

IPO Report

2022

WILMERHALE® 

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REVIEW

Across the board, despite the continuing pall cast by the COVID-19 pandemic, 2021 was a year of very strong IPO deal flow, although aftermarket performance fell well short in comparison to the prior year and broad market indices. The surge in IPOs by special purpose acquisition companies (SPACs) continued at a blistering pace, producing another annual record despite wide swings in quarterly tallies.

Excluding SPAC IPOs and direct listings, the conventional IPO market produced 381 IPOs in 2021, almost double the 209 IPOs in 2020, and the highest annual count since 2000. Each quarter of 2021 accounted for the highest total for that quarter since 2000.

Total gross proceeds for the year were \$134.94 billion, a figure that surpassed 2020's \$76.32 billion tally by 77% and eclipsed 2000's \$108.13 billion total to become the highest annual figure on record.

IPOs by emerging growth companies (EGCs) accounted for 93% of the year's IPOs—up from 90% in 2020.

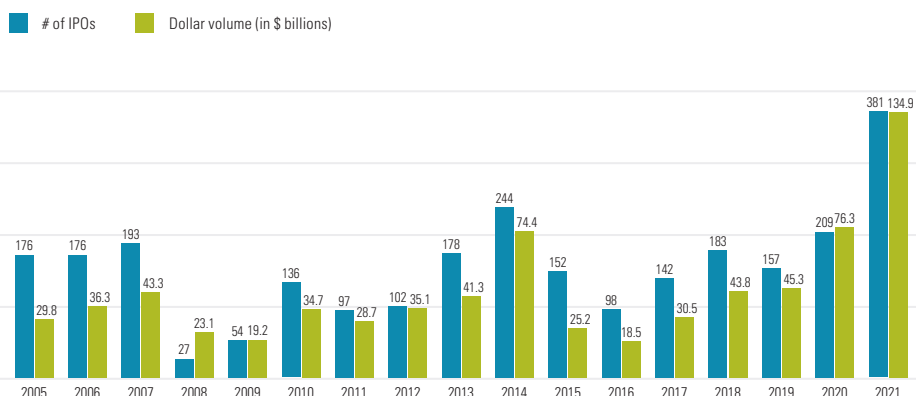
The median offering size for all 2021 IPOs was \$176.9 million, down 2% from the \$180.0 million median for 2020 but 72% higher than the \$102.9 million for the five-year period from 2015 to 2019.

In 2021, the median offering size for IPOs by EGCs was \$167.7 million, 5% higher than the \$160.0 million in 2020. The median non-EGC offering size in 2021 was \$498.8 billion, down 57% from the \$1.17 billion in 2020.

The median annual revenue of all IPO companies in 2021 was \$67.4 million, more than double the \$31.0 million in 2020, and coincidentally equal to the median that prevailed during the five-year period from 2015 to 2019.

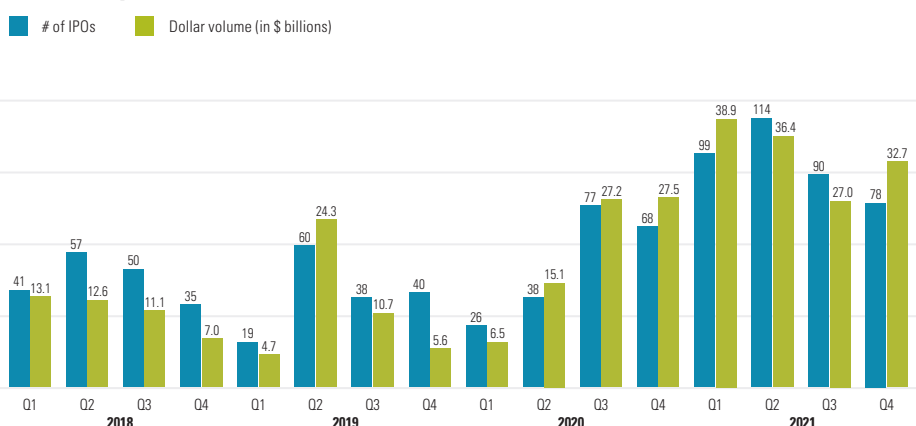
In 2021, 48% of life sciences IPO companies had revenue, down from 53% in 2020. Among non-life sciences IPO companies in 2021, median annual revenue was \$203.2 million, 3% higher than the \$197.2 million median in 2020.

US IPOs by Year—2005 to 2021



Source: SEC filings

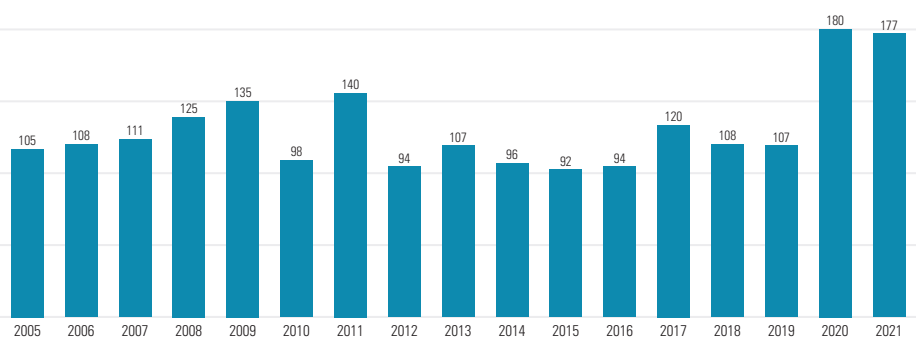
US IPOs by Quarter—2018 to 2021



Source: SEC filings

Median IPO Offering Size—2005 to 2021

\$ millions



Source: SEC filings

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EGC IPO companies in 2021 had median annual revenue of \$41.8 million, compared to \$1.53 billion for non-EGC IPO companies.

The percentage of profitable IPO companies increased to 28% in 2021, from 22% in 2020. Only 10% of life sciences IPO companies were profitable in 2021, compared to 38% of non-life sciences companies.

In 2021, the median IPO produced a first-day gain of 16%, compared to 23% in 2020. These figures represent the two highest median first-day gains since the 24% in 2000.

The median first-day gain for life sciences IPO companies in 2021 was 9%, compared to 17% for non-life sciences IPO companies. Both of these figures were lower than in 2020, when the median first-day gain for life sciences companies was 26%, compared to 20% for non-life sciences IPO companies.

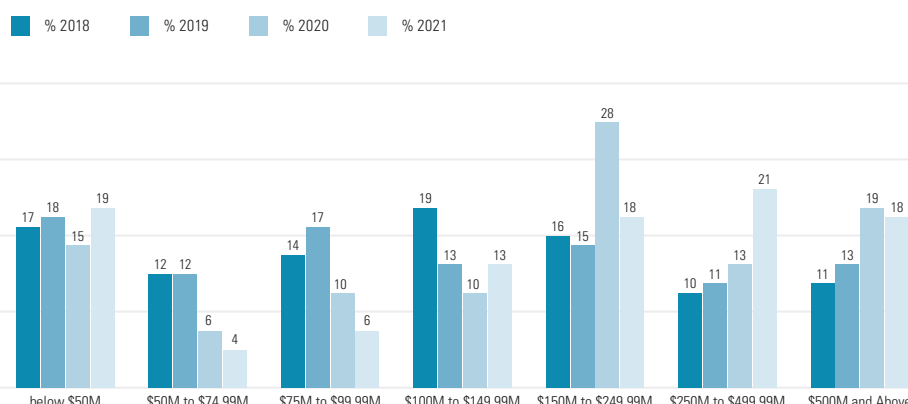
There were 24 “moonshots” (IPOs that double in price on their opening day) in 2021, one more than in 2020. For context, the highest number of moonshots in a single year between 2001 and 2019 was seven.

In 2021, 25% of IPOs were “broken” (IPOs whose stock closes below the offering price on their first trading day), up from 21% in 2020. A higher percentage of life sciences IPOs (28%) than non-life sciences IPOs (24%) were broken.

The median 2021 IPO company ended the year 19% below its offering price—the worst aftermarket performance since 2011. The year’s best-performing IPOs were by Huadi International Group (trading 300% above its offering price at year-end), ZIM Integrated Shipping Services (292%), Esports Technologies (243%) and Regencell Bioscience Holdings (235%).

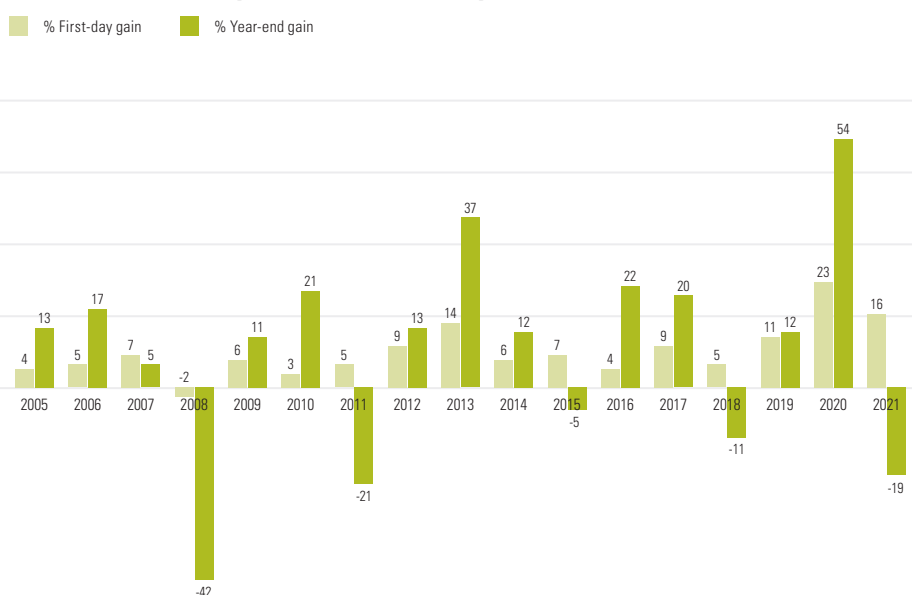
At the end of 2021, 64% of the year’s IPO companies were trading below their offering price—the second-worst figure for this metric since 2000. Life sciences companies fared worse than their non-life sciences counterparts, with three-

Distribution of IPO Offering Size—2018 to 2021



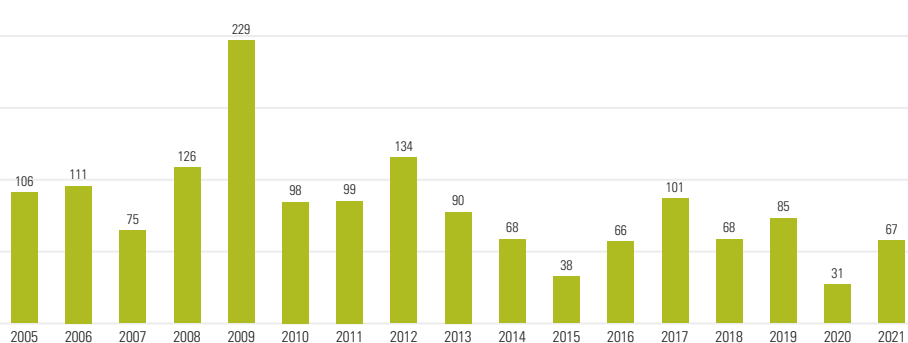
Source: SEC filings

Median IPO First-Day and Year-End Gain by Year—2005 to 2021



Median Annual Revenue of IPO Companies—2005 to 2021

\$ millions



Source: SEC filings and IPO Vital Signs

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quarters trading below their offering price, compared to 57% of other companies.

Individual components of the IPO market fared as follows in 2021:

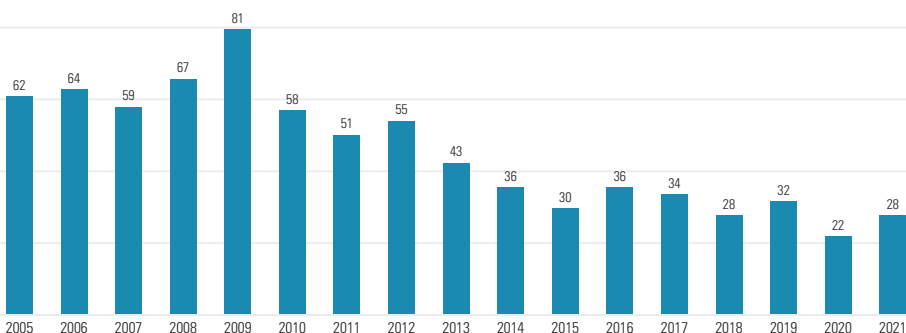
- **VC-Backed IPOs:** The number of IPOs by venture capital-backed US issuers increased by 65%, growing from 95 in 2020 to 157 in 2021—the highest annual figure since the 201 in 2000. The market share of this segment, however, contracted from 64% to 56%. The median offering size for US VC-backed IPOs declined by 4%, from \$182.7 million in 2020 to \$176.0 million in 2021. In comparison, the median offering size for non-VC-backed companies was \$191.2 million. At year-end, the median 2021 US venture-backed IPO company was trading 27% below its offering price.
- **PE-Backed IPOs:** The number of private equity PE-backed IPOs by US issuers almost tripled, from 30 in 2020 to 86 in 2021. Overall, PE-backed issuers accounted for 31% of all US-issuer IPOs in 2021, compared to 20% in 2020. The median offering size for PE-backed IPOs in 2021 was \$335.9 million, down by one-half from the \$674.1 million median in the prior year but still the second-highest annual figure on record. The median PE-backed IPO company ended the year 3% below its offering price.

- **Life Sciences IPOs:** There were 138 life sciences company IPOs in 2021, an increase of 33% from the 104 in 2020. The portion of the IPO market accounted for by life sciences companies decreased to 36% in 2021 from 50% in 2020, largely due to the increase in tech company IPOs. At \$125.9 million, the median offering size for life sciences

DIRECT LISTINGS

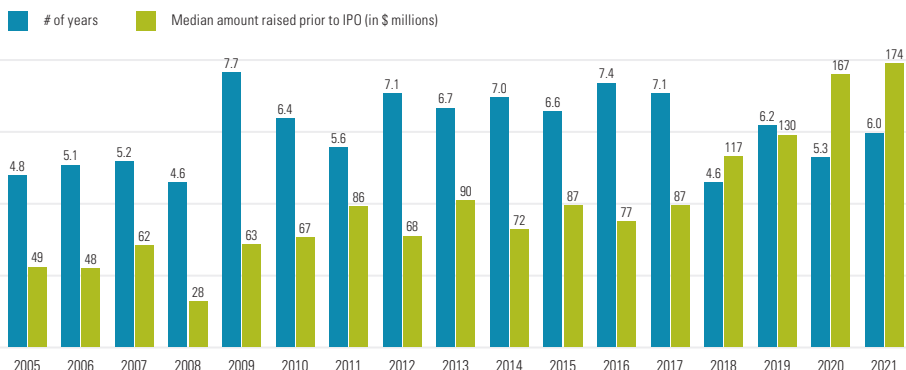
A “direct listing,” in which a private company files a registration statement to register the resale of outstanding shares and concurrently lists its shares on a stock exchange, provides an alternative path to public ownership and liquidity. There were six direct listings in 2021, up from three in 2020, two in 2019, and one—the first direct listing—in 2018. Although the technique remains in its infancy, more can be expected in the coming year.

Percentage of Profitable IPO Companies—2005 to 2021
%



Source: SEC filings and IPO Vital Signs

Median Time to IPO and Median Amount Raised Prior to IPO—2005 to 2021



Source: Pitchbook

IPOs in 2021 was 21% lower than the \$159.1 million in 2020. At year-end, the median life sciences IPO company was trading 27% below its offering price, compared to a loss of 11% for the median non-life sciences IPO company.

- **Tech IPOs:** Deal flow in the technology sector more than doubled, jumping from 69 IPOs in 2020 to 148 IPOs in 2021—the sixth consecutive year of growth. The tech sector’s share of the US IPO market increased to 39% in 2021 from 33% in 2020, representing the industry’s highest market share since the 44% in 2012. The median offering size for tech IPOs in 2021 was \$322.5 million, up 1% from the \$319.0 million median in 2020. The median tech IPO company ended the year 16% below its offering price.

