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Recent Trends in Post - IPO Arrangements for Sponsors and Co-Investors

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In the current market, private equity sponsors are increasingly looking at initial public offerings as a liquidity option for their portfolio company investments. One of the key issues that sponsors need to consider in connection with an IPO are what, if any, governance rights and transfer restrictions for pre-IPO stockholders should survive the IPO. Traditionally, few, if any, of these rights and restrictions survived. However, based on a recent survey we conducted of sponsor-backed IPOs, we identified certain rights and restrictions that are increasingly surviving the IPO.

Trends in Rights and Restrictions

Certain rights and restrictions that are increasingly surviving IPOs of sponsor portfolio companies include the following:

- ***Board Representation***. Contractual rights to board representation historically have terminated upon the consummation of an IPO. However, several of the recent IPOs we surveyed either had contractual rights to board representation continue post-IPO or implemented new rights in connection with the IPO. These rights are typically structured so that the sponsor (or a significant co-investor) has the right to nominate a certain number of directors to the board of the public company, as an agreement among pre-IPO stockholders to vote their shares in favor of a certain number of sponsor (or co-investor) nominees or a combination of both. These rights would typically terminate once the sponsor's (or co-investor's) equity ownership falls below a certain percentage following the IPO.

- ***Veto Rights***. Similar to contractual board representation rights, pre- IPO veto rights historically have terminated upon the consummation of an IPO. However, in a small minority of recent IPOs we surveyed certain contractual veto rights did survive the IPO. These veto rights ranged from the right to approve extraordinary transactions, such as transactions involving a change of control or significant acquisition or equity issuance, to the hiring or firing of a company's chief executive officer. These rights would typically terminate once the sponsor's equity ownership falls below a certain percentage following the IPO.

- ***Transfer Restrictions and Tag-Along and Drag-Along Rights***. Post- IPO transfer restrictions on pre-IPO stockholders have historically been more common than post-IPO governance rights, particularly post-IPO lock-ups that expired later than a traditional underwriter's lock-up and tag-along rights. These restrictions continue to remain popular and in some cases are being broadened and lengthened. For example, certain recent IPOs have included lock-ups and tag-along and drag-along rights that remain in place for as long as two to three years post IPO unless the sponsor has sold down below a certain threshold.

- ***Coordination of Sales***. In transactions where there is a number of co-investors, sponsors are increasingly using "coordination committees" to coordinate sales of shares by pre-IPO stockholders following the IPO. The coordination committee is designed to prevent "front-running" or uncoordinated selling by coinvestors which may adversely affect the market price of the public company's stock. Coordination committees can be tailored to a sponsor's particular facts and circumstances. The coordination committee's function could either be to veto sales by existing investors unless approved by the coordination committee or to notify other investors of a proposed sale so as to permit them to participate in the sale and coordinate selling efforts. The coordination committee may also impose limitations on the ability of the sponsor to effect a distribution in kind of the public company's shares to its limited partners. Coordination committees are frequently structured to dissolve upon the expiration of a certain period of time post-IPO or when the ownership of the pre-IPO stockholders falls below a certain level.

Certain Legal Issues to Consider

Contractual arrangements among pre-IPO stockholders that survive the IPO raise a number of disclosure and reporting issues once the company is public and could adversely affect a sponsor's liquidity options. For example, these arrangements may make pre-IPO stockholders party to these arrangements a "group" for Schedule 13D and 13G and Section 16 reporting purposes. Similarly, it may adversely impact the ability of the sponsor to sell under Rule 144 as the volume limitations may apply to sales by all members of the group. In addition, sponsors with access to material non-public information post-IPO through board representation will also have more limited liquidity options with respect to their shares in the portfolio company than investors without board representation as they will be subject to restrictions on their ability to sell during "black-out" periods as well as other times where they have access to material non-public information regarding the portfolio company.

Conclusion

Private equity sponsors are increasingly adapting the technology of private company governance rights and transfer restrictions to their portfolio companies post-IPO. With IPOs increasingly becoming the exit of choice for sponsors in the current market we would expect this trend to continue. Certain of these arrangements may impact a sponsor's disclosure and reporting obligations, as well as its liquidity options, post-IPO and so should only be implemented with the advice of experienced counsel.

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