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Regulatory: Navigating the "dual track" IPO/M&A process

As the global economy continues to show signs of improvement and markets chart all-time highs, the prospects for initial public offerings (IPOs) look promising and, in particular, the pipeline for IPOs in 2013 appears robust. As has been the trend for the past several years, many companies pursuing an IPO, particularly private equity-backed and venture-backed companies, are expected to run a "dual track" process by pursuing an IPO while simultaneously running a confidential, private auction to sell the company.

The dual track approach is popular because it offers sellers a number of perceived advantages in their search for liquidity and maximum value. The possibility of an imminent IPO lends a sense of urgency to the sale process by creating a "now or never" dynamic for buyers, which can lead to higher sale premiums. A dual track process also allows sellers to preserve optionality as they evaluate the attractiveness of multiple exit (or partial exit) options while hedging against IPO market volatility (which can cause capital markets "windows" to close overnight) and overall deal uncertainty.

The data appears to support the perceived advantages of running a dual track process. A July 2010 study published in the Journal of Business Venturing found that companies sold privately in the course of a dual track process realized a 22 to 26 percent premium over companies acquired without a concurrent IPO process. While a dual track process places increased burdens on management's time and resources, and can further distract management from running the day-to-day operations of the business, a number of synergies between the two paths make the dual track process efficient. For example, for the IPO, the company will set up an electronic data room in which the underwriters and their respective counsel can conduct their due diligence review. The working group will pull together the company's "story" and value proposition, along with detailed business and financial information about the company, which the company will disclose in a registration statement filed with the Securities and Exchange Commission (SEC). Company management will also prepare projections and management presentations. These items play an equally critical role in the M&A path.

The first step in a typical dual track process involves filing the company's IPO registration statement with the SEC. If the company qualifies as an "emerging growth company" under the Jumpstart Our Business Startups Act of 2012, it can file the registration statement confidentially to keep its financial and other disclosures from becoming publicly available. However, the company can issue a press release disclosing the filing, which will initiate the competitive process. During the SEC's 30-day initial review period of the IPO registration statement, the company's financial advisors will contact potential buyers for the M&A process and distribute a "teaser" with high-level information about the company.

Next, the company will negotiate confidentiality agreements with interested buyers and provide a confidential information memorandum (CIM) with information and data largely derived from the IPO registration statement. While projections typically are not included in the IPO registration statement or provided to potential investors in the IPO road show, it is customary for the CIM to include projections. Projections prepared for the M&A

path are typically more aggressive than the internal projections prepared for the IPO as sellers seek to maximize value in connection with a complete, rather than partial, exit of their investment.

Potential buyers will conduct due diligence and provide initial indications of interest. Based on these indications, the company will select a limited number of buyers to proceed to the "second round" of the auction process, during which it will provide more detailed diligence and management presentations. Buyers will then submit final indications of interest, and the company will negotiate definitive documentation to sell the company with a small number of buyers.

Throughout the time that the sale process is progressing, the company will continue to file amendments to its IPO registration statement in response to SEC comments, which further communicates the viability of the IPO path to potential buyers and creates the necessary "tension" that forms the desired competitive dynamic. Typically, the seller will seek to preserve all options until it has a clear view of the preferable path, with the culmination of the dual track process ending in the signing of definitive documentation to sell the company or commencing the road show and pricing the IPO.

Companies should carefully consider which investors to contact in connection with the sale process, because potential buyers who are provided detailed written information about the company will be "boxed out" of purchasing the company's stock in the IPO if the company sale process falls through. This is due to the fact that under federal securities law requirements, companies may not provide written materials to potential purchasers in an IPO until a prospectus complying with the requirements of the Securities Act of 1933 is available. Such a prospectus is commonly referred to as a "preliminary prospectus" or "red herring prospectus." Using a non-compliant preliminary prospectus could be viewed as an illegal "offer" in violation of the Securities Act and potentially provide purchasers who were offered stock a right of rescission under the Securities Act.

Most practitioners take the position that providing detailed written materials to prospective buyers in the M&A path is not problematic (and that such materials are not "offers" to buy securities in the IPO) under applicable securities laws so long as the materials relate solely to the company sale process and the recipients of the information will not be (and will not be permitted to be) purchasers of stock in the IPO. To address these concerns, best practice is not to send the IPO registration statement to potential buyers in the M&A process. Additionally, the confidentiality agreements executed with potential buyers commonly include "standstill" provisions prohibiting buyers from acquiring the target company's stock. These provisions may also explicitly prohibit the potential buyer from purchasing stock in the IPO for a short period of time after the IPO.

As discussed above, the CIM will typically include projections not included in the IPO registration statement. Most practitioners take the position that such projections do not constitute material information in connection with the IPO because they usually are based on numerous aspirational assumptions that cannot be validated and can quickly become stale.

The risk that materials will be disseminated more broadly beyond the limited pool of potential buyers and be leaked to the public is a legitimate source of concern. If private information such as projections becomes publicly available, the SEC may require the company to include (and assume liability for) the information in the IPO registration statement. Accordingly, companies must take precautions to ensure confidentiality in the M&A process.

Carefully orchestrating the timing of steps in both paths in the dual track process is critical so that one process does not get ahead of the other. For example, the company should delay filing an amendment to its registration statement that includes a price range for the stock to be sold in the IPO until such time as it has a good understanding of the likelihood of the M&A path as it will not want to "tip" its hand about the company's valuation in the IPO and adversely affect the price a buyer may offer for the entire company in the sale process.

A dual track process is time and resource intensive. It will require extensive coordination and cooperation among team members, including the seller, management, financial advisors and counsel. If run effectively, however, it can increase the odds that a seller will achieve the most favorable exit and obtain the maximum value available within the context of existing market conditions.

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