- **Foreign-Issuer IPOs:** The number of US IPOs by foreign issuers increased by two-

thirds, from 60 in 2020 to 100 in 2021. Foreign-issuer IPOs accounted for 26% of the market in 2021, down from 29% in 2020. Although this tally represents the highest annual number of foreign-issuer IPOs since the 107 in 2000, foreign issuers saw their lowest market share since the 20% in 2016. Among foreign issuers, Chinese companies led the year with 36 IPOs (China’s highest annual total since the 40 in 2010), followed by companies from Israel and the United Kingdom (each with ten IPOs), Germany (six IPOs) and Switzerland (five IPOs). The median foreign-issuer IPO company ended the year down 35% from its offering price.

In 2021, 131 companies based in the eastern United States (east of the Mississippi River) completed IPOs, compared to 150 western US-based issuers. California led the state rankings with 97 IPOs, followed by New

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York (33 IPOs), Massachusetts (31 IPOs), Texas (16 IPOs) and Florida (15 IPOs).

OUTLOOK

IPO market activity in the coming year will depend on a number of factors, including the following:

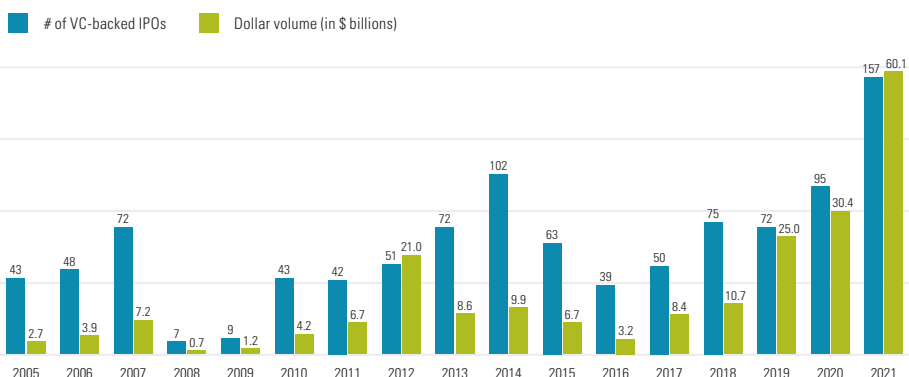
- **Economic Growth:** Following strong GDP increases in the first and second quarters of 2021, economic growth slowed to a tepid 2.3% in the third quarter, hampered by pandemic concerns and persistent bottlenecks in the supply chain. A rebound in the fourth quarter helped buoy annual GDP growth, resulting in initial estimates of 5.7% for the year—the highest annual growth rate since 1984. Although the fluctuations in quarterly GDP point to a skittish economy that remains closely tied to COVID-19 infection levels, the widespread availability of vaccines and the development of new treatments provide hope for a “new normal.” Apart from the pandemic, the economy also faces the headwinds of rising interest rates, inflationary pressures and, more recently, the economic fallout from Russia’s invasion of Ukraine.
- **Capital Market Conditions:** Despite market declines in the third quarter and apprehension following the emergence of each new COVID-19 variant, all major US stock indices ended the year

SPAC IPOs

In 2021, there were 613 SPAC IPOs with gross proceeds of \$144.54 billion, more than double the 2020 tally of 248 SPAC IPOs with gross proceeds of \$75.73 billion, and ten times the 2019 tally of 59 SPAC IPOs with gross proceeds of \$12.07 billion. Deal flow in the SPAC IPO market outpaced the conventional IPO market for the second consecutive year, while SPAC IPO gross proceeds exceeded the conventional IPO market for the first time.

The first quarter of 2021 accounted for almost one-half of the year’s total, with 298 SPAC IPOs raising \$87.01 billion. Pricing activity declined sharply in the second quarter before rebounding in the third and fourth quarters. At year-end, 574 SPACs were searching for a business combination and another 272 SPACs were in IPO registration.

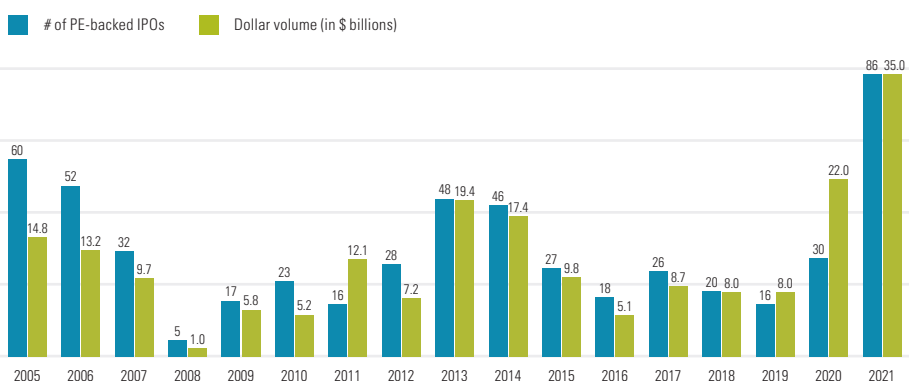
Venture Capital–Backed IPOs—2005 to 2021



Source: SEC filings

Based on US IPOs by VC-backed US issuers

Private Equity–Backed IPOs—2005 to 2021



Source: Refinitiv and SEC filings

Based on US IPOs by PE-backed US issuers

in positive territory, with the Dow Jones Industrial Average up 19%, the Nasdaq Composite Index up 21% and the S&P 500 up 27%. With the median US IPO having outperformed the Dow and Nasdaq in only one of the last five years, some investor interest could shift from IPOs to pre-IPO opportunities.

- **Venture Capital Pipeline:** VC-backed companies enjoyed a record level of investment in 2021, with more than twice as many rounds of at least \$100 million than in 2020. While the ability to raise private “IPO-sized” rounds has become almost routine, allowing companies to delay their public debuts, the desire of investors for cash returns—combined with the favorable returns realized on many VC-backed IPOs in recent years—is likely to draw a steady stream of VC-backed companies to the public markets in 2022.

- **Private Equity Impact:** Restocked with \$475 billion of new capital in 2021, US private equity firms continue to hold large amounts of “dry powder” to deploy. The enormous amount of capital flowing into the PE market and the surge in SPAC IPOs has intensified competition for attractive deals and driven up prices, making it harder for PE firms to allocate investments profitably. At the same time, PE firms face pressure to exit investments—via IPOs or sales of portfolio companies—and return capital to investors.

The IPO market enters 2022 with a pipeline full of well-funded candidates and investors eager to embrace companies with exciting business models and new technologies. Although it will be difficult to top the IPO deal flow of 2021, robust capital market activity can be expected in the coming year.

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CALIFORNIA

The number of California IPOs increased for the fifth consecutive year, growing by 87%, from 52 in 2020 to 97 in 2021—the highest yearly count since the 131 IPOs in 2020.

Buoyed by eleven billion-dollar offerings, including the largest US IPO since 2014, gross proceeds increased by 92%, from \$24.70 billion in 2020 to a record annual total of \$47.36 billion in 2021.

The largest California IPO in 2021 came from electric vehicle maker Rivian Automotive (\$11.93 billion), followed by offerings from Robinhood Markets (\$2.09 billion), Applovin (\$2.00 billion) and Olaplex (\$1.55 billion).

Technology and life sciences companies accounted for 78% of the state's IPO total in 2021—down from their 90% share in 2020.

The number of venture-backed California IPOs increased from 42 in 2020 to 69 in 2021. The 2021 tally represents 44% of all US-issuer VC-backed IPOs, the same as in 2020 and just over the 43% that prevailed during the five-year period from 2015 to 2019.

The median 2021 California IPO produced a first-day gain of 16%. Nano-cap cinema equipment maker Moving iMage was the state's top performer with a first-day gain of 700%, followed by Poshmark (up 142%), DICE Therapeutics (up 117%) and Design Therapeutics (up 107%).

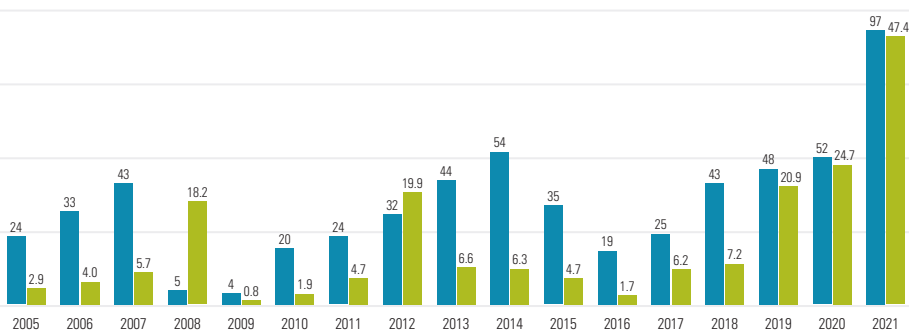
At year-end, 60% of the state's 2021 IPOs were trading below their offering price, with the median California IPO down 14% from its offering price.

The best-performing California IPO of the year was Vera Therapeutics (up 143% at year end), followed by Confluent (up 112%), Prometheus Biosciences (up 108%) and Affirm Holdings (up 105%).

With the largest pool of venture capital-backed companies in the United States and a wealth of entrepreneurial talent, California should remain a major source of strong IPO candidates in the coming year, particularly from the technology and life sciences sectors.

California IPOs—2005 to 2021

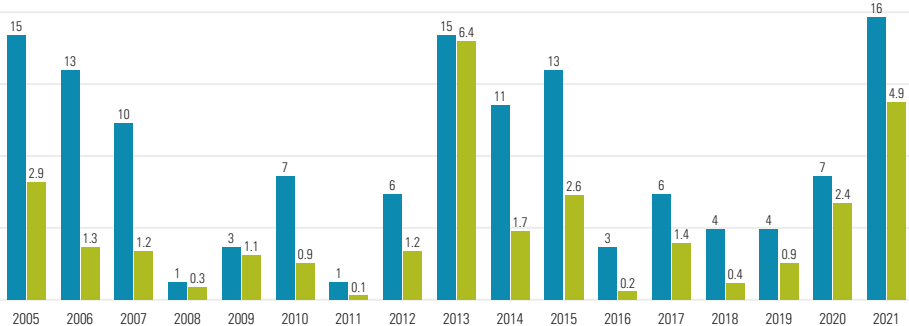
of IPOs Dollar volume (in \$ billions)



Source: SEC filings

Mid-Atlantic IPOs—2005 to 2021

of IPOs Dollar volume (in \$ billions)



Source: SEC filings

MID-ATLANTIC

The mid-Atlantic region of Virginia, Maryland, North Carolina, Delaware and the District of Columbia produced 16 IPOs in 2021, up from seven in 2020 and the highest annual tally since the 24 in 2000.

North Carolina produced six of the region's IPOs in 2021, with Maryland and Virginia each contributing five.

Gross proceeds in the mid-Atlantic region more than doubled for the second consecutive year, growing from \$2.38 billion in 2020 to \$4.86 billion in 2021.

The largest mid-Atlantic IPOs of 2021 came from Virginia-based Fluence Energy (\$868 million), followed by a trio of North

Carolina-based companies—Driven Brands (\$700 million), AvidXchange (\$660 million) and Krispy Kreme (\$500 million).

The median 2021 mid-Atlantic IPO produced a first-day gain of 22%, led by Xometry (up 99%), Privia Health (up 51%) and Neximmune (up 49%).

At year-end, in contrast to nationwide results, 56% of the region's 2021 IPOs were trading above their offering price, with the median mid-Atlantic IPO trading up 10%. The region's best-performing IPOs at year-end were Driven Brands Holdings (up 53%), Bowman Consulting Group (up 52%) and Fluence Energy (up 27%).

The region's traditional strengths in the life sciences, technology, financial services and defense sectors should continue to produce attractive IPO candidates in 2022.

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NEW ENGLAND

After nearly doubling between 2019 and 2020, the number of New England IPOs increased at a more measured pace in 2021, climbing 17%, from 29 in 2020 to 34.

Massachusetts accounted for all but three of the region's IPOs in 2021—the state's tally of 31 IPOs was the third-highest state total in the country—with Connecticut accounting for the remaining three.

Gross proceeds in the region, which had more than tripled between 2019 and 2020, inched up 3%, from \$6.28 billion in 2020 to \$6.47 billion in 2021.

The largest New England IPO in 2021 was by Toast (\$870 million), provider of a cloud-based software and payments platform for the restaurant industry, followed by Signify Health (\$564 million) and Definitive Healthcare (\$420 million).

With 27 life sciences company IPOs in 2021, the region accounted for 25% of all US-issuer life sciences IPOs in the country, compared to 30% in 2020.

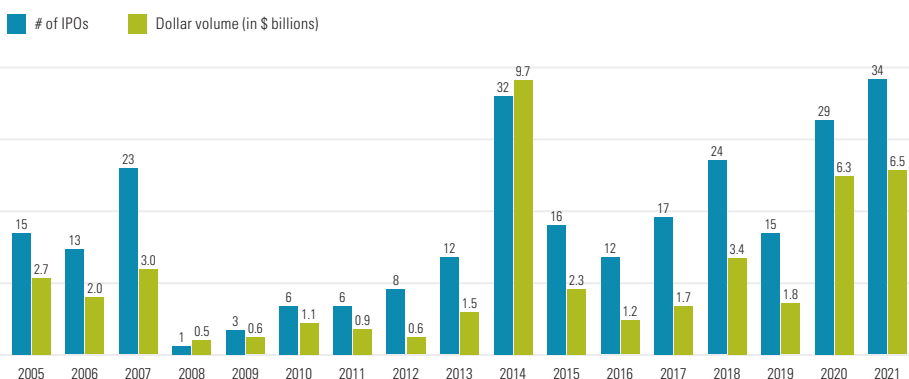
The number of venture-backed New England IPOs increased from 26 in 2020 to 30 in 2021. The region accounted for 19% of all US-issuer VC-backed IPOs in 2021, down from 27% in 2020.

The median 2021 New England IPO produced a first-day gain of 17%. The region's top performers in first-day trading were Vor Biopharma (up 108% from its offering price), Ikena Oncology (up 100%) and Verve Therapeutics (up 68%).

At year-end, the median New England IPO was down 21% from its offering price, with 74% of the region's IPOs trading below their offering price. The best-performing New England IPOs at year-end were Verve Therapeutics (up 94%), Flywire (up 59%) and SEMrush Holdings (up 49%).

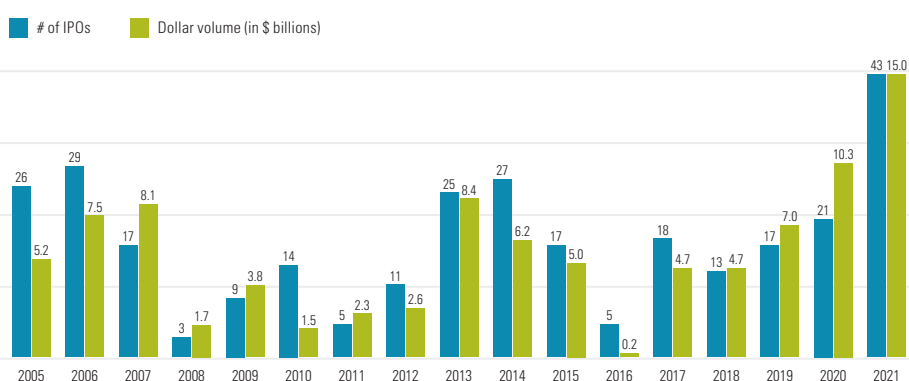
With the region's world-renowned universities and research institutions continuing to spawn tech and life sciences companies, and with strong levels of venture capital investment, New England should continue to generate compelling IPO candidates in the coming year.

New England IPOs—2005 to 2021



Source: SEC filings

Tri-State IPOs—2005 to 2021



Source: SEC filings

TRI-STATE

The number of IPOs in the tri-state region of New York, New Jersey and Pennsylvania more than doubled, from 21 in 2020 to 43 in 2021.

New York produced 33 of the region's 2021 IPOs, representing the second-highest state total in the country for the first time since 2013, with Pennsylvania accounting for six and New Jersey the remaining four.

Gross proceeds from tri-state IPOs increased by 46%, from \$10.26 billion in 2020 to \$15.01 billion in 2021, led by GlobalFoundries (\$2.59 billion), Oscar Health (\$1.44 billion) and UiPath (\$1.34 billion).

The tri-state region produced 20 VC-backed IPOs in 2021, up from 12 the prior year and its highest tally since 1999.

The median 2021 tri-state IPO produced a first-day gain of 6%. The region's top performers in first-day trading were Glimpse Group (up 152% from its offering price), Stronghold Digital Mining (up 52%) and Braze (up 44%).

