Private Equity Newsletter

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Post-IPO Stockholders Agreements

In structuring an initial equity investment and the subsequent stockholder arrangements entered into immediately before a portfolio company's initial public offering, our private equity fund clients often ask, "What rights and obligations should we have after the IPO that are different from the public stockholders?". Should the private equity funds retain their rights to nominate (and obligations to vote for) directors and their tag-along rights, drag-along rights, veto rights and other provisions after public stockholders have acquired a meaningful ownership position? These issues can be particularly difficult in a "club deal" (i.e., a portfolio company with multiple private equity fund investors).

Outlined below are certain legal issues that private equity funds should consider when deciding upon the terms of their post-IPO stockholders agreement in a "club deal" context.

But First, What is Standard?

It is hard to generalize the terms of a "standard" post-IPO stockholders agreement because each portfolio company and group of stockholders presents unique issues. Nevertheless, the decisions made by private equity funds in other, similar situations may provide useful guidance. To see a chart summarizing the key terms of post-IPO stockholders agreements, please click here. This review revealed several interesting findings, including:

» When private equity funds collectively own more than 50% of a portfolio company, they generally do take advantage of the "controlled company exception", which exempts those companies from most of the corporate governance rules imposed by the stock exchanges and NASDAQ, including the requirement that a majority of the board be comprised of independent directors. Audit committee independence requirements will, however, continue to apply.

» In over 60% of these deals, the private equity fund sponsors had the right to designate director nominees post-IPO and required the stockholders that are party to the agreement to vote for the designated nominees.

» Restrictions on transfers of shares most often terminate upon the IPO, but nearly 40% of these IPO companies included (1) tag-along rights, (2) a requirement that one or more non-transferring private equity fund sponsors must consent to transfers by other funds and/or (3) other provisions to coordinate sales by the private equity fund stockholders.

» Private equity funds were granted registration rights in all cases, typically including at least 2-3 demand registration rights for each fund (including shelf registrations) and piggyback registration rights.

» Drag-along rights and veto provisions rarely survive the IPO, although that does occur (but usually, for example, only where 2 out of 3 of the "club members" (or sometimes a board vote that includes independent director approval) agree to a transaction or action).

If the IPO underwriters and/or the private equity funds determine or agree that retaining governance or transfer restrictions post-IPO will adversely affect the offering or the value of the offered shares, then the sponsors may decide that some or all provisions of their pre-IPO stockholders agreement should terminate, other than registration rights.

Should Board Nomination Rights Continue After the IPO?

The advantages of retaining board nomination rights from a business perspective are obvious, and include being assured the opportunity to continue to influence or control the direction of the portfolio company after the IPO and to have enhanced access to information about the company. In a club deal context, if any private equity funds are granted the right to nominate directors, all of the funds typically agree to vote for those nominee(s). Several key legal issues that should be considered when deciding whether to include these rights and obligations are set forth below. Note that certain of these issues will also apply if a private equity fund has representation on the portfolio company board, even if there is no contractual right to that representation.

1. The "Controlled Company" Exception

Stock exchange and NASDAQ rules generally require that a majority of the board of directors, all members of the compensation committee and all members of the nominating or corporate governance committee must be independent after an IPO. However, if the company is a "controlled company", (i.e., more than 50% of the voting power is held by one stockholder or "group"), these requirements do not apply, although each member of the audit committee must be independent even for "controlled companies".

In order to qualify as a "group", the "club members" must have a voting agreement or other agreement relating to the acquisition, holding or disposition of shares and must file a Schedule 13G as a group. An agreement to vote for the directors nominated by the parties to the stockholders agreement qualifies as such an agreement.

There are, however, several disadvantages to creating a "group", as discussed below.

2. Affiliate Status

An agreement among stockholders to vote for the directors nominated by each party increases the risk that each of the stockholders will be deemed to be "affiliates" of the portfolio company. If a stockholder is an "affiliate" of an issuer, its sales of issuer securities will be subject to Rule 144's volume and other limitations that would not apply to non-affiliates after two years. An affiliate may also be held liable under the securities laws for material misstatements or omissions by the issuer. In addition, if an affiliate of the issuer is also affiliated with a broker-dealer (e.g., merchant banking fund of an investment bank), the broker-dealer's ability to make a market in the issuer's shares and issue research reports and recommendations will be restricted.

A private equity fund that would not otherwise be an affiliate of the portfolio company (note that board representation and level of stock ownership are usually key here) should thus consider these implications before agreeing to a post IPO voting agreement.

3. Disclosure Obligations and Liability for "Short-Swing Profits"

Another potential disadvantage of an agreement to vote for designated directors is the additional disclosure obligations that may be imposed by Sections 13 and 16 of the Securities Exchange Act of 1934, and the potential for liability for "short-swing profits" under Section 16.

Beneficial ownership of more than 5% of a class of a public company's equity securities requires the stockholder to report its ownership position and other information by filing a Schedule 13G with the SEC, and in certain cases to file amendments promptly after any material changes in the disclosure. In addition, a beneficial owner of more than 10% (and directors and officers) must report ownership information by filing a Form 3 with the SEC, and report ownership changes by filing a Form 4.

