

*The IPO Exit: A Practical Legal
Guide for Financial Sponsors*

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While 2015 saw a decrease in the total number of sponsor-driven initial public offerings (IPOs) relative to 2014, and recent volatility in 2016 has delayed many IPOs, sponsor-driven IPOs remain one of the predominant methods for venture capital and private equity funds to exit an investment in a portfolio company. According to IPO Watch, there were 111 sponsor-backed IPOs in the United States in 2015, which represented 56.6% of all U.S. IPOs by number and 62.1% by value (Thompson [2016]). This compares to 186 sponsor-backed IPOs in the United States in 2014, which represented 61.2% of all US IPOs by number and 71.1% by value (Thompson [2015]).

This article provides a brief checklist of legal items for sponsors engaging in an IPO exit. It is not intended to provide a comprehensive analysis of all the potentially relevant considerations but provides a guideline for the questions that sponsors and their counsel should consider when undertaking an IPO exit. Inevitably, different sponsors will have different considerations that will impact how they will address the items discussed based on the particular exit.

The Jumpstart Our Business Startups Act, or JOBS Act, and the recently adopted Section 4(a)(7) of the Securities Act of 1933, or Securities Act, have made it easier for

sponsors to undertake an IPO exit while at the same time providing additional flexibility to simultaneously consider a sale of the company and additional private fund raising. The additional flexibility for IPO candidates that qualify as emerging growth companies, or EGCs, has streamlined the process for companies undertaking an IPO and also made it more cost effective.

The ability of an EGC to confidentially file its initial registration statement and subsequent amendments with the SEC provides sponsors with greater flexibility and control in managing a contemplated exit. Now, a sponsor can privately market a portfolio company to potential buyers without publicly disclosing that it may elect instead to exit through an IPO if the prices offered by potential buyers are not sufficiently high. By dual-tracking the sale and IPO process, a sponsor can quickly bring a portfolio company to market even if disposition negotiations break down. However, a sponsor may choose to add additional credibility to the sale process by announcing the potential IPO exit to the market. Additionally, the JOBS Act permits EGCs to “test the waters” by communicating with QIBs (institutional accredited investors) and other sophisticated investors to gauge their interest in a potential IPO prior to filing a registration statement.

LIABILITY CONSIDERATIONS, INDEMNIFICATION AND INSURANCE

Control Person Liability

A private equity or venture capital sponsor planning to take a portfolio company public should carefully consider the possibility that it will be held liable for misstatements or omissions in the registration statement, offering materials, or oral communications by the portfolio company as a “control person” under Sections 11 or 12(a)(2) of the Securities Act. A sponsor is deemed to control a company if it has power, directly or indirectly, to direct the company’s management and policies. To avoid control person liability, a sponsor must show that it did not know or have reasonable grounds to know of the facts giving rise to the underlying liability of the portfolio company. In other words, the violation occurred despite fulsome due diligence efforts by the sponsor. To rely on this defense, sponsors should carefully review and ensure they are comfortable with the offering document.

Representations in the Underwriting Agreement

Particularly in an IPO, underwriters demand extensive representations and warranties in the underwriting agreement from the company to support their diligence efforts. While more often the case for founders, sponsors also are often asked to make representations concerning information contained in the registration statement. This represents an allocation of risk in the event the underwriters are sued with respect to the adequacy of information contained in the registration statement. Typically, the representations given by the sponsor are limited to information concerning the sponsor, but this is sometimes expanded depending on the involvement of the sponsor in the business, and the relationship between the sponsor and the company.

Indemnification of Underwriters

The underwriting agreement contains extensive indemnification provisions providing that the portfolio company will make whole (indemnify) any underwriter who suffers losses as a result of being sued for misstatements or omissions in the offering document.

Sponsors may also be asked to provide an indemnity with respect to information they provide. These provisions should be carefully reviewed to ensure the sponsor is comfortable that the level of coverage is appropriate.

Indemnification by the Company and Insurance

The risk and costs of litigation are typically higher for a public company than for a private one. As a result, sponsors should ensure that the company they plan to take public has appropriate director and officer, or D&O, indemnification provisions in its charter or bylaws or in separate indemnification agreements. Sponsors also should ensure the company’s D&O insurance policies provide adequate coverage for their directors. For instance, sponsors should confirm that the company is the primary indemnitor and insurer. To the extent possible, the sponsor should also request that the portfolio company, in addition to the coverage for the sponsor’s director representatives that is traditionally agreed, also provide indemnification and insurance coverage for the sponsor companies.

