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Navigating a Dual-Track IPO/M&A Process

In 2010, the US IPO market returned to its former strength with more than 150 offerings completed (compared to 63 in 2009 and 31 in 2008). It appears that 2011 will also be a strong year with a significant number of IPOs already completed.[1] For many companies, conducting an auction or other sale process concurrently with filing for an IPO—referred to as a "dual-track" process—has become increasingly popular. Such a process can offer many benefits, including possibly higher valuations and increased flexibility, but comes with unique challenges. Accordingly, a company's board of directors should carefully consider whether a dual-track process is appropriate in light of the company's particular resources, opportunities, circumstances and goals.

This article highlights key considerations when contemplating a dual-track strategy and provides companies, boards and investors with guidance regarding how to conduct a dual-track process effectively.

Advantages and Disadvantages of a Dual-Track Process

The advantages of a dual-track process include:

- **Less dependence on market conditions and greater flexibility**. Market volatility presents a challenge to any IPO process. Favorable market conditions at the launch of an IPO roadshow can change suddenly and adversely impact the IPO's pricing.[2] While companies and underwriters often try to time IPOs to avoid major announcements regarding macroeconomic conditions, the market's reaction to earnings releases or other announcements by major players in the sector can also impact offerings. In addition, the multi-month review process conducted by the Securities and Exchange Commission (SEC) adds an additional element of unpredictability, further exacerbating the ability of a company to take advantage of favorable market conditions. By pursuing a dual-track process, companies can mitigate some of the uncertainty in the capital markets by giving themselves the option of exiting through a sale.

1 Through April 15, 2011, more than 45 IPOs had been completed. Note that the second half of February and the beginning of March is traditionally a quiet time for IPOs due to accounting firms' inability to provide underwriters with "negative assurance" statements after February 11 for companies with a calendar fiscal year. *See* also footnote 7 below.

2 For example, during the week of May 2, 2010, three companies that were planning to price their IPOs either postponed their offerings or reduced their price ranges dramatically following significant market volatility. The S&P 500 dropped 7 percent during that week. *See MIE Holdings Slashes I.P.O.*, May 7, 2010, *available at* http://dealbook.nytimes.com/2010/05/07/

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- **Creates leverage for sale process**. An impending IPO can provide private companies with leverage over potential acquirers. At a minimum, a dual-track IPO process lends a degree of urgency to the acquisition process. Strategic acquirers often view their window of opportunity as closing when a potential target commences an IPO process since the company may not be for sale following its IPO. Even if it is, the terms (particularly the price) may be less favorable. In addition, public companies are likely to include more stringent market checks as to price than would be involved in a private company sale process. As a result, buyers may be more inclined to act in the face of a credible possibility of an IPO, and thus, the perceived leverage of a dual-track process can result in a higher sale price and target-friendly deal terms. Not surprisingly, a recent study on the benefits of dual-track IPO processes found that the sale of a company engaged in a dual-track IPO process resulted in a 22 percent to 26 percent higher premium than the sale of a privately held company not engaged in a concurrent IPO process.[3]

- **Provides the ability to achieve a complete exit and avoids being "frozen" out of control**. An IPO can be a partial liquidity event for investors, but is rarely a complete exit. In many IPOs, investors are not permitted to sell shares or may be permitted to sell only a small number of shares in the over-allotment option that is generally exercised if the share price increases following the IPO. This presents a significant challenge for venture capital and private equity investors, which generally want liquidity for their entire investment as soon as possible and ideally from a single transaction. Pre-IPO investors can therefore find themselves holding a significant stake in a company years after an IPO with little prospect of selling a significant portion without depressing the company's share price absent an underwritten offering. In addition, a private equity shareholder may still hold a significant equity position following an IPO, but face new limits on its ability to control or influence the now-public company. For example, a domestic US public company that is not a controlled company[4] has one year from its IPO for its board to be comprised of a majority of independent directors.[5] Audit committee members of all public companies—controlled or not—must be independent and unaffiliated with any 10 percent shareholder.[6]

A dual-track process may also have significant disadvantages:

