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FINTECH: WHAT PROSPECTIVE BUYERS AND SELLERS NEED TO KNOW

Fintech transactions can be extraordinarily complex to execute, especially given how varied the industry is and will continue to be.

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Despite the economic downturn, 2020 was a record year for transactions involving fintech companies, with 970 completed M&A transactions accounting $283 billion in deal volume. Transaction volume also increased over the year, and in December 2020 alone, there were over 106 M&A transactions in this space accounting for $31.9 billion in deal volume. This leads experts to believe that, as the economy further recovers in 2021, deal volume will continue to be strong in this sector. And while fintech companies vary greatly in nature and encompass everything from payment processing to stock trading to alternative lending to money transfer, among many others, there are a number of commonalities that all buyer and sellers in this industry must consider as part of their transaction.

Regulatory Issues

Complying with government regulations is a significant concern for almost all fintech companies. In many cases, a state license is required to engage in lending activity, act as a money transmitter, engage in virtual currency transactions or conduct brokering activity. Additionally, fintech companies are often regulated at the federal level as well, including by the Consumer Financial Protection Bureau, the Securities and Exchange Commission, the Federal Trade Commission, among other agencies. If there are cross-border or international operations, then foreign regulatory regimes may also apply. The failure to comply with applicable law and regulation could result in consumer refunds, fines, penalties and void agreements with consumers.

Buyers will accordingly heavily diligence the regulatory compliance of the target company as part of any acquisition in this space, through reviewing applicable policies and procedures, compliance audits, regulatory advice from counsel and consumer complaint histories, among other information. Deeper dives into testing specific accounts or transactions may also be necessary in some instances. A seller will need to prepare for this process well in advance, so that any known issues are messaged appropriately to the buyer and buyer does not uncover any “surprises” that the seller is not aware of. Thankfully, most problems can be resolved to mutual satisfaction if sufficient time is allowed to do so as part of the sale process.

Above and beyond understanding historical risk, however, incorporating a target company into the buyer's existing compliance structure may also place new burdens on the acquired company from a regulatory perspective, which both buyer and seller need to understand. From the buyer's perspective, understanding if the acquired target needs to comply with regulations that apply to the buyer's other businesses is important as this may inhibit the ability of the target to grow in the manner that the buyer is projecting. Conversely, if a seller is considering a proposal from a buyer where the purchase price is to be paid on contingent basis based upon achieving performance measures (in what is commonly known as an "earnout"), understanding the buyer's regulatory regime will be important in understanding whether the proposed earnout is achievable.

The acquiror will also require specific and thorough representations and warranties to be made regarding regulatory compliance in the purchase agreement. To the extent these representations are untrue, the seller will have to indemnify the buyer for losses (subject to negotiated limitations) and, if the inaccuracy is significant enough, the buyer may have the ability to walk away from the deal after a binding purchase agreement is signed. If there are specific issues identified in due diligence, the buyer may also ask for a specific indemnity on that issue that is not subject to the limitations that may apply generally to the representations and warranties.

Finally, it should be noted that, in many jurisdictions, the change in ownership of a regulated fintech company will require the approval of relevant regulators. It goes without saying that any consents required will extend transaction timetables (sometimes considerably) and create additional conditionality for the deal, so parties should plan ahead.

Intellectual Property

Given the importance of intellectual property to fintech companies, buyers will need to know that the company has the appropriate rights, either through ownership or a valid license, in the IP necessary for the conduct of its business. However, it is not uncommon for companies, especially those that did not have sophisticated counsel involved in the early stages of its existence, to have uncertainties in the chain of title of its IP. Additionally, some companies neglect to have their employees and independent contractors involved in the creation of IP sign an enforceable and encompassing agreement assigning any IP created to the company as a work for hire. Issues can also present themselves where IP is licensed rather than owned, and the buyer will want to know that the company has the appropriate right, through a license or other contractual arrangement, to use any IP owned by third parties that is material to the business. A buyer will typically conduct thorough due diligence on these issues, including doing searches on public registries as well as reviewing all of the target's documentation and agreements related to IP. Sellers should conduct similar reviews as most of these problems can be corrected retroactively by putting appropriate documentation in place.

