INFORMED. INDISPENSABLE. IN-HOUSE.

Ask Aliya: Do Liquidity Events Help or Hurt Startup Employees?

Employment and Labor

“Ask Aliya” is a column for lawyers who are the first legal hire at their company and need advice from an in-house lawyer who has been there before. Aliya Ramji is the director of legal and business strategy for Figure 1 Inc., a network used by more than 1 million healthcare professionals to share

cases and collaborate. To have your legal questions for startups answered, email aramji@figure1.com with "Ask Aliya" in the subject line.

Dear Aliya,

I have recently joined a startup. I was formerly in a legal department but I am now responsible for operations. I often hear the executives talk about liquidity events. Are liquidity events desirable and do employees benefit or suffer because of a liquidity event?

Khalil

Dear Khalil,

Liquidity events are defined as mergers, acquisitions, or IPOs (initial public offering) of a startup. More often referred to as an exit event, a typical liquidity event is when a startup converts the ownership held by a company's founders and investors into cash. Liquidity events should not be confused with liquidation events where the business of a company is discontinued.

There are three potential liquidity events for startups: mergers, acquisitions, and IPOs. Let’s take a look at all three.

Mergers: A merger usually involves amalgamating with a similar-sized company. Companies that are looking for complementary skills in the market generally choose this exit strategy. A company may also want to merge with an equally sized company to develop a better product using existing strengths and skills rather than creating a new product in-house. Mergers are less common than acquisitions and IPOs.

Acquisitions: Acquisitions are the primary exit strategy for startups. The goal is to sell the company to a larger company for profit. Investors of startups generally have this strategy in mind. The acquirer usually takes over the startup by using cash or stock incentives. Executives and employees of the startup stay on as employees of the acquirer for a period of time in order to cash out and vest their options. Acquisitions provide capital back to investors. Angel investors keep their returns while venture capitalists return the capital to their limited partners.

IPO: When raising more venture capital or private equity money is no longer an option, a company will IPO. An IPO signifies that a company is starting to trade on a stock market and selling a significant number of their shares to both institutional and non-institutional investors. Companies that IPO are the best outcome for venture capitalists or angel investors because they produce large sums of capital to all parties (founders, early employees, and investors). In the past few years, few startups have gone this route. In 2016, only 14 venture-backed companies went public in the United States. More companies are taking longer to IPO because of the high amount of capital available from venture capitalists, private equity firms, and other investment institutions. Moreover, high value startups like Uber and Airbnb do not need to go public to raise capital.

Employees may enjoy certain rewards when a company exits. This is not always the case, however. Less than 10 percent of companies actually reap the rewards of an exit event. As such, how employees fare depends on the company, the number of options an employee has, his or her exercise price, the exit event, and the valuation on exit. Moreover, if the exit event is a merger or acquisition, some employees may not be required or may be redundant on acquisition.

A type of acquisition that is very common in Silicon Valley is acquihires (acquisition plus hiring). In this case, an acquirer is not interested in the product but rather the team and the talent surrounding the product. Acquihires often lead to the closure of the products or services of the target company and employees end up being transferred to the acquiring company where they typically receive significant hiring bonuses. Acquihires tend to happen at an earlier stage of a company rather than at a later stage.

While the ultimate goal of any startup is an IPO, most investors will settle for an acquisition by a large multinational. I imagine many companies would love to be acquired by a company like Samsung , GE, and even more so, Facebook or Google. If for no other reason than that they are leaders in acquihiring, suggesting the acquisition target has built a strong and talented team.

Aliya

Aliya Ramji

Partner

McCarthy Tétrault

Aliya Ramji was previously the director of legal and business strategy for Figure 1 Inc. Presently, she is a partner at McCarthy Tétrault, where she offers guidance on in-house law and startup businesses. She also was a 2016 recipient of ACC’s Top 10 30-Somethings.