When two or more persons form a "group", each person is deemed to be the beneficial owner of the equity securities held by each other member of the "group". An agreement among private equity fund stockholders to vote for designated directors would create a "group". Accordingly, if the group holds more than 5% or 10% of the shares, each private equity fund, including a fund that holds less than 5% or 10% of the outstanding shares, would have filing obligations that it may not have individually (including obligations to file amendments following changes by other members of the group).

Should Board Nomination Rights Continue After the IPO? (cont'd)

Moreover, if the group holds more than 10% of the shares, each member of the group (including a private equity fund that holds less than 10% individually) would become subject to liability under section 16 for "profits" realized from any randomly matched purchase or sale of an issuer's shares by that group member (but not other members of the group) that occurs within a 6-month period.

4. Access to Material Nonpublic Information

A private equity fund stockholder with board representation must be especially sensitive to the prohibition on purchasing or selling securities while in possession of material nonpublic information. Directors typically must comply with the portfolio company's insider trading policy, which restricts the ability of directors and other insiders from selling company securities outside specified window periods. If the director is designated by a private equity fund, best practices would call for the fund itself to abide by the same policy, whether or not the fund is specifically covered by its terms. Even if the timing of a transaction is permitted by the terms of the relevant trading policy, the fund must nevertheless ensure that it is not in possession of material non-public information about the portfolio company at the time of the trade.

5. Potential for Director Liability

The risk of shareholder lawsuits and claims of breach of fiduciary duty are greater with a public company than with a private company.

Should Transfer Restrictions (Consent Requirements, Time and/or Volume Limitations, Sale Coordination Mechanisms, Tag-Along and Drag-Along Provisions) Be Included?

Over 60% of the post-IPO stockholders agreements that we reviewed did not contain any transfer restrictions or other provisions requiring the private equity funds to coordinate their sales of securities after the IPO. However, where multiple private equity funds hold large ownership positions in a portfolio company, certain transfer restrictions may facilitate an orderly exit by these stockholders and address concerns that selling efforts by one fund may undermine the ability of the other funds to exit.

Key legal issues that should be kept in mind when considering whether to retain transfer restrictions include:

1. Aggregation of Rule 144 Sales

Rule 144 is an important exemption from the registration requirements imposed by the Securities Act of 1933 because it allows private equity funds in certain circumstances to sell its shares on the public market after the portfolio company's IPO. To qualify for this exemption, adequate current information about the issuer must be publicly available and the selling stockholder must satisfy the holding period requirements, volume limitations and manner and notice of sale requirements of Rule 144 which are likely to be well known to you.

When two or more stockholders "agree to act in concert for the purpose of selling securities of an issuer," those stockholders must aggregate all of their sales within the preceding three months. For example, if sales by one stockholder require the consent of one or more other stockholders, the sales by all of the stockholders should be aggregated for purposes of Rule 144's volume limitations. Transfer restrictions, including tag-along and drag-along provisions and sale coordination mechanisms, may also constitute an agreement "to act in concert for the purpose of selling securities of an issuer" and thus trigger the requirement to aggregate sales by all stockholders party to the agreement for purposes of Rule 144. Assuming that the volume limitations apply to a given sale, an aggregation requirement acts to limit the ability of an individual "club member" to sell shares into the open market in reliance on Rule 144.

Should Transfer Restrictions (Consent Requirements, Time and/or Volume Limitations, Sale Coordination Mechanisms, Tag-Along and Drag-Along Provisions) Be Included? (cont'd)

2. Affiliate Status

Certain transfer restrictions will affect whether a stockholder is considered an "affiliate" of the issuer, with the implications discussed above. For example, drag-along rights give a stockholder the ability to control the sale of a block of shares, including shares that it does not own. Accordingly, a stockholder with the contractual right to drag along other stockholders in a sale transaction that influences the control of the issuer will be considered an "affiliate" of the issuer. Coordinated sale mechanisms may also have this result. Tag-along rights, on the other hand, do not give any person control over the affected shares and thus do not impact the affiliate analysis.

3. Disclosure Obligations and Liability for "Short-Swing Profits"

An agreement "to act together for the purpose of . . . disposing of equity securities" creates a "group" for Section 13 and Section 16 purposes, so each member of the group would be deemed to own the equity securities held by the other members. If the group's ownership exceeds 5% of the outstanding shares, each member of the group would be required to comply with the disclosure obligations imposed by Section 13 and, if more than 10%, by Section 16 and be subject to liability for "short-swing profits" under Section 16 (in relation to purchases and sales by that private equity fund, and not any other group member, within any six-month period).

4. Termination of Transfer Restrictions

If transfer restrictions are included in a post-IPO stockholders agreement beyond the underwriter's lock-up, the private equity fund stockholders should consider how long these restrictions should continue. Typically, transfer restrictions would terminate either after a specified period of time post-IPO (to allow for an orderly transition period and avoid market disruption shortly following the IPO) or once the stockholders' ownership interests fall below a threshold level (on the theory that a small holder is less likely to disrupt the market for the issuer's securities and/or limit the other shareholders' exit options).

Conclusion

After a portfolio company's IPO, rights to board representation and transfer restrictions on a private equity fund's shares may affect its ability to effect Rule 144 sales and have other legal implications. Consideration should be given to the private equity funds' exit strategy and other business factors, as well as the legal issues summarized above when deciding which provisions of a stockholders agreement should survive the IPO.

Please call your Davis Polk contact if you have any questions regarding post-IPO stockholders agreements or other matters. For a list of Davis Polk's primary private equity lawyers, please click here.