- **Management distraction and risk to business**. Preparing for an IPO requires significant management time and attention. However, there are periods during the IPO process when management devotes less time to the IPO—principally during SEC review periods—and is able to generally refocus on the company's business. Managing the sale of a company also requires a significant investment of time and resources, involving senior management as well as rank-and-file employees to prepare for and facilitate due diligence, negotiate terms, prepare disclosure schedules and so on. A sale process is usually a constant sprint until deal terms are finalized and the transaction is announced. Given the distractions of each process on its own, attempting to orchestrate both an IPO and a sale process at the same time will acutely limit the amount of time and attention that management can spend on customers, products and strategy. As a result, there is a real risk that the business could suffer which, in turn, could significantly impact the success of the IPO, the sale process or both.

- **Competing priorities can lead to a sub-optimal result**. Timing considerations for the IPO and sale process may not align, and the company could find itself prematurely forced to make a decision in connection with one process that has unintended negative consequences. For example, the most challenging time in the dual-track process comes at the end of the SEC review process for the IPO when the company is almost ready to launch its roadshow. If the offering is postponed to continue acquisition discussions, favorable market conditions may disappear or the company's business may decline. Significant delay can also result if the company needs to update its IPO prospectus with more recent financial statements as a result of ongoing acquisition discussions.[7] As discussed above, failure to successfully manage the two processes can challenge the company's business in the meantime.

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3 James C. Brau, Ninon K. Sutton & Nile W. Hatch, Dual-track versus single-track sell-outs: An empirical analysis of competing harvest strategies, 25 Journal of Business Venturing 389-402 (2010).

4 A "controlled company" is one in which more than 50 percent of the voting power for the election of directors is held by an individual, a group or another company. *See* Nasdaq Stock Market ("Nasdaq") Rule 5615(c) and New York Stock Exchange ("NYSE") Listed Company Manual §303A.00.

5 *See* Nasdaq Rules 5605(b)(1) and 5615(b)(1) and NYSE Listed Company Manual §303A.00 and §303A.01.

6 The audit committee must have one independent member on the date of listing on Nasdaq or the NYSE, a majority of independent members 90 days after listing and be wholly independent one year after listing. This requirement also applies to controlled companies. *See* Nasdaq Rules 5605(c)(2) and 5615(b)(1) and NYSE Listed Company Manual §303A.00 and §303A.06.

7 The third quarter interim financial statements of a U.S. company with a calendar fiscal year go stale on February 14 (subject to a permitted extension to the next business day if February 14 falls on a weekend or a federal holiday) with the result that the company cannot complete its IPO until its audited financial statements for the recently ended fiscal year are available. *See* Item 3-12(d) of Regulation S-X. This generally results in a significant drop in IPOs for a number of weeks after February 14 until companies' audited financial statements are available. Similar issues can arise with respect to first, second and fourth quarter financial statements, but are usually less significant because staleness of those financial statements does not result in the need for audited financial statements as is the case with staleness of the third quarter interim financial statements.

Considerations and Suggestions

To address the challenges posed by a dual-track strategy, it is essential to understand the two processes and plan for each in advance. The IPO process involves drafting a registration statement, due diligence by the underwriters and their counsel, an iterative review and comment process with the SEC and the negotiation of an underwriting agreement. The process culminates in a roadshow that typically lasts approximately two weeks followed by pricing. The sale process generally includes the solicitation of a number of potential purchasers, presentations by management, receipt of initial bids, due diligence by potential purchasers, receipt of final bids and negotiation of terms. We discuss below ways in which companies can try to synchronize these processes and identify and address issues in advance.

Financial Advisors

A company conducting a dual-track process will need to engage an investment bank to advise on the process. Among other things, in connection with the sale process, the investment bank will identify and contact potential acquirers, prepare materials for such acquirers, advise on valuation and deal structures and manage the overall sale process. While most private companies do not seek a fairness opinion, the investment bank will nonetheless work closely with the company's board to maximize the number of bidders and, importantly, valuation. In a dual-track process, one or more of the investment banks involved in the IPO process will typically be engaged to assist with the sale process. This raises a number of potential issues.

