only entity, rather than at the level where the rollover sellers hold their equity, but, this means that only buyer's losses (e.g., 75%) are covered, not 100% of losses
  - May be possible to structure policy so that insurance proceeds are first allocated to buyer in the situation where insurance proceeds are haircut, while preserving the ability to seek 100% of losses where no haircut is sought

Treatment of equity awards

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Outstanding equity awards

- Rolling existing equity awards of target into equity awards of acquirer using an exchange ratio based on deal consideration with the rolled equity awards maintaining substantially the same terms and conditions as existing awards:
  - If equity awards are in-the-money options or full value awards (restricted stock or restricted stock units), the rollover preserves the value of the outstanding equity awards and, by maintaining the vesting schedule, the equity awards continue to have retention value
  - If equity awards are out-of-the money options, the rolled options would continue to be out of the money (same "spread value"), which may provide less incentive for the optionholders than cancelling and granting new "at the money" options.
- Cancelling and "cashing out" all or a portion (possibly just the vested options) of the existing equity awards of target in connection with the transaction.
  - Provides liquidity for holders of in-the-money options and full value awards.
  - For out-of-the-money options, these would generally be cancelled for no consideration.
  - Cancelling any unvested outstanding equity awards will eliminate post-closing retention value of those equity awards.

Retention awards

- If equity awards are out of the money, target may consider granting employees cash retention awards to incentivize employees to remain employed through (and potentially following) the closing of the transaction
- To the extent that retention awards require employment following the closing, target may consider providing that buyer assume all or a portion of the liability relating to the retention awards