At year-end, the median tri-state IPO was down 25% from its offering price. The best performing tri-state IPO was by authentication solutions provider authID.ai (up 100% from its offering price at year-end), followed by DigitalOcean Holdings (up 71%) and Hayward Holdings (up 54%).

With a high level of venture capital activity and a sophisticated capital markets ecosystem in the region, the coming year should see tri-state IPOs from emerging life sciences and technology companies and larger, private equity-backed companies.

8 IPO Market by the Numbers

PROFILE OF SUCCESSFUL IPO CANDIDATES

What does it really take to go public? There is no single profile of a successful IPO company, but in general the most attractive candidates have the following attributes:

- **Outstanding Management:** An investment truism is that investors invest in people, and this is even truer for IPO companies. Every company going public needs experienced and talented management with high integrity, a vision for the future, lots of energy to withstand the rigors of the IPO process and public company life, and a proven ability to execute. An IPO is not the best time for a fledgling CEO or CFO to cut his or her teeth.
- **Market Differentiation:** IPO candidates need a superior technology, product or service in a large and growing market. Ideally, they are viewed as market leaders. Appropriate intellectual property protection is expected of technology companies, and in some sectors, such as life sciences and medical devices, patents are *de rigueur*.
- **Substantial Revenue:** Substantial revenue is generally expected—at least \$50 million to \$75 million annually—in order to provide a platform for attractive levels of profitability and market capitalization.
- **Revenue Growth:** Consistent and strong revenue growth—25% or more annually—is usually needed, unless the company has other compelling features. The company should have visibility into sustained expansion to avoid the market punishment that accompanies revenue and earnings surprises.
- **Profitability:** Strong IPO candidates generally have track records of earnings and a demonstrated ability to enhance margins over time, although IPO investors often appear to value growth more highly than near-term profitability.
- **Market Capitalization:** The company's potential market capitalization should be at least \$200 million to \$250 million, in order to facilitate development of a liquid trading market. Substantial post-IPO ownership by insiders may mean a larger market cap is required to provide ample float.

HOW DO YOU COMPARE?

Set forth below are selected key metrics about the IPO market, based on combined data for all US IPOs during the three-year period from 2019 through 2021.

Percentage of IPO companies qualifying as EGCs under JOBS Act	92%
Median offering size	\$163.9 million (18% below \$50 million and 17% above \$500 million)
Median annual revenue of IPO companies	\$59 million (48% below \$50 million and 15% above \$500 million)
Percentage of IPO companies that are profitable	27%
State of incorporation of IPO companies	Delaware—95% No other state over 3%
Percentage of IPOs including selling stockholders, and median percentage of offering represented by those shares	Percentage of IPOs—20% Median percentage of offering—32%
Percentage of IPOs including directed share programs, and median percentage of offering represented by those shares	Percentage of IPOs—44% Median percentage of offering—5%
Percentage of IPO companies disclosing adoption of ESPP	69%
Percentage of IPO companies using a “Big 4” accounting firm	74%
Stock exchange on which the company's common stock is listed	Nasdaq—78% NYSE—22%
Median underwriting discount	7%
Number of SEC comments contained in initial comment letter	Median—16 25th percentile—12 75th percentile—21
Median number of Form S-1 amendments (excluding exhibits-only amendments) filed before effectiveness	Four
Time elapsed from initial confidential submission to initial public filing of Form S-1	Median—72 calendar days 25th percentile—56 calendar days 75th percentile—106 calendar days
Time elapsed from initial confidential submission or initial public filing to effectiveness of Form S-1	Median—104 calendar days 25th percentile—83 calendar days 75th percentile—158 calendar days
Median offering expenses	Legal—\$1,800,000 Accounting—\$1,032,500 Total—\$3,873,750

Other factors can vary based on a company's industry and size. For example, many life sciences companies will have much smaller revenue and not be profitable. More mature companies are likely to have greater revenue and market caps, but slower growth rates. High-growth companies are likely to be smaller, and usually have a shorter history of profitability.

Beyond these objective measures, IPO candidates need to be ready for public ownership in a range of other areas, including accounting preparation; corporate governance; financial and disclosure controls and procedures; external communications; legal and regulatory compliance; and a variety of corporate housekeeping tasks. ■

Constructing a Public-Ready Board of Directors

9 Navigating the Thicket of SEC, Stock Exchange and State Law Requirements

SEC and stock exchange rules impose a variety of independence and other requirements for boards and board committees of public companies, and some states now impose additional diversity requirements. Few private companies satisfy all these requirements. An essential element of a company's IPO planning is to assess the composition of the company's board and board committees and develop a plan to come into full compliance with the applicable requirements within the prescribed timelines.

Although phase-in rules apply to many of these requirements, a company planning to go public ideally should begin discussing potential changes in board composition that may be needed to satisfy all the requirements at least six to twelve months before the IPO. Time will be needed to recruit new members, particularly diverse directors.

Companies are often surprised by how challenging it can be to recruit new directors. This task has increased in difficulty due to a variety of factors, including more stringent independence requirements, the heavier workloads now expected of directors, a perception of increased personal exposure to liability and, most recently, stricter investor policies against director "over-boarding" (several major institutional investors will vote against a director if that director sits on more than four boards or, in the case of a director who is an executive officer, sits on more than two boards). The company should also plan for the possibility that existing directors affiliated with venture capital or private equity investors may want to leave the board shortly following the IPO.

BOARD OF DIRECTORS

— **Independence:** Subject to phase-in rules, Nasdaq and NYSE require a majority of the members of the board, and all members of the audit, compensation, and corporate governance and nominating committees, to be independent within one year after the company's IPO.

— **Determination of Independence:** In order for a director to be

INDEPENDENCE PHASE-IN RULES

ELEMENT	NASDAQ	NYSE
Independent board of directors	The board must be composed of a majority of independent directors within one year of the listing date.	
Audit Committee	The audit committee must have at least one independent member by the listing date, at least a majority of independent members within 90 days of listing, and must be fully independent within one year of listing. ¹	The audit committee must have at least one independent member by the listing date, at least a majority of independent members within 90 days of the effective date of its Form S-1, and must be fully independent within one year of the effective date of the Form S-1.
Compensation Committee	The compensation committee must have at least one independent member by the listing date, at least a majority of independent members within 90 days of listing, and must be fully independent within one year of listing.	The compensation committee must have at least one independent member by the earlier of the date the IPO closes or five business days from the listing date, at least a majority of independent members within 90 days of the listing date, and must be fully independent within one year of the listing date.
Nominating Committee	If the company elects to establish a nominating committee, the committee must have at least one independent member by the listing date, at least a majority of independent members within 90 days of listing, and must be fully independent within one year of listing.	The nominating committee must have at least one independent member by the earlier of the date the IPO closes or five business days from the listing date, at least a majority of independent members within 90 days of the listing date, and must be fully independent within one year of the listing date.

¹ Nasdaq also has a temporary "exceptional and limited circumstances" exception for one non-independent member. This exception allows one director who is independent under Rule 10A-3 but not independent under the general Nasdaq standard, and who is not a current executive officer or employee of the company (or a family member of a current executive officer of the company), to serve on the audit committee for up to two years if the board determines that such service is required by the best interests of the company and its stockholders. A person serving on the audit committee under this exception may not chair the audit committee. Similar exceptions apply to the compensation and nominating committees of Nasdaq-listed companies. Very few companies take advantage of these exceptions.

considered independent, Nasdaq and the NYSE require that:

- the director not have any relationship with the company that would be prohibited by that stock exchange's "bright-line" independence standards; and
- the board, after taking into account all relevant information, affirmatively determine that the director is independent.

— **Impact of Stock Ownership:** Stock ownership, regardless of how high the level, is generally not viewed as an impediment to independence (but may preclude service on the audit committee, as noted below).

— **Diversity:** Nasdaq rules and state law requirements impose board diversity requirements in some circumstances:

- **Nasdaq:** Subject to phase-in rules, a company listing on Nasdaq in connection with an IPO must have—or explain why it does not have—at least two diverse directors (including one female and one underrepresented minority or LGBTQ+) by the later of two years from the date of listing or the date it files a proxy statement for its second annual meeting of stockholders.
- **State Laws:** Depending on board size, California requires public companies headquartered in California to have up to three female directors (requirement became effective at the end of 2021) and up to three directors from

Constructing a Public-Ready Board of Directors

10 Navigating the Thicket of SEC, Stock Exchange and State Law Requirements

“underrepresented communities” by the end of 2022. Washington requires public companies incorporated in Washington (subject to several exceptions, including for emerging growth companies, smaller reporting companies and controlled companies) to have boards on which at least 25% of the members are women or to provide a “board diversity discussion and analysis” to stockholders. Various other states are considering similar board quota and/or diversity disclosure requirements. (Board diversity is discussed further on pages 12–13.)

- **Size:** Neither SEC, Nasdaq nor NYSE rules stipulate board size.

AUDIT COMMITTEE

- **General:** Subject to phase-in rules, Nasdaq and NYSE require listed companies to have an audit committee composed of at least three members of the board of directors, each of whom is (1) independent within the meaning of the general Nasdaq or NYSE rules described above and (2) independent within the stricter meaning of SEC Rule 10A-3.
- **“Super Independence”:** Rule 10A-3 precludes a person from serving on the audit committee if the person:
 - accepts, directly or indirectly, any consulting, advisory or other compensatory fees from the company (other than compensation for board service and certain retirement compensation); or
 - is an “affiliate” of the company (a person who, directly or indirectly, controls, is controlled by, or is under common control with, the company).
- **Impact of Stock Ownership:** A person can be an “affiliate” due to large stock ownership. Rule 10A-3 contains a safe harbor for ownership of 10% (post-offering) or less. Ownership of 20% (post-offering) is generally viewed as the upper bound, although even higher examples exist.
- **Financial Literacy:** Nasdaq and NYSE rules require each member of the audit committee to be financially literate,

with at least one member having experience in finance or accounting.

- **Audit Committee Financial Expert:** Each public company is required to disclose annually whether or not its audit committee has at least one member who is an “audit committee financial expert,” as defined in SEC rules, and, if not, to explain why it does not. This effectively requires every public company to have an audit committee financial expert.
- **Size:** Nasdaq requires the audit committee to have a minimum of three members at all times. NYSE requires the audit committee to have at least one member by the listing date, at least two members within 90 days of the listing date, and at least three members within one year of the listing date.

COMPENSATION COMMITTEE

- **General:** Nasdaq and NYSE require listed companies to have a compensation committee composed of members of the board of directors who are independent within the meaning of the general Nasdaq or NYSE rules described above.
- **“Enhanced Independence”:** Nasdaq and the NYSE require that, in determining the independence of members of the compensation committee, the board must consider all factors relevant to whether a director has a relationship that is material to that director’s ability to be independent of management, including:
 - the source of compensation of such director, including any consulting, advisory or other compensatory fees paid by the company to such director; and
 - whether such director is affiliated with the company.
- **Impact of Stock Ownership:** Nasdaq and the NYSE have indicated that ownership of company stock, even if it represents a controlling interest, does not automatically disqualify a director from service on the compensation committee.
- **Rule 16b-3:** Section 16(b) of the Securities Exchange Act of 1934 requires directors, executive officers and 10% stockholders

BRIGHT-LINE INDEPENDENCE STANDARDS

While there are some differences between the bright-line independence standards of Nasdaq and the NYSE, as a general matter a person cannot be considered independent if:

- he or she is, or at any time during the past three years was, an employee of the company;
- his or her family member is, or at any time during the past three years was, an executive officer of the company, with an exception for interim service as an executive officer (for a period not exceeding one year under Nasdaq rules; NYSE rules do not specify a maximum period of interim service);
- he or she (or a family member) has, or at any time during the past three years had, a “compensation committee interlock,” which exists when an executive officer of Company A serves on the compensation committee of Company B at the same time that a director of Company A (or his or her family member) serves as an executive officer of Company B;
- he or she (or a family member) has, or at any time during the past three years had, certain specified relationships with the company’s auditor, including the company’s internal auditor in the case of the NYSE;
- he or she (or a family member) has certain specified relationships with another entity that, in the past three years, received payments from or made payments to the company for property or services in excess of:
 - in the case of Nasdaq, the greater of \$200,000 and 5% of the recipient’s gross revenues for that year; or
 - in the case of the NYSE, the greater of \$1 million and 2% of the other company’s gross revenues for that year; or
- he or she (or a family member) received compensation from the company in excess of \$120,000 during any twelve-month period within the past three years, other than compensation for service on the board or a board committee, compensation paid to a family member as a non-executive employee, and certain other exempted payments.

to disgorge to the company any “profit” realized through any purchase and sale (or any sale and purchase) of equity securities of the company within a period of less than six months. SEC Rule 16b-3 provides that the grant of a stock option or other equity compensation

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award will not be considered a matchable purchase if the grant is approved by a board committee consisting of two or more directors, each of whom is a “non-employee director” within the meaning of Rule 16b-3. Although workarounds exist, it is desirable for each member of the compensation committee to qualify as a “non-employee director.”

- **Size:** Nasdaq requires that the compensation committee consist of at least two directors, while the NYSE does not specify a minimum number of members.

OTHER STANDING COMMITTEES

Post-IPO, public company boards—particularly among larger companies—sometimes voluntarily create other standing committees to help fulfill board duties. According to the 2021 U.S. Spencer Stuart Board Index, among S&P 500 companies, the average number of standing board committees is 4.2, with the following prevalence:

- Executive committee—27% (down from 33% in 2016)
- Finance committee—27% (down from 31% in 2016)
- Science and technology committee—13% (up from 9% in 2016)
- Risk committee—12% (unchanged from 2016)
- Environment, health and safety committee—11% (up from 7% in 2016)
- Public policy/social and corporate responsibility committee—7% (down from 10% in 2016)
- Legal/compliance committee—6% (up from 5% in 2016)
- Investment/pension committee—3% (unchanged from 2016)
- Acquisitions/corporate development committee—2% (unchanged from 2016)
- Strategy and planning committee—2% (unchanged from 2016)

The 200 public technology companies covered by the 2021 U.S. Technology Spencer Stuart Board Index have fewer standing board committees on average than S&P 500 companies and are less likely to have most types of standing committees covered by both reports.

CORPORATE GOVERNANCE AND NOMINATING COMMITTEE

- **NYSE:** NYSE rules require each listed company to have a nominating or corporate governance committee composed solely of independent directors under the NYSE’s general definition of independence.
- **Nasdaq:** Although not mandating that each listed company establish a nominating or corporate governance committee, Nasdaq rules require director nominees to be selected, or recommended for selection by the board, by either a nominating committee composed solely of independent directors or by a majority of the independent members of the board. Most Nasdaq-listed companies elect to have a nominating and corporate governance committee to satisfy this requirement.
- **Size:** Neither NYSE nor Nasdaq prescribe any minimum size for the nominating and corporate governance committee.

EXEMPTIONS

- **Controlled Companies:** A controlled company is exempt from the requirements that a majority of the directors be independent and that the board maintain a separate compensation committee and a separate corporate governance and nominating committee (or, in the case of Nasdaq, have a majority of the independent directors make nominations). A controlled company is not exempt from audit committee requirements.
- **Smaller Reporting Companies:** A smaller reporting company is required to comply with all director independence and board committee requirements, except that it is exempt from the “enhanced independence” requirements for compensation committee members mandated by the Dodd-Frank Act.
- **Foreign Private Issuers:** A foreign private issuer is permitted to follow its home-country practices in lieu of some corporate governance requirements as long as it satisfies Exchange Act

DEFINITIONS

For purposes of various exemptions, the following definitions apply:

- **Controlled Company:** A company in which a majority of the voting power for the election of directors is held by an individual, a group, or another company.
- **Smaller Reporting Company:** A company that, as of the last business day of its most recently completed second fiscal quarter, has a public float of less than \$250 million or, if the company has a public float of less than \$700 million or has no public float, had less than \$100 million in revenue in its most recent fiscal year.
- **Foreign Private Issuer:** A company organized under the laws of a foreign country and in which 50% or less of its outstanding voting securities are directly or indirectly owned of record by US residents, or in which a majority of its executive officers or directors are not US citizens or residents, a majority of its assets are not located in the United States and its business is not administered principally in the United States.
- **Emerging Growth Company:** A company that had total annual gross revenues of less than \$1.07 billion (subject to adjustment every five years for inflation, with the next adjustment due in April 2022) during its most recently completed fiscal year. A company’s EGC status lasts until the last day of the fiscal year following the fifth anniversary of its IPO, subject to earlier termination in specified circumstances.

requirements for audit committees and makes public disclosure of the home-country practices it follows. A foreign private issuer is also exempt from the requirements that a majority of the directors be independent and that the board maintain a separate compensation committee and a separate corporate governance and nominating committee (or, in the case of Nasdaq, have a majority of the independent directors make nominations).