It is customary for IPOs to have at least two investment banks serving as bookrunners. The bookrunners are responsible for managing the overall process and, specifically, for allocating shares to potential investors as part of the IPO "book-building process" during the roadshow. Having more than one bookrunner primarily serves to enhance distribution and research coverage, and also serves as a form of insurance in the unlikely event that one of the banks cannot agree with the other banks on valuation and withdraws from the syndicate.

Unlike the IPO, however, a sale process may not require the involvement of multiple investment banks. As a result, while an IPO contemplates allocation of the underwriting discount among a syndicate of banks, the fees paid in connection with an M&A transaction often contemplate a smaller number of recipients and possibly only one bank. This problem has no easy solution. Some companies engage more than one bank to advise on the sale process, but delineate a more substantive role for one bank and reflect this in the banks' respective compensation. This may be perceived as appropriate insofar as it is transparent to all parties. In this regard, it is worth remembering that banks do not generally receive any fees or expense reimbursement for their work on an IPO unless the offering closes. Conversely, some companies will engage only one of the bookrunners to advise on the sale process.

This issue raises another consideration that pre-IPO companies should bear in mind long before initiating an IPO process. It is less common for companies to sign engagement letters with investment banks in connection with an IPO. However, some companies may sign an engagement letter with a bank in connection with a private financing round prior to commencing the IPO and agree to a "tail" provision in that letter. Such a provision often entitles the investment bank to receive a fee in connection with any subsequent M&A transaction that occurs within an agreed period of time following the termination of the engagement. It is worth considering how that provision will operate at the time of the IPO if the investment bank in question is not engaged as an underwriter for the IPO. Ultimately, the company may have little choice and address the tail provision when the dual-track process starts (i.e., engage the same investment bank or pay the fee even if the bank is not engaged).[8]

8 Another possible way to address this issue is to ensure that the engagement letter makes it clear that the bank must be the "procuring cause" of the acquisition transaction in order to receive its fee. If this approach is adopted, the engagement letter would generally require that the acquirer is an entity approached by the bank during the term of the engagement.

Timing of Initiating Contact With Potential Acquirers

Contact with potential acquirers is generally initiated following the first filing of the registration statement with the SEC, which is generally the first formal announcement of the IPO. In some cases, if the IPO process has considerable promise, the company may receive and respond to one or two rounds of SEC comments before commencing a sale process. Absent significant issues, the time from the initial filing of the registration statement to when the company is ready to launch the roadshow will likely be at least two and a half to three months. It is also possible to prepare the registration statement and not file it with the SEC. In that case, the existence of the registration statement can be used to inform potential acquirers that the company has a credible alternative to an acquisition.

The registration statement filed by a domestic US company (including a non-US company that does not qualify as a foreign private issuer) will be publicly available on EDGAR and, thus, potential buyers will see that the company has initiated an IPO process. On the other hand, foreign private issuers may submit their registration statements confidentially to the SEC and conduct their IPO processes in complete confidentiality until just before a roadshow is launched.

Complying With Securities Laws Communication Restrictions

There will likely be considerable concern regarding what materials can be provided to potential acquirers without violating restrictions on communications under US securities laws. These restrictions are intended to prevent companies from conditioning the market before a prospectus conforming to the requirements of the Securities Act of 1933, including a price range, is available to potential investors. As a result, after an IPO registration statement is filed with the SEC and before a price range is included, subject to limited exceptions, the issuer is prohibited from using any written materials that could be considered an offer. The term "offer" is broadly construed by the SEC to include any material deemed to prepare or condition the market for the proposed offering.

Communications restrictions also apply to underwriters. Investment banks have been forced to withdraw from a number of high-profile IPOs because their employees inadvertently distributed prohibited written materials to potential investors.[12] As a result of such underwriters' actions or the company's actions, companies have been forced to include risk factors noting that IPO investors may claim that they have rescission rights in the future as a result of violations of publicity restrictions under the securities laws.[13]

Despite legitimate concerns about managing communications during an IPO process, the provision of materials to potential acquirers in connection with a dual-track process is generally not problematic. Potential acquirers will typically be strategic acquirers and, as such, unlikely to be potential IPO investors. Irrespective of the identity of the potential acquirers, communications during the sale process should not be construed as an "offer" of securities in the IPO if drafted to relate solely to the acquisition process and directed at entities that will not (and may not) be purchasers in the IPO. In this context it is important to note that any entity that receives materials in connection with a potential acquisition cannot participate in the IPO. By definition, the materials they receive may not be an offer of securities, and any subsequent investment in the IPO would undermine that fact.

