Do Your Due Diligence: Startups and Secondary Transactions

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Following reports that record numbers of investors in private startups are exploring selling equity before an IPO or liquidity event, it's important to remember that secondary sales often pose issues that are not present in a direct startup investment. Among other items, a careful review of the startup's governing documents and securities laws, a strategic approach to diligence, and engaging tax advisers are critical.

Secondary Transactions

A May 20, 2022 article by Eric Savitz in Barron's Magazine, "The Tech Selloff Is About to Cause Big Problems for Start-Ups, Too" (https://www.barrons.com/articles/tech-stocks-selloffs-ipos-startups-51653086050), noted that banks that target the secondary market have recently seen record levels of interest from sellers of private company equity.

A "secondary" sale is a sale of equity from a seller other than the issuer or startup. The seller may be a prior investor or a startup employee who received equity compensation. The proceeds are paid to the selling equity owner, rather than the startup.

Prospective participants in a secondary transaction may be under the impression that the issues are generally the same as in a direct investment. However, secondary transactions often present risks unique to secondary transactions. This article highlights a few such risks, and it's strongly recommended that any party in a secondary transaction engage counsel to advise on all issues that may arise.

The startup's governing agreements

The startup's governing agreements, such as an LLC's operating agreement or a corporation's certificate of incorporation, bylaws, or shareholder agreement, are important to review in any secondary transaction. These documents often impose restrictions or conditions that must be satisfied for a sale to be valid, including a right of first refusal in favor of the startup or other investors, a "tag-along" right requiring the seller to allow other investors to participate in the sale, or a requirement to produce a legal opinion that the proposed sale is exempt from registration under securities laws. Parties should make sure that all such restrictions or conditions are satisfied, or else the transaction may be invalidated.

Compliance with applicable securities laws

Among other rules, securities laws prohibit securities, including equity in many startups, from being offered or sold unless registered with the applicable authorities or exempt from registration. In a direct startup investment, the startup generally must ensure that the investment complies with securities laws. However, in a secondary sale, the startup is generally not a party to the transaction and compliance is the responsibility of the buyer and seller.

There are possible options for a secondary transaction to be exempt from registration, often requiring that the parties refrain from any general solicitation in arranging the deal. Parties should discuss options with an attorney experienced in this area.

Information and diligence

In a direct investment, investors can conduct diligence and pose questions to the startup directly. In a secondary transaction, the startup is generally not a party to the transaction and therefore may have little incentive to provide information. Potential buyers should be strategic when seeking diligence information and may need to be prepared to invest with only limited diligence or walk away if questions aren't answered adequately.

Tax issues

There may be tax issues that are not present in a direct startup investment, particularly if the startup is taxed as a partnership. For example, if the startup is taxed as a partnership and the FMV of the startup's assets are greater than its tax basis in those assets, the buyer may have tax liability attributable to that unrealized gain even though the appreciation did not occur during the buyer's ownership. The buyer may consider requiring the startup to make an election under Section 754 of the Internal Revenue Code to help avoid that tax liability. The buyer should consult tax advisers on the timing, mechanics, and potential consequences of the election.

Takeaways

The above issues are all relatively unique to secondary transactions and may not be intuitive to a party with only direct investment experience. Parties should understand that a successful secondary transaction will require taking a lead role to ensure all legal and tax issues are adequately addressed. Legal counsel should be engaged to address these issues early and mitigate the risk of unwanted surprises down the road.

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