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Top 8 Considerations for Significant Stockholders in an IPO

- ✓ **Be aware of potential "control person" liability**: If a significant stockholder "controls" the issuer, the stockholder may have similar liability under the Securities Act as the issuer.
  - Potential controlling persons should familiarize themselves generally with the disclosure used in connection with the IPO (i.e., prospectus, roadshow and testing the water materials). They should pay particular attention to any high-level statements about an issuer's strategy, business, or financial performance.
  - "Control" generally means the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise. This is not a bright line test; it's a fact intensive analysis.
  - Control person liability could also apply to members of the issuer's board. Consider whether the significant stockholder have a board designee.
- ✓ **Consider implications of designation as an "underwriter" by the SEC**: If the significant stockholder will be a selling stockholder, there is a risk that the SEC will ask that the prospectus include a statement that "the selling stockholder may be deemed an underwriter."
  - This carries the risk of the attachment of the attendant Securities Act liability for underwriters.
  - The stockholder should make sure to review the issuer's response to SEC comment letters and ensure that the issuer tries to resist including this language in the prospectus.
  - The "underwriter" analysis primarily hinges on whether the stockholder purchased the shares of the issuer with "a view to the distribution of those securities."
    - This often depends on the length of time the securities have been held by the stockholder and the role played by the selling stockholder in the offering (i.e., is the selling stockholder helping in typical underwriter role to market the securities).
  - Selling stockholders who believe they are also "control persons" often do not fight this language.
    - Their view is if they are a controlling person, they already have control person liability under and selling stockholder liability under the Securities Act. In other words, if they already have these liabilities, irrespective of being deemed an underwriter, than the inclusion of this language does significantly change their exposure to liability.
- ✓ **Review disclosure about significant stockholder in the prospectus and other offering materials**: The prospectus will include disclosure re: 5%+ stockholders, as well as all selling stockholders.
  - The disclosure will typically cover the identification of beneficial ownership, percentage ownership, and location of executive offices.
  - Transactions between a significant stockholder and the issuer will also need to be disclosed as related party transactions.

✓ Review underwriting agreement and lock-up:

- Significant stockholders, in particular control persons, will sometimes be asked to provide the same reps and warranties and indemnity as the issuer in the underwriting agreement. Typically, this assumption of risk by the stockholder is not appropriate.
- If the stockholder is a selling stockholder, the underwriting agreement will typically include reps from the selling stockholders (i.e., free and clear ownership, authorization, etc.) and will require selling stockholders to provide indemnification to the banks.
  - Powers of attorney and custody agreements will also be required of selling stockholders.
- A significant stockholder, regardless of whether they are selling, should expect to be asked to sign a lock-up.
  - 180 days is standard but it is driven by the investment banks/market; it is not a rule.
  - Make sure exceptions to the lock-up cover any contemplated transactions - often the investment banks will allow for those exceptions if they are discussed in advance and there is a legitimate business need.

✓ Be familiar with the quiet period/gun jumping or "publicity restriction" policies that are implemented: Affiliates of an issuer, even if they are not employees of an issuer, are also subject to the IPO restrictions on publicity and discussions about the company leading up to the pricing of the IPO.

✓ Be familiar with contemplated post-IPO corporate governance policies and structure: Confirm these policies and structure conform to any investor rights agreement that the significant stockholder is a party.

✓ Be aware of FINRA rules if the significant stockholder has an affiliated broker/dealer participating in the offering: Conflict of interest and compensation arrangements with the affiliated broker dealer may be implicated and require additional disclosure and/or the use of a qualified independent underwriter.

✓ Post IPO considerations:

- Reporting obligations: Under Section 13 (if 5%+ beneficial holder) and Section 16 (if 10%+ beneficial holders) of the Exchange Act, such holders are required to make public filings regarding their share ownership and changes in such ownership.
- Section 16 matching: Section 16 includes prohibitions on certain share transactions by 10%+ beneficial holders.
  - The most widely applicable restriction provides that any profits realized by a Section 16 reporting person from any "purchase" and "sale" of securities (or sale followed by a purchase) within any period of less than six months may be recovered by the issuer. There are additional labilities attached to these types of trades.
- Insider trading: Insider trading risk is heightened as the Exchange Act imposes an obligation to either disclose material nonpublic information or abstain from trading on controlling stockholders, who owe a fiduciary duty to the issuer's stockholders.
- "Control" securities: Be aware that even post-IPO, an affiliate of an issuer may not be able to freely trade its shares and would be required to comply with Rule 144's trading restrictions, even if those shares that are purchased in the public market.