Materials Provided to Potential Acquirers

Potential acquirers in a sale process are often initially provided with a short "teaser" prepared by the company and the investment bank. A teaser typically contains summary financial data and general information about the company. The banks will likely also prepare a confidential information memorandum containing more detailed information. This will generally be distributed only to potential acquirers that indicate an interest in proceeding further and sign a confidentiality agreement.

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9 *See* Rule 169 under the Securities Act.

10 *See* Rule 433(b)(2)(ii) and Rule 433(f) under the Securities Act. Note that a free writing prospectus subjects the issuing party to liability under Section 12 of the Securities Act.

11 *See* Rule 134 under the Securities Act.

12 *See*, e.g., Oops. UBS Loses GM IPO Gig Due to Stray Email, November 10, 2010, available at http://blogs.wsj.com/deals/2010/11/10/oops-ubs-loses-gm-ipo-gig-due-to-stray-email/.

13 *See* Section 12(a)(1) of the Securities Act, which grants any person who purchased a security in violation of Section 5 of the Securities Act the right to rescind the purchase.

There will likely be pressure to provide the IPO registration statement itself to potential acquirers. This should generally be avoided until a preferred bidder has been selected. The registration statement is a selling document for use in connection with the IPO. SEC rules actually prohibit its distribution to potential IPO investors until a price range is included in it.[14] Even though the sale process is not an offer of securities, distribution of the registration statement can blur that line. In any event, a registration statement filed by a domestic US company is publicly available on the SEC's website and can (and invariably will) be viewed by any potential acquirer. In the case of a foreign private issuer, the confidential information memorandum should contain all information relevant to potential purchasers extracted from the registration statement that has been confidentially submitted to the SEC.

It is likely that discussions will also focus on the company's financial model: the detailed set of projections that the company prepares for the investment banks and their research analysts in an IPO. In parallel with the company's model, the investment banks' research analysts will build their own financial model to test the company's underlying assumptions and may ultimately use slightly different assumptions than the company. Potential acquirers will, of course, want to see the company's model. This can be shared under strictures of confidentiality once the company is satisfied that the potential acquirer's interest is bona fide and the company is comfortable with the potential acquirer's price indications. Conversely, an investment bank should not provide its model to a potential acquirer and should generally avoid expressing its views on the company's financial model.The investment bank's model may differ from the company's model and, to the extent a potential acquirer relies on it in its acquisition decision, the bank may be exposing itself to potential liability.

Methods of Contacting Potential Acquirers

Although the content of the materials provided to potential acquirers generally does not raise significant concerns under US securities laws, the risk that those materials may be disseminated beyond the potential acquirers or that news of the dual-track process may leak is a legitimate source of concern. Although the materials in the hands of the potential acquirers should not be considered an offer of securities for the purpose of US securities laws, the same conclusion may not hold if those materials are disseminated to the wider public. Similarly, press speculation about a potential sale of the company discussed in the context of the potential IPO may cause the SEC to question whether the company took appropriate precautions to avoid publicity about the process.

There is no fixed practice regarding the methods used to disseminate materials in connection with a dual-track process. The investment bank acting as advisor may want to contact dozens of potential acquirers and, initially, no confidentiality agreement will be in place with those entities. The use of email increases the risk that materials will be forwarded to others and may ultimately reach the public or press. The ideal approach is initially to contact the appropriate person at a potential acquirer by telephone. If practicable, the teaser could be sent in hard copy if the individual contacted indicates an interest in engaging in further discussions. Subsequently, after a confidentiality agreement is signed, the confidential information memorandum can also be mailed. Of course, practical considerations often result in the use of email. Common sense dictates that emails are sent only to those who have been contacted initially by telephone rather than contacting a large number of individuals by email as part of the auction process. Email communications should stress the confidentiality of the process and that materials should not be forwarded (although this is no substitute for a binding confidentiality agreement if the potential acquirer is interested in receiving more information).

