

What You Need to Know about Acqui-Hires

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The term “Acqui-hire” is commonly used to describe an M&A transaction where the buyer is predominantly interested in acquiring key employees of the target and not specifically the underlying business and/or assets. This type of transaction is particularly common in the technology and software industries, where key talent can often be more valuable than the underlying product or service, although it has become more prevalent in other industries as well. For the target employees and founders, such an acquisition may represent a “soft landing” in the event that they find that their organization won’t scale in the way that was previously imagined or if their funding sources have dried up.

These transactions tend to be smaller, from a dollar perspective, than most M&A deals, but that does not mean they are not complex (and, in fact, can often be more complex than typical transactions). Below are just some of the issues that often come into play.

Structure

Acqui-hires can take the form of a stock sale, asset sale or merger, like any other type of M&A transaction. Most commonly, however, they take the form of an asset sale where the buyer is only acquiring certain identified assets (such as IP) and certain limited liabilities (if any) because the acquiror is not primarily interested in acquiring the underlying business as a going concern. If no IP is acquired, a buyer may seek a license to all of the seller’s IP as a defensive measure against infringement claims in the future (such as if another party acquires that IP and brings a nuisance IP claim). On the other hand, the equityholders of the target company may push for a merger or stock sale so that all of the liabilities of the target will be assumed by the buyer.

Liabilities of the Remaining Company

If the transaction is structured as an asset sale, the target company will remain in place after the sale and accordingly will need to be wound down (whether immediately or after some period of time where minimal operations are maintained). As part of this process, the remaining liabilities of the target company will need to be satisfied, so sellers need to plan ahead and leave sufficient acquisition consideration in the target to make sure creditors are paid. A dissolution process can be complicated

and time consuming, and it is important to have legal counsel involved in that process as well.

Purchase Price and Valuation

In standard M&A transactions, buyers will value a business based upon financial measures (most commonly EBITDA multiples), but in acqui-hires, buyers may instead value a target company based on the anticipated production of its founding team in the future (e.g., a valuation based on a dollar amount per employee acquired). This makes early discussions around valuation particularly important. These discussions should clearly delineate what is “purchase price” for the business and what is “compensation” for the founders, as this line can often be blurred in these types of transactions, and the two types of consideration have disparate tax implications as discussed below.

Corporate Considerations

Related to the foregoing, in many acqui-hires, the target board of directors will include members of the employee team that is being acquired. Directors generally owe fiduciary duties to a company that requires them to act in the best interest of all equityholders. Accordingly, there is risk that by approving the deal, these employee-directors may be acting in their own self-interest with respect to the compensation package they are being offered rather than in the interest of all stockholders. To protect themselves from these types of claims, the board should work closely with the company’s lawyers to make that all compensation issues are fully disclosed and that proper approvals (including any required by stockholders of the target company) are obtained.

Employment Issues

Given the central focus on talent in an acqui-hire, employment terms tend to be a main focus of the negotiations. Buyers should think strategically about the compensation package for the acquired team to motivate them to stay on after the closing, including the granting of time-vesting options. Another strategy that buyers can use to incentivize retention is the use of “earnouts.” Under these arrangements a portion of the purchase price is only paid out only upon the achievement of certain milestones, which can include simply that the employee remains employed as of a certain date or meeting other financial or operational metrics. Whatever the milestone, if the seller has money at risk they are more likely to remain engaged to protect that interest.

On the other hand, the team being acquired will want to seek protection if things don’t go as expected. For earn-outs, this could mean pushing for the ability to control certain aspects of the business so the acquired employees have freedom to reach those earn-outs as they see fit. The acquired team may also seek severance protection for situations where they are terminated without cause. There will also be push and pull on the scope and length of any non-competes that the employees will have to sign as part of these arrangements (which will intertwine with limitations on these restrictive covenants under applicable law).

Given their importance, employment arrangements can be the most complex part of any transaction negotiation and it is not uncommon that each different team member has their own individualized package. So be sure to allow sufficient time to negotiate and finalize these deal points.

Finally, if there are employees that are not going to be joining the buyer, the target must comply with all employment laws with respect to termination of these employees, such as complying with the WARN Act in any layoffs and any severance obligations under any existing employment agreements.

Tax Considerations

With respect to any payments that the employees will receive, careful consideration must be given as to the appropriate tax treatment of those payments. In general, purchase price will be taxed at capital gains rate while amounts paid as employment compensation will be taxed as ordinary income rates. Additionally, sellers should consider whether the so-called “parachute payment” provisions of Section 280G of the U.S. Internal Revenue Code, which could result in punitive excise taxes, would be applicable to any such payments. Tax advisors should be looped in early to analyze these issues.

Conclusion

Acqui-hires can be incredibly beneficial for both buyers and sellers and represent the start of a great new partnership. But the parties should be aware of the various legal issues that come into play that make these transactions different than the standard M&A transaction. These transactions often need to move quickly, such as where the acquired business may be running out of cash, so it is important for parties be aware of these potential pitfalls and be prepared to run at speed to close a deal.

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