An important threshold question for an IPO company that qualifies for exemptions from corporate governance requirements is whether to take advantage of the exemptions, as the absence of these investor protections may be perceived negatively in the market and adversely affect the marketing of the offering. ■

Board Diversity Planning Now Part of the IPO Process

12 Public Companies Face a Variety of Diversity Requirements and Expectations

In recent years a variety of stakeholders have become increasingly vocal in advocating for more diversity on public company boards. The efforts to increase board diversity—by securities regulators, stock exchanges, proxy advisory firms, institutional investors, state legislatures, and even investment bankers, among others—have gained traction and now affect both the IPO process and life as a public company.

Recruitment of new directors has always been on the checklist when preparing for life as a public company, primarily to satisfy stock exchange independence requirements. The recruitment of diverse board candidates is now also an important part of that checklist, and could even impact the company's choice of lead IPO underwriter.

Recruiting new directors is not a new challenge in the IPO process—time is needed to identify and vet suitable candidates. Recruiting new diverse directors can be especially challenging due to the large number of public companies currently seeking to enhance their board diversity. Regardless of whether a search firm is used to increase the pool of candidates, the process of identifying new directors typically involves an unexpectedly large amount of board time and effort.

Accordingly, companies should begin thinking about the recruitment of diverse directors as soon as they conclude that an IPO is a realistic goal. While securing new directors is not an absolute requirement for an IPO, starting the recruitment process early enough that new directors can be onboarded before the IPO will likely accelerate their integration into the fabric of the board.

SEC RULES

An SEC rule requires public companies to disclose in their proxy statement whether—and if so, how—diversity is considered in identifying director nominees. The SEC left it to each company to determine how it defines diversity when adopting this requirement. In partial response to this SEC rule and other efforts

FORMAT OF NASDAQ ANNUAL DISCLOSURE REQUIREMENT

BOARD DIVERSITY MATRIX (AS OF [DATE])				
Total Number of Directors	#			
	Female	Male	Non-Binary	Did Not Disclose Gender
PART I: Gender Identity				
Directors	#	#	#	#
PART II: Demographic Background				
African American or Black	#	#	#	#
Alaskan Native or Native American	#	#	#	#
Asian	#	#	#	#
Hispanic or Latinx	#	#	#	#
Native Hawaiian or Pacific Islander	#	#	#	#
White	#	#	#	#
Two or More Races or Ethnicities	#	#	#	#
LGBTQ+	#			
Did Not Disclose Demographic Background	#			

to increase the gender diversity of boards, many public companies now include in their corporate governance guidelines a statement about giving consideration to diversity in evaluating director candidates and requiring the same of any third parties hired to conduct a director search.

During 2022, the SEC is expected to propose several ESG-related rule changes, including enhanced disclosure requirements regarding board diversity.

NASDAQ RULES

In August 2021, the SEC approved new Nasdaq rules that, subject to a phase-in period, require every Nasdaq-listed company to:

- have—or explain why it does not have—at least two board members who are diverse, including one who self-identifies as female and one who self-identifies as an underrepresented minority or LGBTQ+; and
- publicly disclose, at least once per year, in a standardized matrix format prescribed by Nasdaq, aggregated information on the voluntarily self-identified gender, racial/ethnic and LGBTQ+ status of the company's directors, to the extent permitted by applicable law.

Less stringent thresholds apply for foreign issuers, smaller reporting companies, and boards with five or fewer members. SPACs that have not completed a business combination transaction are exempt from the rules.

A company going public is not required to be in compliance with the rules at the time of its IPO or to include in the Form S-1 any diversity information pursuant to the rules. Instead, following completion of the initial phase-in period, a company listing on Nasdaq in connection with an IPO generally must have—or explain why it does not have—at least one diverse director by the later of one year from the date of listing or the date the company files a proxy statement for its first annual meeting of stockholders and at least two diverse directors by the later of two years from the date of listing or the date it files a proxy statement for its second annual meeting of stockholders.

PROXY ADVISOR POLICIES

The two leading proxy advisory firms, ISS and Glass Lewis, have each adopted voting policies relating to board diversity.

For Russell 3000 and S&P 1500 companies, ISS will generally recommend voting

Board Diversity Planning Now Part of the IPO Process

13 Public Companies Face a Variety of Diversity Requirements and Expectations

against the chair of the nominating committee where there are no women on the board or where there are no racially or ethnically diverse members. That recommendation could extend to other directors on a case-by-case basis. Beginning in 2023, ISS plans to apply its gender diversity policy to all companies.

For Russell 3000 companies, Glass Lewis will generally recommend voting against the nominating committee chair of a board with fewer than two gender diverse directors and against the entire nominating committee of a board with no gender diverse directors. For annual meetings held after January 1, 2023, Glass Lewis will move from a fixed numerical approach and will recommend voting against the nominating committee chair of a board at a Russell 3000 company that has less than 30% gender diversity. In addition, Glass Lewis will recommend voting against the chair of the nominating and/or governance committee of S&P 500 companies that provide insufficient board diversity disclosure. Glass Lewis will also make recommendations in accordance with mandatory board composition requirements set forth in applicable state laws.

INSTITUTIONAL INVESTOR POLICIES

The three largest institutional stockholders—BlackRock, State Street Global Advisors and Vanguard—each include a separate section on board diversity in their voting guidelines and have increased their engagement with public companies about board diversity in recent years. While the views of these investors largely overlap with other diversity requirements, their influence on proxy voting should be considered by companies building their boards.

STATE LAW REQUIREMENTS

States are playing an increasingly active role in promoting board diversity among companies that are incorporated under their laws or satisfy other criteria. For example, California and Washington mandate specified levels and types of board

diversity, while Illinois, Maryland and New York mandate disclosure regarding board diversity. Other states are considering mandatory board diversity legislation, or have adopted (or are considering) non-binding resolutions urging public companies to increase board diversity. This is a quickly evolving area; companies need to monitor developments in applicable states to remain in compliance.

IPO PROCESS AND INVESTMENT BANKERS

Because the operative characteristics of diversity extend beyond visible attributes, companies should consider adding self-identification questions to their director recruiting documents and IPO director questionnaires.

While diversity self-identification is customary in the employee hiring process, it has only recently migrated to the director recruitment process.

Goldman Sachs has formally acknowledged the importance of board diversity in its client engagement policies. In February 2020, Goldman announced that it will only underwrite IPOs of companies that have at least one diverse board member and, starting in 2021, would “raise this target to two diverse candidates for each of our IPO clients.” While no other bulge-bracket investment banks have followed Goldman’s lead, the momentum created by the various other stakeholders discussed above is driving all companies considering an IPO to give more thought to board diversity. ■

INSTITUTIONAL INVESTOR BOARD DIVERSITY POLICIES

Blackrock	Blackrock assesses a board's diversity in the context of a company's domicile, business model and strategy. Blackrock believes boards should aspire to 30% diversity of membership and encourages companies to have at least two directors who identify as female and at least one who identifies as a member of an underrepresented group (defined as individuals who identify as Black or African American, Hispanic or Latinx, Asian, Native American or Alaska Native, or Native Hawaiian or Pacific Islander; individuals who identify as LGBTQ+; individuals who identify as underrepresented based on national, indigenous, religious or cultural identity; individuals with disabilities; and veterans). Blackrock requests boards to disclose: (a) the aspects of diversity that the company believes are relevant to its business and how the diversity characteristics of the board, in aggregate, are aligned with the company's long-term strategy and business model; (b) the process by which candidates are identified and selected, including whether professional firms or other resources outside of incumbent directors' networks have been engaged to identify and/or assess candidates, and whether a diverse slate of nominees is considered for all available board nominations; and (c) the process by which boards evaluate themselves and any significant outcomes of the evaluation process, without divulging inappropriate and/or sensitive details.
State Street	For Russell 3000 companies, State Street may vote against the nominating committee chair or the board leader, in the absence of a nominating committee, if a company doesn't have at least one female board member. Additionally, if a company fails to meet this expectation for three consecutive years, State Street may vote against all incumbent members of the nominating committee. If a company in the S&P 500 does not disclose the gender, racial and ethnic composition of its board, or does not have at least one director from an underrepresented racial or ethnic community, State Street will vote against the nominating committee chair.
Vanguard	Vanguard will generally vote against the nominating and/or governance committee chair (or other director if needed) if a company's board is making “insufficient progress” in its diversity composition and/or in addressing its board diversity-related disclosures. The factors Vanguard will consider include applicable market regulations and expectations, along with additional company-specific context. Vanguard also believes that board composition should appropriately represent the company's markets and long-term strategic needs, and that boards should demonstrate how they intend to continue making progress.

Duty of Oversight Is Mission Critical for Boards

While the fiduciary duties of directors and officers are the same whether a company is privately owned or publicly traded, the risk of claims by dissatisfied stockholders alleging breaches of these fiduciary duties becomes much more significant once the company is public.

One particular type of breach of fiduciary duty claims—those based on an alleged failure of the board’s duty of oversight—has become especially common in recent years, and highlights how important it is for the board of an IPO company to ensure the company has appropriate reporting systems and controls and procedures in place from its first day as a public company.

WHAT IS REQUIRED?

The duty of oversight requires directors to make a good faith effort to implement an oversight system and then monitor it. Allegations that directors violated their duty of oversight are often referred to as *Caremark* claims, after a landmark 1996 case involving that company.

Oversight liability can arise if either:

BOARD FIDUCIARY DUTIES

The fiduciary duties of directors and officers under Delaware law consist of:

- the **duty of care**—an obligation to act on an informed basis after due consideration of relevant materials and appropriate deliberations; and
- the **duty of loyalty**—an obligation to refrain from deriving a benefit from a transaction not generally available to all stockholders, and to otherwise act in good faith.

A board’s duties are enhanced in the acquisition context, especially when the company is going to be acquired.

While almost every company going public will include in its charter a provision eliminating the personal monetary liability of directors (but not officers, as this is not authorized by the Delaware corporation statute) for violations of the duty of care, breaches of the duty of oversight are considered to be non-exculpable breaches of the duty of loyalty and directors who violate the duty of oversight may therefore face personal liability.

- the directors utterly fail to implement any reporting or information system or controls (“failure to implement” claims); or
- having implemented such a system or controls, the directors consciously fail to monitor or oversee its operations, thus disabling themselves from being informed of risks or problems requiring their attention (“failure to follow-up” claims).

While *Caremark* claims have historically been described as “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment,” since mid-2019 Delaware courts have allowed *Caremark* claims to proceed in at least six cases in which the court determined that the plaintiffs adequately alleged that directors had abdicated their oversight responsibility by failing to implement and/or monitor an oversight system.

RECENT CASES ALLOWING CAREMARK CLAIMS TO PROCEED

Most notably, in *Marchand v. Barnhill*, a case stemming from a listeria outbreak involving Blue Bell Creameries that resulted in three deaths and caused the company to recall all of its products, cease production at all plants and dismiss over one-third of its employees, the Delaware Supreme Court reversed the lower court’s dismissal of a stockholder’s *Caremark* claim. The allegations upon which the court allowed a “failure to implement” claim to proceed included that:

- food safety was the mission-critical compliance issue for Blue Bell;
- the board did not have a committee overseeing food safety;
- there was no board-level process to address food safety issues or protocol for advising the board of food safety reports and developments; and
- board minutes did not mention discussion about food safety concerns existing prior to the listeria outbreak or generally reflect discussion of food safety matters.

BOARD ACTIONS TO FULFILL OVERSIGHT OBLIGATIONS

Summarized below are some of the actions a board of directors can take to help fulfill and document its oversight obligations and minimize the risk of liability under the *Caremark* standards of liability.

To address its obligation to implement appropriate reporting or information systems or controls, the board should:

- Ensure management and the board each has a process for identifying and regularly reviewing key risks, and document those processes;
- Explicitly assign responsibility for oversight of key risks (either to the full board or a board committee) and include corresponding proxy disclosure once public; a separate risk committee is not required and has not become very common outside the financial services industry;
- Not rely solely on the existence of regulatory requirements—such as SEC or other reporting requirements, or FDA requirements for life sciences companies—as a basis for assuming an adequate reporting system exists;
- Avoid being completely dependent on management reporting, including by having the board (or designated board committee) hear directly from chief compliance and risk officers, and ensure there are systems in place for employees and corporate partners to raise concerns; and
- Establish an expectation and protocol for management to promptly report significant regulatory or compliance developments to the board (or designated board committee).

To address its obligation to monitor or oversee the operation of the systems or controls the board has implemented, the board (or designated board committee) should:

- Be vigilant for warning signs (often referred to as yellow or red flags) and follow up when identified, including giving consideration to the engagement of outside advisors;
- Receive regular reports on key risk and regulatory issues;
- Ensure that meeting minutes demonstrate that the board (or designated board committee) is regularly exercising oversight and following up on potential concerns; and
- Exercise care in informal communications (such as emails and texts), because such materials may in some situations need to be produced in response to a books and records request.

Duty of Oversight Is Mission Critical for Boards

Since *Marchand*, Delaware's Chancery Courts have allowed *Caremark* claims to proceed in cases involving, among others, a life sciences company whose lead product candidate suffered from a low confirmed success rate and ultimately ran into FDA problems; an auto parts manufacturer that had persistent problems with internal controls and oversight of related person transactions ultimately requiring it to restate its financial statements; and a pharmaceutical company whose subsidiary engaged in, and ultimately pleaded guilty to, criminal activities relating to the inappropriate repackaging of oncology drugs into syringes.

NO ONE-SIZE-FITS-ALL APPROACH TO OVERSEEING RISK

Discharging their duty of oversight requires directors to do more than rely on government regulation of a company's industry or general discussions of operational issues with management at board meetings. Rather, directors must demonstrate that they have used good faith efforts to put in place at the board level a reasonable system of monitoring and reporting about the company's key risks, especially those that relate to "mission-critical" regulatory matters, legal compliance and public safety.

There is no one-size-fits-all approach. Boards have discretion to implement context- and industry-specific approaches to risk oversight that are tailored to the activities and resources of the businesses

PROTECTING DIRECTORS FROM LIABILITY

As part of its IPO preparations, a company should ensure that its corporate charter provides, to the maximum extent permitted by law, for indemnification of, and advancement of expenses to, directors and the exculpation of directors from personal monetary liability for breaches of the duty of care. The company should also procure an adequate D&O insurance policy before pricing its IPO (D&O insurance is discussed further on page 23). To supplement these measures, many public companies also enter into separate indemnification agreements with each director and officer. Many director candidates will not join a board that does not offer these protections.

CAUTIONARY TALE FROM RECENT CAREMARK CLAIM

In October 2021, the Delaware Chancery Court dismissed claims against the directors of Marriott, a hospitality company that in 2018 discovered a data security breach perpetrated since 2014 through the reservation database of a hotel chain that Marriott acquired in 2016. The breach exposed the personal information of approximately 500 million guests.

In dismissing the plaintiff's "failure to implement" claims, the court concluded that none of the directors faced a substantial likelihood of liability because:

- Marriott's board consistently ranked cybersecurity as one of the company's primary risks;
- The board and its audit committee were routinely apprised of cybersecurity risks and mitigation efforts and received annual reports that specifically evaluated cyber risks;
- The company engaged outside consultants to improve, and auditors to audit, its corporate cybersecurity practices; and
- Management provided the board with the information and reports plaintiff described as red flags.

The court also dismissed the plaintiff's "failure to follow-up claims," finding that plaintiffs had not adequately pleaded that Marriott's board learned of, or remained idle with respect to, any legal or regulatory violations.

Now the cautionary tale: While the claims against the Marriott board were dismissed, the court's opinion raised its own red flag: "Oversight violations are typically found where companies—particularly those operating within a highly-regulated industry—violate the law or run afoul of regulatory mandates. But as the legal and regulatory frameworks governing cybersecurity advance and the risks become manifest, corporate governance must evolve to address them. The corporate harms presented by non-compliance with cybersecurity safeguards increasingly call upon directors to ensure that companies have appropriate oversight systems in place."