Confidentiality Agreements

A confidentiality agreement with potential acquirers is standard for any sale process and a dual-track process is no exception. However, in connection with a dual-track process, it is important to remember that the company is still privately held and its standard form of confidentiality agreement may not include a standstill provision. Such a provision prevents potential acquirers from seeking to acquire a company in a hostile transaction after termination of acquisition negotiations. It is advisable to include a standard public company standstill provision in the confidentiality agreement executed by potential acquirers in a dual-track process. If the dual-track process ends with a successful IPO rather than an acquisition, it would be highly undesirable for a former potential acquirer to make a hostile offer for the company during the period immediately following its IPO.[15]

14 *See* Item 503(b)(3) of Regulation S-K.

Disclosure Regarding the Sale Process

If the dual-track process ultimately results in a successful IPO, the fact that it was preceded by a sale process is generally not considered material to investors in the IPO. The motivation to conduct a sale is generally unrelated to any material facts associated with the company that are not already disclosed in the registration statement. Accordingly, there is typically no disclosure about the sale process in the registration statement.

Disclosure of Information Provided During the Sale Process

It is difficult to make generalizations regarding whether a potential acquirer who received information during the sale process is "cleansed" at the time of the IPO so that it could trade in the company's securities following the IPO. The fact that the registration statement may not, by law, contain a material misstatement or omission is helpful in concluding that all material information has been disclosed; however, there is no doubt that companies and underwriters sometimes exclude positive information from a registration statement based on a determination that such information is not material. For example, a company that gives a range of its potential earnings for a recently completed quarter may know that its results will likely be at the top of that range. Such information may also be known to a potential acquirer as a result of its diligence during the sale process. As a result, a fact-specific analysis will be necessary in each case. Of course, the inclusion of a standstill provision in the confidentiality agreement largely obviates the need for such a determination.[16]

Management Incentives

Management of a company engaged in a dual-track process may prefer the option of taking the company public over being acquired. While many factors impact this, the desire to manage and grow the company as an independent public entity can be a significant factor. This desire may be even stronger among company founders. It is therefore important that the board of directors considers management's incentives to complete either an acquisition or an IPO. The board should tally up the compensation that management is likely to receive in either scenario (including in the case of termination following an acquisition) and make the necessary adjustments to incentivize management to implement whatever decision is taken by the board.

Conclusion

Many elements of an IPO process are similar to those of a sale process: preparation of detailed selling documents (registration statement/confidential information memorandum); preparation of a financial model/detailed forecasts; organization of due diligence materials; detailed management presentations; and the use of an investment bank (underwriter/M&A advisor). Nevertheless, the additional work required for a successful dual-track process is more than incremental. The effort required will, at times, distract management from the IPO process and from running the company's business. Nevertheless, the possibility of obtaining liquidity in a single transaction at a higher valuation generally makes a dual-track process appealing to investors in a company, and can increase significantly the likelihood of an exit transaction. Although there are additional considerations in the context of a dual-track process, with advanced planning and prudent decision-making, the dual-track process can be navigated successfully.

15 It is interesting to note that a nascent trend in IPO lock-up agreements is to include an exception to the restrictions on transfers in the case of a bona fide third-party acquisition proposal to acquire control of the company. This has appeared in only a minority of transactions and is clearly intended to enable shareholders to respond to such an acquisition proposal after the execution of the lock-up agreement (which often occurs as early as the initial filing of the registration statement) through the 180-day lock-up period following the IPO.

16 The underwriters' research departments also have access to detailed information about the IPO company, including the financial model. Those research analysts are generally considered not to be in possession of material nonpublic information at the time they initiate research coverage more than 40 days after the IPO. This is premised on the extensive disclosure in the registration statement and the notion that the near-term information in the financial model is stale. *See* NASD Rule 2711(f)(1)(A) prohibiting a broker-dealer that was a manager or co-manager in an IPO from publishing research until 40 calendar days after the date of the IPO.

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