SALE OF SHARES IN THE PORTFOLIO COMPANY

A sponsor usually does not sell all of its holdings in a portfolio company’s IPO. The sponsor’s holdings are typically too large to sell in the market at one time. A sponsor selling its entire holdings may signal to the market that it believes the company has limited upside. Additionally, investors often want to see the proceeds of the offering used to fund the company or pay down debt. However, it is important for the sponsor at the time of its investment to negotiate for the right to participate in the IPO and control the timing thereof, as well as registration and control rights, if any, following the IPO.

Lock-Up Agreements

In connection with an IPO, underwriters typically insist on lock-up agreements that prohibit the selling of shares by the company, its directors, executive officers, and most stockholders. While traditionally these lockups have remained in effect for 180 days, they have increasingly become subject to negotiation. Additionally, in order to maintain management stock holdings, sponsors

may want to negotiate management lock-ups that are longer and more restrictive than required by the underwriters. One typical restriction prohibits sales until the sponsor's ownership falls below a certain threshold.

Registered Secondary Offerings and Unregistered Resales

Following the IPO, sponsors need to be able to sell their shares of the post-IPO company. This can be done in a registered secondary offering or via unregistered sales that comply with Rule 144, so-called Section 4(a)(1 1/2) of the Securities Act or the recently adopted Section 4(a)(7). The manner and timing of how the sponsor intends to sell its holdings should be carefully considered at the time of its investment and revisited prior to the IPO to ensure that appropriate documentation is in place to facilitate these sales. Sponsors should consider including registration rights for registered resales, corporate law restrictions on sales of more significant positions, methods to promote orderly sales when multiple sponsors are involved, access to material non-public information and how that can impact trading, and whether typical pre-IPO agreements related to tag-along and drag-along rights should continue after the IPO. While traditionally most pre-IPO transfer rights of sponsors fall away upon an IPO, it has become increasingly common to see IPOs include tag-along and drag-along rights that remain in place for as long as two or three years following the IPO, unless the sponsor has sold down below a certain threshold.

Registration Rights

While changes to Rule 144 and the recent adoption of Section 4(a)(7) have increased the flexibility of lenders in liquidating their holdings, sponsors should always negotiate for registration rights. These rights provide sponsors with the ability to have their shares registered with the Securities and Exchange Commission for resale following an IPO. Demand rights, though more desirable because they allow a holder to trigger the registration process, are less common than their counterparts, piggy-back rights. Nonetheless, most sponsors are able to obtain some form of demand rights and often unlimited piggy-back rights, which allow a holder to include shares in a registration already being affected by the issuer. Sponsors should carefully consider the timing

of their ultimate exit, as this will determine how the registration rights are structured.

WKSI Automatic Shelf

When possible, sponsors should require the company to set up a "WKSI" automatic shelf. A primary benefit of doing so is that the number of shares to be sold under the shelf does not need to be disclosed in advance, which decreases any potential price "overhang" that could exist if investors see that a significant block of stock may be sold.

Opt-Out Statutes

Because sponsors may need flexibility to sell large positions or undertake other transactions without having to obtain board approval, they often request that their public portfolio companies opt-out of Section 203 of the Delaware General Corporation Law and other state takeover statutes, or at least limit the antitakeover provisions applicable to the portfolio company until the sponsor's stock ownership falls below a certain level. Section 203 imposes a three-year moratorium on business combinations with any buyer who acquires 15% or more of a company's stock, unless the acquisition is approved by the company's board or stockholders. This section provides post-IPO boards with significant leverage to negotiate aggressively on behalf of public stockholders, thereby impacting terms of a contemplated sale by sponsors or even preventing the transaction entirely. Similarly, the ability of the post-IPO board to withhold a waiver enhances its leverage over the sponsor and could make it more challenging for a sponsor to receive a control premium not shared by other stockholders.

Coordination Committees

Sponsors often rely on "coordination committees" to coordinate post-IPO sales among multiple pre-IPO stockholders in order to prevent "front running" or uncoordinated selling by co-investors. However, such committees should be tailored to the sponsor's particular circumstances. For instance, the committee could hold veto rights over sales by existing investors. Alternatively, the committee's role could be merely ministerial— notifying other investors of a proposed sale— thereby allowing them to participate in the sale and to

coordinate with other investors. The committee may also limit the sponsor's ability to make an in-kind distribution to its limited partners of the company's shares. Sponsors should also carefully consider the duration of a coordination committee. Committees can be structured to dissolve upon the conclusion of a specified period of time post-IPO or when the holdings of pre-IPO stockholders fall below a particular threshold.

CONTROL RIGHTS FOLLOWING AN IPO

Traditionally, most sponsor rights that allow the sponsor to influence decisions of the company fall away upon an IPO. However, sponsors have increasingly sought to ensure they have sufficient control over the company post-IPO. There is always a balancing act as to what will be acceptable to the public investors in the IPO and at what price, as well as how investor advocacy groups will react to these controls. Sponsors will need to take a hard look at what, if any, control mechanisms should survive or if new governance restrictions should be implemented.