As a result, all boards are now well advised to treat cybersecurity risk as mission critical.

they oversee. For example, the board of a life sciences company is not required to have a shadow regulatory group or to hire independent external experts as long as the board itself includes directors with sufficient experience in the areas of key regulatory risk faced by the company, but FDA and other regulatory matters should be on the agenda for every regular board meeting.

DO YOUR WORK AND DOCUMENT IT

Practically speaking, directors need to be able to demonstrate that they have been proactive in discharging their risk oversight responsibilities. This generally means being able to show that:

- the company has sufficient reporting and compliance systems;
- regulatory and compliance issues are effectively reported to the board; and
- when issues are reported to the board, the board takes initiative to address such issues.

The importance of contemporaneously documenting the board's oversight,

including in minutes of board meetings, has taken on increased significance given that it is now common for plaintiffs' lawyers to use information gathered through books and records requests in an effort to craft a complaint that is more likely to withstand a company's motion to dismiss. Under Section 220 of the Delaware General Corporation Law, a stockholder can demand inspection of a company's books and records by demonstrating, among other things, that the inspection is for a "proper purpose," such as to investigate wrongdoing by the board. Recent cases suggest that the scope of books and records access may be broadening, stockholder purposes are more likely to be found proper, and courts are more willing to consider awarding legal fees to stockholders when companies inappropriately refuse to produce documents.

Tasking a board committee with oversight of specific market or industry risks may help demonstrate the board's due care in monitoring such risks, though a separate committee is not required if oversight is handled by the full board. ■

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 <i>Initial Public Offering of Common Stock</i> \$306,682,000 July 2021 Counsel to Issuer		 <i>Public Offering of Common Stock and Preferred Stock</i> \$97,750,000 September 2021 Counsel to Underwriters		 <i>Public Offering of Common Stock</i> \$402,500,000 November 2021 Counsel to Issuer		 <i>Public Offering of Common Stock</i> \$100,013,500 June 2021 Counsel to Underwriters		 <i>Initial Public Offering of Common Stock</i> \$137,916,000 February 2021 Counsel to Issuer		 <i>Initial Public Offering of Common Stock</i> \$178,755,000 October 2021 Counsel to Underwriters		 <i>Public Offering of Common Stock</i> \$265,650,000 January 2021 Counsel to Issuer		 <i>Initial Public Offering of Common Stock</i> \$230,000,000 September 2021 Counsel to Issuer		 <i>Initial Public Offering of Common Stock</i> \$129,906,000 October 2021 Counsel to Issuer	
 <i>Initial Public Offering of Common Stock</i> \$267,697,000 September 2020 <i>Public Offering of Common Stock</i> \$168,000,000 January 2021 Counsel to Issuer		 <i>Capital Raise (public rights offering and related PIPE transactions)</i> \$78,000,000 November 2021 Counsel to Issuer		 <i>Initial Public Offering of Common Stock</i> \$98,370,000 October 2020 <i>Public Offering of Common Stock</i> \$57,000,000 February 2021 Counsel to Underwriters		 <i>Public Offerings of Common Stock</i> \$288,581,000 July and October 2021 Counsel to Issuer		 <i>Initial Public Offering of Common Stock</i> \$230,000,000 June 2020 <i>Public Offering of Common Stock</i> \$225,400,000 January 2021 Counsel to Issuer		 <i>Initial Public Offering of Common Stock</i> \$209,300,000 August 2021 Counsel to Underwriters		 <i>Initial Public Offering of Common Stock</i> \$86,480,000 March 2020 <i>Public Offering of Common Stock</i> \$50,000,000 July 2021 Counsel to Issuer		 <i>Public Offerings of Senior Notes</i> \$3,100,000,000 March and September 2021 Counsel to Issuer			
 <i>Rule 144A Placements of Convertible Senior Notes</i> \$1,050,000,000 February 2021 <i>Senior Secured Notes</i> \$500,000,000 June 2021 Counsel to Issuer		 <i>Public Offering of Common Stock</i> \$173,017,500 January 2021 Counsel to Underwriters		 <i>Initial Public Offering of Common Stock</i> \$200,000,000 December 2021 Counsel to Issuer		 <i>Public Offerings of Senior Notes</i> \$8,950,000,000 August and October 2021 €8,050,000,000 (including €550,000,000 of sustainability notes) October and November 2021 Counsel to Issuer		 <i>Public Offerings of Common Stock</i> \$194,810,000 January and August 2021 Counsel to Issuer		 <i>Initial Public Offering of Common Stock</i> \$199,750,500 August 2020 <i>Public Offering of Common Stock</i> \$257,008,000 July 2021 Counsel to Underwriters		 <i>Public Offering of Common Stock</i> \$64,687,500 March 2021 Counsel to Issuer		 <i>Initial Public Offering of Common Stock</i> \$143,750,000 March 2021 Counsel to Underwriters		 <i>Public Offerings of Senior Subordinated Notes</i> \$850,000,000 March 2021 <i>Common Stock</i> \$1,903,041,000 September 2021 <i>Senior Notes</i> \$2,000,000,000 November 2021 and February 2022 Counsel to Issuer	
 <i>Public Offering of Common Stock</i> \$161,920,000 March 2021 Counsel to Issuer		 <i>Initial Public Offering of Common Stock</i> \$142,312,500 February 2022 Counsel to Underwriters		 <i>Rule 144A Placement of Convertible Senior Notes</i> \$414,000,000 December 2021 Counsel to Issuer		 <i>Initial Public Offering of Common Stock</i> \$201,250,000 November 2021 Counsel to Underwriters		 <i>Initial Public Offering of Common Stock</i> \$193,600,000 January 2022 Counsel to Underwriters		 <i>Public Offering of Senior Notes</i> \$4,000,000,000 (including \$750,000,000 of sustainability-linked notes) October 2021 Counsel to Issuer		 <i>Initial Public Offering of Common Stock</i> \$120,000,000 May 2021 Counsel to Issuer		 <i>Public Offering of Senior Notes</i> \$1,000,000,000 December 2021 Counsel to Issuer			

IPOs Find Their New Normal

18 Pandemic-Era Practices Transform the IPO Process

Beginning in March 2020, with most of the business world working from home due to the COVID-19 pandemic, the IPO process became completely virtual, a shift that produced no adverse consequences while yielding unexpected efficiencies.

At the same time, IPO deal flow increased substantially, shaking off steep stock market declines and economic concerns at the outset of the pandemic to produce the highest volume of conventional IPOs in two decades and an astonishing number of SPAC IPOs.

Although the frenzied pace of IPO activity will not continue indefinitely, many of the pandemic's IPO practices are likely to persist in the post-pandemic world. Various recent adjustments to post-IPO public company life are also likely to remain in place.

IPO PROCESS

- **Overall Timeline:** Although timelines are affected by multiple factors, the pace of the overall IPO process has quickened during the pandemic. For conventional IPOs, the median time between the initial Form S-1 submission and effectiveness has declined, from 112 days in 2019 to 104 days in 2020 and then to 101 days in 2021—the lowest annual figure since at least 2007—even while deal volumes have surged.
- **Due Diligence:** The universal use of virtual data rooms has prevented the pandemic from having any effect on documentary due diligence. Site visits—which ordinarily are not undertaken outside of manufacturing and certain other industries—are being conducted in accordance with local COVID-19 protocols.
- **All-Hands Meetings:** Org meetings and drafting sessions (as well as board meetings) are being held virtually by videoconference and are proceeding seamlessly. Even before the pandemic, many in-person meetings had shifted online. Drafting sessions, for example, were often conducted remotely, with the registration statement displayed on the screen for group discussion and editing.

— **Company Disclosures:** During 2020, the SEC staff issued guidance on disclosure considerations arising from the pandemic and its impact on company operations, liquidity and capital resources. Pandemic-related disclosures are now commonplace in risk factor disclosures, MD&A (with a focus on known trends and uncertainties associated with the pandemic) and elsewhere in IPO prospectuses.

— **SEC Rule Amendments:** The SEC has taken several steps to facilitate document submissions. Most importantly, the agency adopted rules to permit the use of electronic signatures generated by DocuSign and other e-signature applications when filing registration statements and other documents. The SEC also established a secure file transfer process for the electronic submission of supplemental materials.

— **Submission Process:** The lack of in-person meetings has not affected the ability of working groups to finalize the Form S-1 before each filing or submission. In recent years, lengthy in-person sessions at the financial printer had already begun to disappear, in favor of shorter sessions—often held by conference call—to fine-tune the Form S-1 just before submission.

— **SEC Review:** The nature and timing of SEC review is unchanged (even before the pandemic, many staff members worked remotely). Nearly every IPO Form S-1 continues to receive a “full review.”

— **Marketing:** Road show and “test-the-waters” meetings are being held virtually, enabling company management to meet remotely with more potential investors in less time than required by in-person meetings—while saving money on travel expenses. “Test-the-waters” meetings are increasingly viewed as a core component of the marketing effort, rather than being primarily feedback-oriented. With investor meetings going virtual and no time wasted on travel, road show schedules have become shorter—thereby reducing exposure to market risk. Electronic road shows continue to supplement live road show meetings for retail investors.

— **Pricing and Closing:** No IPOs have been canceled after pricing, despite the unprecedented market volatility that has prevailed at times since the pandemic's onset. Remote closings—which had already become the norm—are conducted by telephone and electronic document exchange.

POST-IPO MATTERS

Some SEC and stock exchange actions that were taken to reduce the pandemic's impact on public companies have ended, while modifications to other public company practices are likely to continue.

— **Financial Guidance:** In light of the extraordinary economic uncertainty and operating volatility that characterized the early stages of the pandemic, many public companies withdrew pre-pandemic guidance, updated their guidance, or stopped providing guidance altogether. As economic concerns have been tempered and operations stabilized, most public companies that previously provided guidance have resumed doing so, while highlighting the continuing uncertainties created by the pandemic and sometimes using wider ranges than under prior practice.

— **Annual Meetings:** Given the pandemic-era safety concerns posed by in-person meetings, and restrictions on the size of public gatherings, virtual-only annual meetings of stockholders have become commonplace. Institutional investors may urge public companies to resume in-person (or hybrid) annual meetings in the post-pandemic world, but the extent and timing of a widespread return to in-person annual meetings is uncertain.

— **Liability and Enforcement:** According to Cornerstone Research, there were 19 federal and state securities class action filings involving COVID-19 disclosures in 2020, with another 10 such filings in the first half of 2021. The SEC's Division of Enforcement continues to bring enforcement actions against public companies for misleading disclosures about the financial effects of the pandemic. ■

Drafting Sessions in a Nutshell

19 Best Practices Remain Sound in the New Normal

Preparation of the Form S-1 requires hard work and close collaboration among the entire working group. The Form S-1 is not a “form” in the usual sense. Cutting and pasting from other IPO filings will not produce a prospectus that simultaneously discharges the company’s disclosure obligations, tells a compelling story, encourages readers to invest, adequately communicates relevant risks, and still is succinct enough to hold an investor’s attention.

By the time of the organizational (or “org”) meeting, the company typically will have prepared a rough draft of the business section, or at least a detailed outline of the company’s basic story and key messages. In parallel, company counsel will be preparing a draft of the balance of the Form S-1, with placeholders as needed.

Beginning with the org meeting, or shortly thereafter, drafting sessions of the core working group—the company’s senior management, company counsel, the managing underwriters, underwriters’ counsel and, for discussions focused on financial and accounting matters, the independent auditor—will be held to review and discuss the Form S-1. The drafting sessions will become increasingly granular with each successive meeting, as discussions progress from a conceptual level to nitty-gritty details.

At the org meeting, there will usually be a high-level discussion of the company’s business, strategy and positioning. If an initial draft (or outline) of the business section has been distributed, there may be conceptual discussion of it at the org meeting.

In subsequent drafting sessions, the actual text of the draft document will be reviewed. Early on, this will take the form of section-by-section or paragraph-by-paragraph discussions, but fairly soon the working group will begin to focus on each sentence and even each word. The primary emphasis of the first few sessions will be the business section, with the financial statements, MD&A, risk factors, management, and executive compensation sections typically following. Proposed graphics should be shared early in the

process to allow time to process revisions and produce high-resolution versions for inclusion in the prospectus. Toward the end of the drafting process, the group—usually led by the underwriters—will turn to the prospectus summary. The other sections of the Form S-1 are generally not discussed in detail in group drafting sessions. Instead, underwriters’ counsel will gather input from the underwriters and combine this with its own comments in one or more markups of the Form S-1 to be provided to company counsel.

Following each drafting session, the draft document will be revised, generally by company counsel (although the underwriters will often hold the pen on the initial revisions to the business

section), to reflect the working group input, and then recirculated in advance of the next drafting session. Comments are either provided during the drafting sessions or submitted separately in writing. Throughout the drafting process, Form S-1 disclosures will also be shaped by the ongoing due diligence.

Drafting will continue in this fashion until the company and underwriters are prepared for the initial submission of the Form S-1. The duration of this phase and the number of drafting sessions vary, but a total of four or five drafting sessions over a period of four to six weeks from the org meeting to the initial submission is typical. ■

TIPS FOR EFFECTIVE DRAFTING SESSIONS

Drafting sessions will proceed more smoothly and efficiently if the working group adheres to basic guidelines such as the following:

- **Duration and Frequency of Sessions:** Shorter, focused drafting sessions are typically the most productive. Until the end of the drafting process, when sessions typically turn to document cleanup and filing preparations, sessions generally should be limited to three or four hours. In order to provide ample time for updated drafts to be prepared, circulated and reviewed, drafting sessions should generally be held no more frequently than once a week. Twice-weekly sessions are often used when the prospectus is complex (such as the scientifically dense business section in a life sciences company prospectus) or the offering timeline unusually brisk—this trend has accelerated with remote sessions that do not require participants to travel.
- **Remote Sessions:** During the COVID-19 pandemic, drafting sessions have been held remotely by videoconference without significant issues. During live editing sessions, company counsel typically shares a computer screen and makes appropriate edits (or notes high-level concepts for offline incorporation). In the post-pandemic world, virtual sessions are likely to remain the preferred format, due to their time and expense savings and the convenience of easily viewable, live on-screen editing (as compared to projecting the document on a conference room wall). Selective in-person sessions may also be helpful toward the beginning of the process or for discussion of the most critical portions of the Form S-1.
- **Circulation of Drafts:** The draft sections of the Form S-1 to be discussed at a drafting session should be circulated sufficiently in advance to permit thoughtful review prior to the session and productive discussion at the session. The amount of review time needed will depend on the length, complexity and drafting stage of the sections to be discussed, and could range from as little as one day (such as for a near-final draft of the prospectus summary) to several days or more (such as for the first draft of the business section or MD&A). Similarly, participants who wish to propose significant revisions for consideration at the session should circulate the text prior to the session.
- **Nature of Comments:** Expectations about the nature of comments to be considered at the drafting session should be clarified in advance. At earlier stages in the drafting process, it will typically be more efficient to discuss foundational topics, such as company positioning and structuring of the business section, at a more abstract level, without focusing on specific wording. Later in the drafting process, the focus of the drafting sessions should shift to finalizing specific language, and participants should provide comments in the form of specific text and typewritten riders rather than conceptual comments.
- **Coordination of Underwriter Comments:** Comments from all managing underwriters should be coordinated through underwriters’ counsel to avoid a situation in which each underwriter submits separate and potentially conflicting comments to company counsel.

Risky Business—Tips for Crafting Effective Risk Factors

A key component of an IPO prospectus is the risk factors section, which discusses the material factors that make an investment in the company speculative or risky. Required by SEC rules, risk factors should clearly describe each material risk the company faces and how that risk may impact the company's business, results and performance. Well-drafted risk factors that highlight the potential risks facing a company also serve another purpose—they can help protect against potential liability in securities litigation by refuting a claim that the company did not warn investors of such risks.

During the IPO process, the SEC staff reviews the risk factors as part of its overall review of the Form S-1 registration statement. Staff comments on risk factors frequently focus on making the discussion less generic and more specific to the company. The staff often asks the company to state the extent of each risk plainly and directly and to provide examples evidencing the risk. Other comments on risk factors may request that the company remove mitigating language and avoid redundancy, or may point out inconsistencies between the risk factors and other statements in the prospectus. An IPO cannot proceed until all staff comments are resolved.