Open Source Software

Open source software is particularly attractive to start-ups attempting to keep costs down. But the improper utilization of open source software could substantially reduce, or even completely eliminate, the value of a company's software to a potential acquiror. Certain open source licenses impose "reciprocity" or "share-alike" requirements. These licenses may provide that any user who develops proprietary software that incorporate the licensed open source software (into a so-called "combined work") may have to make the entire combined work available to third parties under the same terms as the open source license. The combined work is deemed "tainted," and as a result any for-profit technology licensing business model may become untenable. Accordingly, buyers need to conduct a thorough review of the target's use of open source software. For sellers, understanding these risk is crucial as well, as alternate software solutions can usually be developed that will preserve the target's value proposition.

Data Privacy

Given that fintech companies have access to highly confidential information on individuals, data privacy, cybersecurity and data breach issues are particularly relevant in this industry. Depending on the customer base, the target fintech company could be subject to state (e.g., California's Consumer Privacy Act), federal (e.g., through oversight from Federal Trade Commission) and international regulations (e.g., the European General

Data Protection Regulation). The potential for legal exposure — from substantial fines to class action lawsuits — could be significant. Given this risk, a buyer will want to understand the target company's IT and data security policies, including how the company gathers data and personal information and how it uses that data, stores that data, encrypts (or protects) that data, and destroys that data. If there have been historical breaches, the buyer will want to understand what notices were given, what remediation was done, and if there have been any suits, enforcement actions or settlements related to such breaches. Given the sensitive nature of the data, buyers and sellers should also be careful to establish strict protocols for sharing information in due diligence – and avoid having the due diligence process itself cause a security issue.

Employee Retention

Often, a large part of the value of a fintech company lies in the capabilities of key executives, engineers, developers and similar people who will drive future product development and expansion.

The buyer may therefore require that certain team members sign employment agreements as part of the transaction, which provide some assurance that these individuals intend to remain with the business going forward. However, sellers should be aware that if having these agreements signed constitutes a condition to the closing of the deal, there is risk of these team members holding up the transaction in order to negotiate better employment terms or extract deal consideration. Additionally, buyers will also often put in place a new equity incentive plan for the go-forward company or allow the acquired employees to participate in the buyer's existing equity incentive plan. The exact type of plan will depend on the structure of the entity issuing the incentive. To effectively encourage retention, however, these plans should be subject to time-based vesting (in addition to other vesting conditions). As they are unlikely to participate in such plans themselves, sellers will need to consider how much they would like to be involved in the negotiation of these terms as part of the transaction.

In circumstances where there is particular risk of employee departure, the buyer may want to consider holding back part of the purchase price and subject that payment to an earnout. From a buyer's perspective, this structure can incentivize key employees to stay on with the business in order to meet stated goals and mitigate risk if they do not. From the seller's perspective, however, earnouts can cause concern because the seller will not control the target company during the measuring period and thus does not have ultimate say in what steps the business can take to satisfy the earnout. Accordingly, when an earnout structure is used, there will be significant negotiation as to what restrictions will be included in the purchase agreement to limit what the buyer can do without the seller's agreement.

Capitalization

Given high startup costs, it is common for fintech companies to have complicated capital structures with a number of different holders of stock or other equity interests, whose participation will all have to be considered in the context of a transaction.

If the transaction is structured as a sale of equity, then each minority shareholder must sign the purchase agreement and agree to sell its shares. To the extent there is a real risk that a minor shareholder may refuse, the parties may consider structuring the transaction as a merger or sale of assets, which are transaction structures that do not require every shareholder to sign on (although in some cases minority shareholders may still have rights to block those transactions). This decision should be made early on in consultation with your corporate attorney and tax advisors as picking the wrong structure can have significant tax impacts and switching transaction structures in the middle of a deal will result in substantial cost and delay.

With respect to holders of equity incentives, it is prudent for a seller's professional advisers to review any relevant plans prior to going to market to confirm that there are no problems with its implementation, which can have significant tax impacts. Even if there are no such problems, a buyer will generally require those incentives to be cashed out and terminated at closing and require termination agreements from each holder. Accordingly, it is necessary to determine the process for effecting this cancellation early on. Additionally, buyers and sellers must consider the extent to which holders of equity incentives can be treated like other shareholders with respect to providing indemnification, escrowing consideration and participating in any earnout payments

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