Board Representation, Nomination Rights, Voting Agreements

Sponsors often assume that a large equity stake or classified staggered board structure offers sufficient control over a post-IPO company. Though useful, in many cases a sponsor may want to take the additional step to ensure that they have the ability to nominate directors to the board post-IPO by obtaining contractual rights to do so pre-IPO, by means of voting agreements among pre-IPO stockholders to vote their shares in favor of sponsor nominees. However, the benefits of post-IPO control must be balanced against the risk that such voting arrangements will create a group that is subject to additional reporting requirements as well as potential resale restrictions.

Companies controlled by a sponsor post-IPO are not required to undertake an independent nominating process for directors provided they are subject to contractual provisions governing the nomination of their directors. Thoughtful sponsors who negotiate for such provisions pre-IPO can thus retain the right to nominate or designate directors to serve on the board and/or specific committees of the board of their controlled companies. This, in turn, allows a sponsor to restrict the rights

of the post-IPO company's board to nominate directors for election by the stockholders.

Veto, Voting Rights, and Dual-Class Structures

Companies controlled by a sponsor following an IPO need to consider whether to include provisions in their organizational documents that enable them to retain control over such companies. Common provisions include multiple or dual-class share classes with disparate voting rights and veto rights, or limitations over specified actions by such company or the board. Traditionally, pre-IPO veto rights will cease to have effect following the consummation of an IPO. However, these rights have become more common following the IPO. Veto rights range from the right to approve extraordinary transactions—such as transactions that would result in a change of control, a major acquisition, or the incurrence of significant debt or major equity issuances—to the appointment or termination of a company's CEO, to various compensation matters.

By retaining a class of common stock post-IPO with higher voting rights and issuing the lower voting common stock to the public, the sponsor can preserve post-IPO control over the company. However, depending on the company, many underwriters express concerns about a possible negative impact on the IPO's offering price and often advise against a dual-class structure. These dual-class structures are also subject to significant scrutiny by proxy advisory firms, who may advise voting against directors of companies who endorse this structure.

OTHER CONSIDERATIONS

Conflicts of Interest and Corporate Opportunities

One item that is often overlooked is the potential for conflicts of interest between the sponsor and post-IPO portfolio company in future corporate transactions. Sponsors should consider including a provision in the company's organization document that the company waives any obligation of the sponsor and its appointed board representatives to not compete with the company or to present the company with any corporate opportunities.

Management Services Agreements

Sponsors often enter into management services agreements with their portfolio companies whereby the sponsors receive transaction fees as well as annual management fees for providing advisory services to the company. Sponsors need to consider whether a final payment is required in connection with the termination of any such agreements—for instance when the company undertakes an IPO or if there is a change of control of the company.

Information Rights

Because a post-IPO portfolio company could become the target of a potential buyer, it is in the sponsor's best interest to negotiate for a contractual right to disclose the company's confidential information to any such buyer for diligence purposes prior to taking the company public. Barring such contractual right, the sponsor would need the post-IPO board's consent to disclose information concerning the company. However, management may be reluctant to give such consent due to competitive or proprietary concerns, even if disclosure was subject to a confidentiality agreement.

Tax Structures and UP-C

While a fulsome discussion of the various tax considerations that need to be taken into account in connection with an IPO exit is beyond the scope of this article, the so-called UP-C partnership structure has gained increasing popularity. The UP-C partnership structure allows sponsors to benefit from flow-through tax treatment even after the conclusion of an IPO. Prior to an IPO, many portfolio companies of financial sponsors are organized under state law as LLCs or LPs that are treated as partnerships for income-tax purposes.

As a result, such portfolio companies pay no entity-level corporate income tax. Until recently, the convention was to convert any such company into a C-corporation prior to the closing of its IPO. As a result, stockholders of the new corporation experienced double taxation—with the corporation first paying corporate income tax and then the stockholders paying income tax on any dividends they received. In an UP-C structure, the IPO corporation owns interests in the existing LLC or LP and some or all of the pre-IPO owners continue to own interest in such company. The pre-IPO owners' interest are generally illiquid but agreements are put into place for the owners to flip their LLC or LP interests into shares of the public corporation.

It is important for sponsors to focus on corporate governance and liquidity rights at the time of their initial investment and, in any event, well in advance of initiating an IPO exit. It is also important for sponsors to understand the potential liability concerns associated with being a significant shareholder in an IPO exit. The failure to do so could result in significant exposure for the sponsor.

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