Below are some tips for crafting effective risk factors:

- **Focus on the risks facing your company.** The risk factors section should address industry-specific, company-specific and investment-specific risks. These

RISK MISCHARACTERIZATION

Several recent cases have involved allegations that certain risks had been mischaracterized as merely hypothetical. In one prominent example, Facebook agreed to pay a \$100 million penalty to settle SEC allegations that it had made misleading statements in its public filings for more than two years by presenting the risk of misuse of Facebook user data as merely hypothetical when it knew that a third-party developer had misused the user data. In another example, Pearson, a London-based public company, agreed to pay a \$1 million penalty to settle SEC charges that it misled investors by referring to a data privacy incident as a hypothetical risk when, in fact, the cyber intrusion had already occurred.

risks should be tailored to how they may specifically impact an investment in the company and explain why management is concerned about these risks, both near-term and long-term.

While a company's disclosure may include risks that many companies face (such as retention of key personnel, clinical trial risks [for life sciences companies] and cybersecurity risks), the company should describe how these common risks are unique to the company or its securities. Generic recitations of every conceivable risk that the company or any other similar company might face should be avoided; a "kitchen sink" approach may dilute the value of the risk factors by burying the most important ones.

- **Get feedback from all relevant participants.** In order to make sure that the disclosure covers all material risks faced by the company, feedback should be sought from all key players—management, the board of directors, the independent auditor and outside legal counsel. Each group will bring its own perspective to the risks facing the company, including the potential significance and magnitude of those risks.

Discussions with management about risk factors should extend from the finance and legal groups to include the company's senior personnel in each major business function. For a life sciences company, this means soliciting feedback from members of the R&D, medical and regulatory organizations. In many companies, cybersecurity considerations will require the involvement of information technology personnel. Once you know what is keeping members of the management team up at night, you will be able to prepare more meaningful risk factors.

- **Look at disclosures from comparable companies (but remember that they are only examples).** An important part of the preparation of risk factors is to look at the disclosures made by companies in the same industry with similar characteristics (often called "comps"). But don't automatically gravitate to the top leaders in your industry. For example,

RECENT SEC GUIDANCE

Recent SEC guidance affecting the risk factors section includes:

- **COVID-19:** In 2020, the SEC staff issued guidance regarding disclosure and other securities law obligations that public companies should consider with respect to the COVID-19 pandemic (CF Disclosure Guidance: Topics No. 9 and No. 9A, March 25 and June 23, 2020).
- **Cybersecurity:** In 2018, the SEC issued comprehensive guidance on cybersecurity disclosure by public companies (Securities Act Release No. 33-10459, February 21, 2018). The guidance states that cybersecurity risks should be disclosed if those risks are among the "most significant factors that make investments in the company's securities speculative or risky." In addition, the guidance indicates that companies may need to disclose previous or ongoing cybersecurity incidents in order to place discussions of these risks in the appropriate context and notes that disclosure of a material cybersecurity incident cannot be avoided merely because the incident is the subject of an ongoing internal or external investigation.
- **IP/Technology:** In 2019, the staff issued disclosure guidance with respect to intellectual property and technology risks that may occur when public companies engage in international operations (CF Disclosure Guidance: Topic No. 8, December 19, 2019).
- **LIBOR Transition:** In 2021, the staff issued its latest guidance on the risks associated with the mandatory transition from the London Interbank Offered Rate (LIBOR) benchmark interest rate for corporate debt (SEC Staff Statement on LIBOR Transition—Key Considerations for Market Participants, December 7, 2021).

it usually is not a helpful exercise for a pre-clinical stage life sciences company to focus on the risk factors of a major pharmaceutical company with multiple approved products, or for an early-stage consumer e-commerce company to align its risk factors with those of the dominant players in its industry—in both cases the risks are likely very different. Most companies going public can readily identify their comps, and the company's IPO underwriters can usually validate or supplement the company's selections.

Once comps are identified, a common technique for starting the drafting

Risky Business—Tips for Crafting Effective Risk Factors

21 Strategies for Avoiding Stockholder Claims While Satisfying Disclosure Obligations

process is to assemble a grid listing the risk factors contained in their SEC filings. This is a good way to identify risks you may not have thought about that should be included in your risk factors. Also, a review of relevant industry analyst commentary may identify additional risks that investors perceive to exist in the company's industry and should be addressed in the company's own risk factors.

- **Check your risk factors against the rest of the prospectus.** The risk factors should be prepared against the backdrop of all of a company's disclosure and should be consistent with how the company and its business are discussed throughout the entire prospectus. If risks and uncertainties facing a company are identified in the discussion of the business but not in the risk factors, the SEC is likely to ask about it. For example, if a company is involved with litigation regarding the intellectual property rights of one of its product candidates, there should be a corresponding risk factor that explains what would happen if those intellectual property rights were lost. New risks can arise at any time so you should be always asking if anything has changed that requires an update to any disclosure, including the risk factors.
- **Don't try to mitigate risks.** Once a risk has been identified, a natural instinct is to explain why the risk isn't as much of a risk as it may appear to be. While companies are allowed to provide mitigating disclosure in other sections of the prospectus (such as MD&A), companies are not allowed to mitigate any of the disclosure in the risk factors. If you try to mitigate risks, you can weaken the protective value of risk factors.
- **Don't characterize risks that have materialized as merely hypothetical.** Companies should not talk about the risk that an event "may" or "could" occur if in fact the event has occurred—instead, the risk factor should acknowledge that the event has occurred and describe its implications for the company.
- **Make the disclosure easily understandable.** The SEC has long

championed the use of plain English in disclosure—clear, concise language that the average investor will understand. Avoid inside baseball and remember that the average investor does not live, sleep, eat and breathe the company the way you do. This means no legal jargon or highly technical terms. Risk factors should be drafted so that the key points are clear, easily identified and easy to understand. When possible, use tables and bullet lists to highlight your points.

- **Organize risk factors logically with relevant headings.** The discussion of risk factors must be organized logically with relevant headings and each risk factor should be set forth under a caption—typically consisting of several sentences—that adequately describes the risk. Risk factors should be grouped together by theme, such as risks related to the company's business and industry; risks related to the offering and ownership of the company's common stock; and, depending on the nature of the company's business, risks related to regulation, intellectual property or foreign operations. For example, a life sciences company should include all material risks that relate to the development, clinical testing and regulation of its products and product candidates in one section, with a heading that describes that category of risks. Within each

grouping, risks generally should be listed in descending order of importance.

- **Comply with SEC rules on presentation.** The risk factors section must immediately follow the prospectus summary and must be captioned "Risk Factors," rather than with a euphemism such as "Investment Considerations." To the extent generic risk factors are included, they must be disclosed at the end of the section under the caption "General Risk Factors." If the discussion of risk factors is longer than 15 pages (which is almost always the case in an IPO), the prospectus summary must include a series of concise, bulleted or numbered statements—not longer than two pages—summarizing the principal risk factors.
- **Consider SEC guidance and comments.** The SEC periodically issues guidance on risk factor disclosures, covering emerging risks and other topics that the staff believes companies have not been adequately addressing. SEC guidance often serves as a road map for areas of particular focus in staff review. You should also review comment letters the SEC has sent to similarly situated companies on their risk factors. Reviewing these comments can help your company avoid receiving the same or similar comments on its risk factors. ■

RISK FACTORS BY THE NUMBERS

The typical length of risk factor sections—and the number of risk factors included—has increased dramatically over the years, in tandem with growth in the typical length of IPO prospectuses and heightened liability concerns. Whereas a decade or so ago it was commonplace for the risk factors section of an IPO prospectus to run 15–25 pages and to include 40–50 risk factors, today's norm is 30–55 pages and 65–80 risk factors. The percentage of SEC staff comments devoted to risk factors has also increased, due in part to the staff's efforts to focus on the most significant issues presented by the company's business and its disclosure in the prospectus. The following data from all US-issuer IPOs over the past 15 years illustrates these trends:

Period	Median Length of Risk Factors Section (pages)	Median Length of Prospectus (pages)	Length of Risk Factors as Percentage of Total Prospectus	Percentage of SEC Comments Devoted to Risk Factors
2007–2011	19	179	10.6%	8.3%
2012–2016	27	200	13.5%	9.1%
2017–2021	39	225	17.3%	11.8%

In almost comical contrast, the entire prospectus for Microsoft's 1986 IPO was less than 50 pages long and the risk factors section—entitled "Certain Factors"—consisted of seven fairly generic risks on two pages.

Why Due Diligence Matters

Bloomberg columnist Matt Levine, a former lawyer and investment banker, likes to say every bad thing that is done by or happens to a public company is securities fraud (although he acknowledges this is not exactly accurate). Applying this expression to an IPO, management should assume that any “bad” things in the company’s history or current business—which may include things that are not actually illegal or wrong—that are not disclosed after the offering is complete could affect the market price of the company’s stock and result in securities fraud claims brought by IPO investors.

To avoid this outcome, a key task for all IPO participants is to undertake a thorough process to identify and understand any “bad” things involving the company and, where appropriate, include disclosure in the Form S-1 informing prospective investors about such things. This “due diligence” is the essential process the IPO working group utilizes to unearth “bad” things, identify information that must be disclosed in the Form S-1 or that is otherwise relevant to an understanding of the company’s business and finances, and investigate and verify statements made in the Form S-1.

THE PURPOSES OF DUE DILIGENCE

For companies—which are strictly liable for material misstatements or omissions in the Form S-1—the primary purpose of due diligence is enhanced disclosure, which reduces the likelihood of claims for securities fraud and of disgruntled investors following an IPO. Inaccurate or incomplete disclosures in the Form S-1 that come to light after the IPO can hurt the company’s stock price and lead to unhappy investors, even if they do not sue. A company’s due diligence also helps its directors and officers establish a due diligence defense.

The fiduciary duties and corporate responsibilities of directors and officers demand a prudent focus on due diligence. The specter of personal liability provides an additional incentive for due diligence, although directors and officers rarely make personal payments to settle IPO securities

litigation, due to the availability of D&O insurance and the presence of more attractive defendants in most cases—the company, which lacks a due diligence defense, and the underwriters and auditors, which have much deeper pockets.

For underwriters, in addition to establishing a due diligence defense, the primary motivation for conducting due diligence is to avoid the reputational harm posed by a serious deficiency in a Form S-1 or an association with a failed company, and the desire to ensure a successful IPO. The commitment committees at investment banks that must approve any underwriting expect a detailed presentation from the banking team before agreeing to commit the bank to underwriting the deal.

SOURCES OF POTENTIAL LIABILITY

Section 11 of the Securities Act of 1933 provides the principal basis for civil liability in connection with an IPO. Offering participants can also incur liability under various other statutory provisions, including Section 12 of the Securities Act.

- **Section 11:** Under Section 11(a), and subject to the due diligence defense (except for the company), the company, each director, each officer who signed the Form S-1, each underwriter, and each auditor and other person named as an expert in the Form S-1, may be liable if the Form S-1 contains any material misstatements or omissions. The potential liability of auditors and other experts extends only to the portions of the Form S-1 prepared or certified by such persons. Selling stockholders are not subject to Section 11 claims.
- **Section 12:** Section 12(a)(2) provides IPO investors with recourse for material misstatements or omissions—including both written and oral statements—made in connection with the IPO, including road show presentations and “test-the-waters” communications. Section 12 claims generally may be brought against the company and underwriters and, in some cases, against selling stockholders.

THE DUE DILIGENCE PROCESS

Due diligence by the underwriters—who typically lead the overall diligence process—is a pervasive and constant accompaniment to the entire IPO process. Key components of due diligence include:

- review of the company’s records, contracts, financial statements, business plans, public statements and communications, regulatory compliance, litigation, intellectual property and other relevant documents;
- diligence sessions with management, auditors and relevant third parties to learn about and evaluate the company and its prospects, including the particular risks it faces;
- inquiries of key customers, business partners and other relevant third parties regarding the company;
- searches of public records and background checks on directors, officers and principal stockholders;
- a “backup” process by which counsel independently substantiates factual statements made by the company in the Form S-1;
- ensuring that relevant diligence results are appropriately addressed in the Form S-1;
- “comfort” letters from the auditors and legal opinions from counsel; and
- thorough follow-up to resolve potential issues that arise. ■

THE DUE DILIGENCE DEFENSE

An important defense for defendants (other than the company) for both Section 11 and Section 12(a)(2) claims is the so-called due diligence defense. In effect, the defense permits a defendant to avoid liability by demonstrating that, after reasonable investigation, he or she believed the disclosure in question was true and correct in all material respects. There is no single blueprint for establishing a due diligence defense. The steps can vary based on a defendant’s role in the offering and may depend in part on the particular facts and circumstances of the company and offering.

The ABCs of D&O Insurance

23 Coverage Provides Important Protection Against IPO Liability

Directors' and officers' liability insurance (commonly called "D&O insurance") provides coverage for liabilities incurred in connection with service as a director or officer, including IPO liabilities if an appropriate policy is purchased. Nearly all public companies have at least some D&O insurance. Private company D&O policies, although not uncommon, typically have a public offering exclusion, so a company going public must purchase a new D&O policy to obtain coverage for the IPO and for its operations as a public company.

COMPONENTS OF D&O INSURANCE

There are three basic D&O insurance components for public companies: Side A, Side B and Side C. Side A can be purchased separately, Side A and Side B can be combined in "AB" insurance, or all three can be combined in "ABC" insurance.

- **Side A:** Under Side A, the insurer promises to pay expenses incurred by directors or officers that are not indemnified by the company or that the company is financially unable to pay. Side A policies have exclusions for fraud, although a fraud exclusion typically does not prevent insurers from contributing to a settlement of a securities fraud claim. A variant on Side A, called "DIC Side A," provides coverage when there is a "difference in conditions" between the Side A policy and an underlying ABC policy.
- **Side B:** Under Side B, the insurer promises to pay—after payment by the company of a stated amount referred to as a "retention"—indemnification expenses that the company must otherwise pay on account of a claim against a director or officer. Unlike Side A, Side B does not cover non-indemnifiable expenses. Side B works much like any other insurance: After paying the premium and any retention amount, and subject to the policy's exclusions, the insurer will pay up to the policy limit for many of the company's indemnity obligations to directors and officers (including most defense costs and many settlements or judgments).
- **Side C:** Side C (also called entity coverage) covers the company itself for securities claims. The motivation for

Side C coverage is to prevent the insurer from avoiding payment of a portion of the defense or settlement costs on the grounds that the coverage covers only the individual directors and officers and not the company (even though in most securities cases there is little incremental cost associated with defense of the company by the same counsel defending the company's directors and officers).

In addition to Side A, Side B and Side C coverage, some policies include additional coverage enhancements, typically subject to a sub-limit (or cap) on the amount payable by the insurer, for expenses incurred by the company in certain circumstances. Examples of coverage enhancements include an agreement by the insurer to cover expenses incurred in investigating a derivative demand (sometimes referred to as "Side D" coverage); coverage for other kinds of investigations; so-called crisis management coverage (for expenses incurred for public relations consultants in certain emergencies); and underwriter indemnity coverage (for expenses incurred pursuant to the company's obligation to indemnify the underwriters under an underwriting agreement).

Most IPO companies seek to purchase ABC insurance plus DIC Side A coverage. The principal advantage of ABC insurance is that it shifts the costs of defending claims against directors and officers to the insurer. ABC insurance also has the practical effect of facilitating settlements of securities claims because plaintiffs' lawyers tend to calibrate their settlement demands to the amount of available insurance and because directors generally find it easier to approve settlements when a substantial part of the cost is paid by insurance.

An alternative is to purchase Side A—only insurance. Side A insurance is cheaper than ABC insurance or ABC insurance plus DIC Side A insurance because the company is required to pay expenses that an ABC policy would otherwise cover. Because a Side A policy covers only the directors and officers, creditors in bankruptcy cannot assert that the policy proceeds are an asset of the bankruptcy estate that should be preserved to pay

claims against the estate (although this issue also can be addressed by appropriate policy language in an ABC policy). Side A insurance cannot be exhausted by the costs of defending securities claims against the company.

PROCURING D&O INSURANCE

D&O insurance is usually purchased in tiers from multiple carriers. After selecting the type and amount of coverage, the company should ask company counsel to review the actual policy. All D&O policies are not the same, and many important provisions must be understood and, in some cases, negotiated.

In recent years, D&O insurance has become significantly more expensive, the size of each tier has tended to decrease (requiring more insurers to achieve desired coverage limits), retentions have increased dramatically, and available terms have become less favorable, as insurers seek to manage the risks that they underwrite. In general, D&O insurance is even more expensive and terms less favorable for companies going public via a SPAC business combination rather than a conventional IPO.

To reduce insurance expense, some companies have responded by reducing coverage under Sides B and C, coupled with significantly higher retentions. However, for companies embarking on an IPO—in which the company, the officers who sign the Form S-1 and all directors face liability for material misstatements or omissions in the Form S-1—ABC insurance remains the most popular alternative. ■

"CAPTIVE" D&O INSURANCE

In January 2022, the Delaware General Corporation Law was amended to permit Delaware corporations to employ "captive insurance" arrangements (insurance provided by or through a wholly owned subsidiary funded by the corporation) to protect indemnifiable persons. While too early to tell, some Delaware companies may wish to consider establishing captive arrangements as part of their D&O insurance programs to reduce the cost of traditional D&O insurance.

Don't Forget Pre-IPO Estate Planning

Company executives should not overlook estate planning—perhaps more aptly named wealth transfer planning—in advance of an IPO. Many pre-IPO company executives probably do not consider themselves wealthy, and a simple will may be the extent of their estate planning. For an executive holding a substantial amount of company equity, however, an imminent IPO presents wealth transfer opportunities, no matter how humble the company's (or the executive's) beginnings. Expert advice is needed, as estate planning is a complex and fluid area of the law, and the following is merely a brief introduction to the topic.

TAXATION OF INDIVIDUALS AND ASSETS

Federal law imposes four types of taxes on individuals and their assets: gift, estate, generation-skipping transfer (GST) and income taxes. Many states impose income and estate taxes, but most do not impose gift or GST taxes. The following summary applies to federal tax law only, as of December 31, 2021. The federal gift, estate and GST tax exemptions described below are scheduled to revert to \$5,000,000 in 2026 (adjusted for inflation measured from 2010).

- **Gift Tax:** Gift taxes apply to gifts made during the lifetime of the donor and are imposed on the donor rather than

the recipient. No gift tax is payable with respect to gifts to a US citizen spouse or to qualifying charities, or with respect to the payment of tuition and medical expenses on behalf of another person if paid directly to the educational institution or medical provider. Other than for eligible charitable donations, the donor may not deduct gifts from his or her taxable income. Each donor has an annual, per-recipient exclusion (\$16,000 for 2022 and adjusted for inflation in subsequent years) and a lifetime exemption (\$12,060,000 for 2022 and adjusted for inflation in subsequent years). Gifts that exceed the annual exclusion count against the lifetime exemption. A married couple may elect to combine their annual exclusions and lifetime exemptions when donating property owned by either of them (referred to as “gift splitting”). The maximum gift tax rate on taxable gifts is 40%.

- **Estate Tax:** Estate taxes apply to assets owned upon death and are imposed on the decedent's estate. Transfers upon death to a US citizen spouse are exempt from tax in the decedent's estate, as are transfers to qualifying charities. For 2022, the first \$12,060,000 (adjusted for inflation in subsequent years) of an estate is exempt, but this amount is subject to reduction by any portion of the lifetime gift tax exemption utilized, and the maximum estate tax rate on taxable estates is 40%.
- **GST Tax:** The GST tax applies to transfers to or for the benefit of grandchildren or more remote descendants. GST tax is imposed at a flat rate equal to the highest estate tax rate and is in addition to applicable gift and estate taxes. There is a lifetime exemption equal in amount to the estate tax exemption (\$12,060,000 for 2022 and adjusted for inflation in subsequent years).
- **Income Tax:** Income taxes are imposed on compensation income, interest and dividend income, and capital gains at marginal rates that are as high as 37%. Certain taxpayers are subject to an additional 3.8% tax on net investment income.

BASIC WEALTH TRANSFER PLANNING TECHNIQUES

Wealth transfer planning has three principal objectives: minimization of gift, estate, GST and income taxes; preservation and management of assets; and protection of assets from creditors. Basic wealth transfer planning techniques, even in the absence of an IPO, include the use of:

- annual gift exclusions, to transfer modest amounts of wealth tax-free;
- tax-free payments of tuition and medical expenses, on behalf of family members, directly to an educational institution or medical provider;
- “Section 529” education savings plans funded with cash contributions below the donor's annual gift exclusion (which may be pre-funded in an amount up to five times the annual exclusion) and which permit investment earnings to accumulate free of federal (and some state) income taxes until withdrawn to pay qualifying educational expenses;
- the lifetime gift tax exemption, to remove assets and future appreciation from the taxable estate;
- the GST tax exemption, to insulate from the GST tax assets that pass (or may pass in the future) to grandchildren or more remote descendants;
- irrevocable insurance trusts, to remove life insurance proceeds from the taxable estate; and
- taxable gifts that exceed the annual and lifetime exemptions, to generate future tax savings.

ADVANCED PRE-IPO TECHNIQUES

Two common pre-IPO wealth transfer techniques are gifts of company stock to irrevocable trusts and gifts of company stock to grantor retained annuity trusts. Other structures are also possible.

Irrevocable Trusts

An irrevocable trust enables assets to appreciate in value outside of an estate and is an effective tool for leveraging

WHY NOW?

Many estate planning techniques focus on asset transfers upon the death of the owner, but properly structured gifts during the owner's lifetime can produce even greater tax savings. Because gift taxes are based on the fair market value of the property at the time of transfer, the goal of pre-IPO estate planning is to transfer company stock before its value appreciates substantially and while its value is more uncertain, potentially providing flexibility in valuation. To maximize the tax savings, the transfers should occur as early as possible—when the stock has its lowest value—but significant benefits can still be realized when the transfers do not occur until IPO planning is underway. By contrast, charitable donations generally should be made of appreciated property—such as post-IPO stock—to maximize the value of the donor's income tax deduction.

Don't Forget Pre-IPO Estate Planning

EXAMPLES OF USE OF GRAT FOR PRE-IPO STOCK

- The grantor transfers company stock in January 2022 to a three-year GRAT.
- The IRS benchmark rate for January 2022 is 1.6%.
- The company goes public in the fall of 2022.
- The company's stock appreciates 50% in the first year and 10% in each of the second and third years.
- If the company stock is valued at \$1,000,000 upon transfer, the grantor receives annual annuity payments of \$344,056 (a total of \$1,032,168) and \$676,175 passes free of gift tax to the beneficiaries at the end of the GRAT term.
- If the company stock is valued at \$5,000,000 upon transfer, the grantor receives annual annuity payments of \$1,720,282 (a total of \$5,160,846) and \$3,380,867 passes free of gift tax to the beneficiaries at the end of the GRAT term.

gift tax exemptions. In simple terms, the owner of the assets (called the “grantor”) establishes a trust for the benefit of his or her children or other beneficiaries and funds it with a gift of company stock valued at no more than the then-available portion of the grantor's lifetime gift tax exemption. By applying the grantor's lifetime gift tax exemption, the initial stock gift is free of gift tax, and all future appreciation in the stock's value is excluded from the grantor's estate. If the grantor's grandchildren (current or future) are beneficiaries of the trust, the grantor's lifetime GST tax exemption can also be applied, to exempt from the GST tax any eventual transfers of trust assets to grandchildren or more remote descendants. If the grantor is married, the amount of company stock that can be transferred to the irrevocable trust without triggering any gift or GST tax can be doubled if the grantor elects with his or her spouse to engage in gift splitting (assuming the grantor's spouse has sufficient gift and GST tax exemptions available).

For income tax purposes, the cost basis of the assets transferred to the trust is the same as the cost basis in the grantor's hands when the assets are contributed

to the trust. If the assets are sold by the trustees of the trust (or by any beneficiary to whom the assets are distributed by the trustees), federal capital gain taxes plus applicable state capital gain taxes may be incurred. In many cases, the trustees of an irrevocable trust initially funded solely with company stock sell shares over time to diversify the trust's holdings.

With a “non-grantor” trust, the trust, and in some circumstances the trust beneficiaries, pay the taxes on the trust's income (including capital gains attributable to trust assets). By contrast, with a “grantor” trust, the grantor continues to pay the income taxes, enabling the trust to grow without being diminished by income tax payments, and the grantor's payment of this income tax is not subject to gift tax or GST tax. A grantor trust typically contains provisions that allow it to be converted to a non-grantor trust, after which the trust and the trust beneficiaries, rather than the grantor, will be responsible for the trust's income taxes.

Grantor Retained Annuity Trusts

Grantor retained annuity trusts (GRATs)—if structured as “zeroed-out” GRATs as described below—permit future appreciation in the value of an executive's company stock to be transferred to the executive's children or other beneficiaries, outside of the grantor's estate, without paying any gift taxes, and without depleting the executive's lifetime gift tax exemption. Any kind of assets may be contributed to a GRAT, but the technique is particularly powerful when a GRAT is funded with an asset—such as pre-IPO stock—that is expected to appreciate substantially during the GRAT term. GRATs may be used in tandem with, or independent of, other irrevocable trusts.

With the basic GRAT structure, the grantor contributes property to an irrevocable trust and receives an annual distribution—or “annuity”—from the trust for a period of years. At the end of the GRAT's term, the remaining trust assets, if any, are distributed to or held in trust for designated beneficiaries. With a so-called zeroed-out GRAT, the annuity payments are calculated to repay the grantor the fair

market value of the assets (determined at the time the assets are contributed to the GRAT), plus a benchmark rate of return set by the IRS monthly to reflect prevailing interest rates, so that no gift tax applies to the original contribution to the GRAT. If the annuity payments are calculated to repay less than the fair market value of the contributed assets plus the benchmark rate of return, the difference is subject to gift tax upon the transfer of the assets, unless the donor has a sufficient lifetime gift tax exemption available to shelter the difference from gift tax.

The annuity payments may be made in whole or in part in cash, if the GRAT has any cash, or by returning company stock or other trust assets to the grantor. If the value of the trust property in any year is insufficient to satisfy the annuity payment required to be made that year, the trustees distribute all of the remaining trust property to the grantor, the GRAT terminates, and nothing is left for distribution to the trust's remainder beneficiaries. If, however, the trust property appreciates in value at a rate exceeding the benchmark rate, some trust assets—potentially a very substantial amount—will necessarily remain at the end of the GRAT term.

For income tax purposes, a GRAT is a grantor trust, and the grantor is required to report on his or her personal income tax return any income and capital gain attributable to the GRAT assets during the GRAT term. The grantor's payment of this income tax is the economic equivalent of a gift tax-free contribution of additional property to the GRAT. The annuity payments made by the GRAT to the grantor do not constitute additional taxable income to the grantor and can be used by the grantor to pay the GRAT's tax liabilities.

If the grantor dies during the GRAT term, his or her estate will receive the remaining annuity payments and some or all of the GRAT assets will be included in the grantor's estate for estate tax purposes. Any property remaining at the end of the GRAT term will be distributed to the trust's beneficiaries, but the full benefits of the GRAT will not have been realized.

Don't Forget Pre-IPO Estate Planning

26 Wealth Transfer Techniques Can Be Particularly Effective in Advance of an IPO

For this reason, GRATs with short terms (such as two or three years) are typically recommended for pre-IPO stock.

Typically, the assets remaining at the end of the GRAT term are retained in trust for the benefit of the grantor's descendants. The distribution of assets in trust to a grantor's descendants, rather than outright to them, has several advantages, including flexibility regarding the timing, purposes and amounts of subsequent distributions to the beneficiaries, and the protection of trust assets from claims of beneficiaries' creditors.

Future grandchildren and more remote descendants are permissible beneficiaries of a GRAT but distributions to them would be subject to the GST tax. Because of limitations on the allocation of the grantor's GST tax exemption to trust assets, however, GRATs are typically better suited for asset transfers to (or in trust for) the grantor's children, rather than grandchildren and more remote descendants.

Transfer Restrictions and Securities Law Issues

Company stock held by executives typically is subject to contractual transfer restrictions. If the executive holds restricted stock subject to vesting, unvested shares typically cannot be transferred. Right of first refusal provisions frequently have an exception permitting the executive to transfer vested shares to trusts for the benefit of family members if the transferee agrees to be bound by the provisions. If the shares are subject to a pre-IPO voting agreement, the trust will also need to agree to adhere to it. The underwriters will probably insist that any trust formed by a company executive sign the same lockup agreement that is signed by other pre-IPO stockholders.

An exemption from registration should be available for an executive's transfer of company stock to a trust. After the company is public, the trust should be able to resell the shares pursuant to Rule 144, once the applicable holding period is satisfied, or the executive may be able

to transfer to the trust any registration rights he or she has along with the shares.

RELATED MATTERS

For executives of pre-IPO companies, wealth transfer planning is an opportune time to consider various related matters that are routinely addressed in connection with estate planning.

- **Will:** A will expresses a person's preferences for the disposition of his or her assets upon death, including the identity of the person (called the executor or personal representative) who will oversee the process. Without a will, state law will automatically stipulate the beneficiaries of the assets and a court will appoint an executor, neither of which may align with the decedent's wishes. If a person has minor children, a will can also name a guardian for the children following his or her death; although not bound by this designation, a court will ordinarily follow it. Once established, a will should be periodically reviewed and updated to reflect changed circumstances and preferences.
- **Healthcare Proxy:** A healthcare proxy (also called a living will, healthcare directive, or power of attorney for healthcare) expresses a person's preferences regarding the nature and extent of medical treatment desired if he or she becomes unable to make or communicate healthcare decisions due to serious illness or unconsciousness and authorizes another person to make medical and healthcare decisions on his or her behalf. A separate authorization in compliance with the Health Insurance Portability and Accountability Act (HIPAA) for the release of medical records to the designated healthcare agent should accompany the healthcare proxy. Without a healthcare proxy, the family of a sick or injured person may be put through the additional anguish of seeking court orders to implement end-of-life care decisions.
- **Durable Power of Attorney:** Similar to but broader in scope than a healthcare proxy, a durable power of attorney gives another individual the legal authority to

VALUATION CONSIDERATIONS

Gifts of company stock to GRATs or other irrevocable trusts must be valued at fair market value at the time of the transfer. Illiquid stock in a private company—such as pre-IPO stock held by a company executive—should be valued by an independent appraiser. An independent valuation of the common stock that is conducted contemporaneously for purposes of Section 409A of the Internal Revenue Code should be sufficient to value the executive's common stock, unless other circumstances exist that affect the executive differently than other holders of common stock. A valuation done only by the company's board of directors is subject to a higher risk of challenge by the IRS. Each time a GRAT makes an annuity payment in company stock, an updated independent valuation should be obtained to determine the correct number of shares to distribute.

In most instances, a gift tax return is required to be filed with the IRS upon funding a trust with company stock. Although a gift tax return is not required when funding a zeroed-out GRAT, because the value of the gift is zero, voluntary filing of a gift tax return is advisable. If the gift tax return fully discloses the property transferred to the GRAT and the manner in which the gift was valued at zero, and the return is not audited within three years after filing, the IRS cannot subsequently dispute the valuation. A copy of the valuation report should be attached to the gift tax return.

act on his or her behalf, typically with respect to financial matters. It is said to be "durable" because it will remain in effect after the person's incapacity. The person granting the power of attorney must be competent at the time of grant and can revoke it at any time while competent.

- **Asset Protection Techniques:** Anyone with significant assets, including executives of IPO companies, should take steps to shield his or her assets from claims. Various techniques are available, such as a homestead exemption for the executive's residence, the use of corporations for business activities, and the manner in which a married couple holds assets. One of the simplest and most effective devices is insurance, including the purchase of automobile insurance with coverage limits much higher than state law minimums (which often are quite low), and the purchase of an ample amount of personal "umbrella" liability insurance. ■

Flashy Numbers on the Rise

27 IPO Companies Increasingly Give Investors a Peek at Preliminary Financial Results

Although the financial statements contained in an IPO prospectus need not be updated as long as the most recent balance sheet is less than 135 days old, beginning the road show after the completion of a fiscal quarter but prior to the availability of financial statements for that quarter is often problematic. Prospective investors will be curious about the quarter's financial results, but the company (and the underwriters) will be reluctant to include preliminary information prematurely, and the SEC staff will scrutinize any estimated financial results for a recently completed fiscal period—often called “flash results”—that are included in the preliminary prospectus. Satisfying all these constituencies under the time pressure of launching the road show can be difficult.

Despite these challenges, the use of flash results has increased substantially over the past decade. The increase reflects investor expectations and the desire of companies to commence the road show as soon as conditions are receptive, even if it falls in between quarter-end and the availability of financial statements for that quarter.

Flash results, if included, are typically presented in the summary section of the preliminary prospectus under a caption entitled “Recent Developments.” Aside from marketing considerations, whether to include flash results in the preliminary prospectus will depend on the length of time since the end of the quarter and the status of the company's normal quarter-end closing procedures, among other factors, including the following:

— **Due Diligence:** As a threshold matter, due diligence must be satisfactorily addressed. The underwriters will need to fashion appropriate due diligence procedures, such as a review of the available financial information for the quarter, discussions with the company's finance personnel, and an assessment of the company's track record in developing reliable estimates of a quarter's financial results prior to completion of closing procedures. The nature of due diligence will depend in part on the availability of comfort on the flash results from the company's auditor.

— **Auditor Comfort:** If the flash results include specific numbers extracted from the company's accounting records, agreed-upon comfort may be available from the auditor, but if the flash results consist of ranges, the auditor cannot provide any comfort. When comfort is not available, the underwriters may require the company's CFO to provide a closing certificate covering the flash results.

— **Nature of Flash Results:** Based in part on the above considerations, the company needs to determine whether to present estimated revenue only, or both estimated revenue and income (or another P&L measure), and whether to present ranges or specific numbers. Revenue estimates are usually easier and faster to develop than income estimates, but the omission of an income measure may be misleading if inconsistent with estimated revenue or past income levels. In general, the use of ranges that are narrow and meaningful under the circumstances is considered acceptable. If a non-GAAP financial measure is presented, SEC rules require the company to reconcile the measure to the most directly comparable GAAP financial measure. A brief discussion of the quarter's results is often included. Other reliable financial or operating data may also be included.

— **Related Disclosures:** The basis and limitations of the flash results should be explained in the preliminary prospectus. The company may alert investors that the final results may vary from the estimated results, but should not attempt to disclaim responsibility for the estimates. The disclosure may also state that the company's auditor has not audited, reviewed or compiled the flash results.

— **Year-End Considerations:** If the company has completed its closing procedures for the fourth fiscal quarter and financial results for the quarter and year are available, but the year-end audit is not yet complete, the auditor cannot perform an AS 4105 review of that information but may be able to provide comfort on aspects of it.

— **SEC Review:** The SEC staff will focus on whether the flash disclosure is balanced

and not misleading, typically resulting in the inclusion of both revenue and income metrics. The examiner may also ask the company to justify the use of ranges, to explain the basis of the preliminary results, and to eliminate or revise excessive disclaimers. Proposed flash disclosures are submitted for review either as part of an amendment to the Form S-1 or separately to the examiner in advance of public filing.

— **Timing Impact:** To avoid the awkwardness of circulating revised flash disclosures during the road show, underwriters generally prefer to clear the proposed disclosures with the SEC examiner before finalizing the preliminary prospectus. Several days, or more, can be required to resolve staff comments on flash disclosures. If necessary, flash results can also be introduced for the first time during the road show through the use of a free writing prospectus, but this approach is generally disfavored.

— **Updating:** If financial statements covering a period for which flash results are included in the preliminary prospectus become available prior to pricing, the Form S-1 must be updated with those financial statements and related disclosures (such as MD&A). This circumstance can trigger the need to prepare and disseminate a free writing prospectus, potentially delaying completion of the offering. In most cases, however, the company should be able to predict when such financial statements will become available and plan accordingly. ■

PREVALENCE OF FLASH DISCLOSURES

Between 2017 and 2021, 27% of US IPO companies presented flash results (including 33% of all companies that completed IPOs in the second half of 2021), compared to 17% in the preceding five-year period and up from less than 5% between 2007 and 2010. Underscoring the additional challenges posed by the inclusion of flash results once a year-end audit is underway, only 6% of US IPO companies between 2017 and 2021 presented flash results for their fourth fiscal quarter (although that percentage was nearly double the figure for the preceding five-year period).

We Just Went Public and I Can't Sell My Stock?

Lockup agreements prohibit stockholders from selling shares acquired prior to an IPO—and often shares acquired in or after the IPO—for a specified period of time (most commonly 180 days) following the IPO. Typical lockup language is broad and, with only limited exceptions, sweeps in any sale, offer to sell, pledge, grant of an option to purchase, short sale, hedging transaction or other disposition of common stock of the company; any options or warrants to purchase any shares of common stock of the company; and any securities that are convertible into or represent the right to receive common stock of the company.

In the underwriting agreement, the company typically agrees that during the lockup period, subject to specified exceptions, it will not, without the prior written consent of the lead managing underwriters, offer, sell, contract to sell, pledge, grant any option to purchase, make any short sale, or otherwise transfer or dispose of, directly or indirectly, or file a registration statement relating to, any of its securities.

PURPOSES

The purpose of lockup agreements is to help maintain an orderly market in the company's common stock while the distribution of shares is completed and initial trading develops. In the absence of lockup agreements, many pre-IPO shares typically would be eligible for immediate sale in the public market, potentially flooding the market and exerting substantial downward pressure on the market price of the newly issued shares. Lockup agreements are also intended to avoid the negative signal that can be sent by insider sales soon after the IPO. Similarly, the company's lockup obligations are intended to minimize selling pressure and additional dilution during the lockup period.

PARTIES

All existing stockholders, option holders, directors and officers are usually asked to enter into lockup agreements in connection with an IPO. Although companies often

believe that obtaining lockup agreements from the holders of 90% to 95% of the pre-IPO outstanding shares should be adequate, underwriters typically seek lockup agreements from all pre-IPO stockholders because 5% or 10% of a company's pre-IPO outstanding shares can represent a large percentage of the public float in the immediate aftermarket.

All parties typically sign the same form of lockup agreement, with occasional variations to implement pre-existing lockup arrangements previously negotiated by investors.

The company's financing agreements with pre-IPO investors and its pre-IPO employee stock plans will typically contain IPO lockup provisions. Pre-existing lockup agreements, however, generally do not provide the exact coverage requested by the underwriters and, in most cases, new lockup agreements—in the format preferred by the lead managing underwriters—will be sought.

TIMING

Lockup agreements are signed in advance of the IPO and generally go into effect immediately. Occasionally, the transfer restrictions in the lockup agreement do not become effective until the date of the preliminary prospectus used in the road show, or the date of the first public filing of the Form S-1. If the transfer restrictions go into effect at any time prior to the effectiveness of the Form S-1, pre-IPO private sales by stockholders or a pre-IPO acquisition of the company in a stock transaction will require consent of the underwriters absent specific exceptions in the lockup agreement.

Most lockup agreements provide for automatic termination if the IPO does not occur prior to a specified date. When negotiating the lockup agreement, the company should insist that the termination date be set several months or more after the anticipated offering date, or retain the option to extend the termination date if it is still pursuing the offering, to reduce the likelihood that the company will be forced to procure new lockup agreements if the IPO is delayed.

WHAT IS NEGOTIABLE?

The following lockup provisions are regularly negotiated:

- Pre-IPO stockholders routinely are granted the ability to make gifts and estate planning transfers as long as the recipients remain bound by the lockup.
- Stockholders who are not required to file Section 16 reports ordinarily are allowed to resell shares acquired in the open market.
- Section 16 insiders are often permitted to enter into Rule 10b5-1 trading plans as long as no sales are made pursuant to such plans during the lockup period.
- Lockup agreements sometimes permit cash exercises of options, the transfer of shares to the company, or "sell-to-cover" market transactions in connection with option exercises or upon the vesting or settlement of restricted stock or restricted stock units. These exceptions are often limited to the extent necessary to satisfy the payment of applicable withholding taxes and confined to transactions that will not require Section 16 reporting.
- The company's lockup obligations typically have exceptions for equity grants and issuances under stock plans described in the prospectus and issuances in connection with company acquisitions or strategic transactions (usually capped at a specified percentage of the total number of shares outstanding upon completion of the IPO), as long as each recipient enters into a lockup agreement for the remainder of the lockup period.

RELEASES

The lead managing underwriters (either one lead manager in its sole discretion, or two or more of the lead managers jointly, as specified in the lockup agreement) are permitted to release shares from the restrictions contained in lockup agreements, either selectively or *en masse*.

Pre-IPO investors sometimes seek a provision to the effect that a portion of the locked-up shares will be released if the company's stock is trading at least a specified percentage higher than the offering price within a prescribed time frame after the IPO (typically no sooner than 60 to 90 days after pricing). When the stock performs well, investors might prefer an early lockup release

We Just Went Public and I Can't Sell My Stock?

to an underwritten secondary public offering because the lockup release permits investors to select the timing of sales and avoid the underwriting discount and potential liability associated with an underwritten public offering. Investors may also request time-based, staggered releases within the first 180 days, perhaps coupled with a longer lockup period for later release tranches.

Investors sometimes also request the inclusion of a “most favored nation” (MFN) provision requiring the lead managing underwriters to release them from the lockup to the same extent other stockholders are released. The likely effect of an MFN provision—absent a share threshold below which releases do not trigger the release of other shares—is that the lead managers will not grant any release requests. If included, an MFN provision often provides that the release of a stockholder from the lockup in connection with a registered follow-on public offering will not trigger the release of any other stockholder who is given the opportunity to participate in such public offering on a pro rata basis and declines to participate. Although discretionary lockup releases sometimes occur—most commonly when pre-IPO stockholders sell shares in a secondary public offering during the lockup period—MFN provisions are rare.

FINRA Rule 5131 requires the book-running lead manager to notify the company at least two business days before the release or waiver of any lockup or other restriction on the transfer of shares by company directors or officers, and requires the book-running lead manager (or the company) to announce the release or waiver, except where its sole purpose is to permit a transfer of shares without consideration and where the transferee agrees in writing to be bound by the same lockup agreement. (A lockup release to permit the sale of locked-up shares in a registered public offering may be disclosed in the registration statement for the offering.) Public announcement of a lockup release can adversely hurt the stock's market price.

A board of directors must be mindful of its fiduciary duties when agreeing to the release of some, but not all, stockholders from lockup agreements. In a case involving Zynga's IPO, the Delaware Court of Chancery refused to dismiss a lawsuit brought against Zynga's board of directors alleging that the board had breached its fiduciary duties by modifying Zynga's IPO lockup agreements (with the consent of the IPO underwriters) to enable certain stockholders, including half the board, to sell a portion of their shares in a registered public offering (underwritten by the same underwriters) two months before the IPO lockup period would have expired. Based on the court's holding, the release of shares from lockup restrictions for a rational business reason should be protected by the business judgment rule if approved by disinterested, independent directors.

EVOLVING PRACTICES

The scope, duration and release conditions of lockup agreements have historically been all but non-negotiable in IPOs.

In recent years, with keen competition among investment banks to lead the IPOs of strong candidates, and the rise of SPAC mergers and direct listings—often with more flexible lockups, or none at all in the case of most direct listings—as viable alternatives to conventional IPOs, companies and investors increasingly have been able to negotiate more favorable lockup terms. This trend, which is particularly evident among technology companies, often results in complex lockup formulations that defy easy characterization.

The following types of lockup terms that diverge from historical norms have become more common in the last two years:

- shorter lockup periods for a portion of the shares held by non-executive employees;
- staged, time-based releases for all holders, beginning sooner than 180 days after pricing;
- early release provisions for a portion of the locked-up shares based on the aftermarket trading price of the company's stock (typically 25–33% above the IPO price,

“BLACKOUT” PERIODS—AVOIDING UNINTENDED LOCKUP EXTENSIONS

When negotiating the terms of the lockup agreement, the company should consider how the anticipated expiration date of the lockup period will fall in relation to broadly applicable and regularly scheduled quarter-end “blackout” periods during which trading in company securities will not be permitted under the company's insider trading policy following the closing of the IPO. For example, because lockup agreements typically are signed before the exact offering date is known, the lockup period could be scheduled to expire during a blackout period, which would have the unintended consequence of extending the lockup until the end of the blackout period for all holders—typically directors, officers and many (or all) employees—subject to blackout periods prescribed by the company's insider trading policy.

Underwriters have become more willing to address this issue by providing that the lockup will expire (for all or a portion of the locked-up shares) a specified number of days prior to the beginning of the blackout period, but no sooner than a specified minimum number of days after the offering. Alternatively, if not all employees are subject to the company's regular, quarter-end blackout periods, and the company wants the lockup to expire on the same date for all holders, the lockup agreement could provide that the lockup period will not expire until the opening of the regular trading window after the blackout period ends (typically the beginning of the third trading day after the company's issuance of an earnings release for the quarter). Although this approach ensures uniform treatment of all holders, it could result in a lengthier lockup than intended.

generally not sooner than 60–90 days after the IPO, often not before the company's first earnings release, and sometimes excluding directors and officers); and

- expiration of the lockup period for some or all locked-up shares shortly before the beginning of the company's first or second regularly scheduled quarter-end “blackout” period following its IPO, effectively reducing the lockup duration by anywhere from a few days to several weeks or more, depending on the timing of the scheduled termination date in relation to the applicable quarter-end and the company's insider trading policy.

Of these examples, the “blackout” provision has been the most common. ■

Are You an Officer?

30 You May Need a Scorecard to Keep Track of the Answer

This seemingly simple question often yields a surprisingly complex answer because SEC rules, state corporate law, federal tax law and common parlance provide multiple definitions of “officer.” The answers under these different definitions are significant, as they can trigger various disclosure obligations and potential liabilities.

CORPORATE OFFICERS

A company’s “corporate officers” are defined by state corporate law and the company’s bylaws. Corporate officers have the authority and duties specified in the bylaws or established by the board, can generally create binding obligations on behalf of the company, and often receive the benefit of any indemnification provisions contained in a company’s charter or bylaws. In addition, employees with titles ordinarily conferred on officers (such as vice president) can have “apparent authority” or “implied authority” to bind the company in dealing with third parties even if they are not appointed corporate officers. There are no specific SEC disclosure obligations that flow from “corporate officer” status.

OFFICERS

Rule 3b-2 under the Exchange Act defines a company’s “officers” as its president, vice president, secretary, treasury or principal financial officer, controller or principal accounting officer, and any person routinely performing corresponding functions for the company. This definition, although expansive, has limited practical significance since most required management disclosures apply to “executive officers” and not “officers” generally.

EXECUTIVE OFFICERS

Rule 3b-7 under the Exchange Act defines a company’s “executive officers” as its president; any vice president in charge of a principal business unit, division or function; any other officer who performs a policy-making function; and any other person who performs similar policy-making functions.

NAMED EXECUTIVE OFFICERS

Item 402(a)(3) of Regulation S-K defines a company’s “named executive officers” (NEOs) as anyone who served as the principal executive officer or principal financial officer during the company’s previous fiscal year, regardless of compensation, and the other three highest-paid executive officers who were serving as executive officers at the end of the company’s previous fiscal year (plus up to two additional individuals who served as executive officers during the last completed year and for whom disclosure would have been required but for the fact that they were not serving as executive officers of the company at the end of the year). Emerging growth companies and smaller reporting companies are only required to identify three NEOs (including anyone who served as the principal executive officer during the previous fiscal year), plus up to two additional individuals who served as executive officers during the last completed year and for whom disclosure would have been required but for the fact that they were not serving as executive officers at the end of the year.

PRINCIPAL OFFICERS

Various SEC rules and forms reference—but do not define—a company’s “principal executive officer” (almost always the CEO), “principal financial officer” (almost always the CFO) and “principal accounting officer” (usually the CFO or controller). These officers must sign (and potentially have personal liability for) registration statements (such as a Form S-1 for an IPO) and certain other SEC filings.

SECTION 16 OFFICERS

Specified officers of every public company—often referred to as “Section 16 officers”—are subject to the public reporting and short-swing liability provisions of Section 16 of the Exchange Act. Pursuant to Rule 16a-1(f) under the Exchange Act, a company’s Section 16 officers generally are the same as its executive officers, except that the principal accounting officer (or the controller, if there is no

principal accounting officer) automatically is a Section 16 officer even if the company does not otherwise consider such person to be an executive officer. References in stock exchange rules to “executive officers” (for example, the requirement for compensation committee approval of executive compensation) generally mean Section 16 officers.

OFFICERS SUBJECT TO SECTION 162(m)

Section 162(m) of the Internal Revenue Code disallows a federal income tax deduction by a public company for compensation in excess of \$1 million paid in a single tax year to a “covered employee,” generally defined as the principal executive officer, the principal financial officer, the other three highest-paid officers, and any individual who has been such a “covered employee” for any tax year beginning on or after January 1, 2017. For tax years beginning after December 31, 2026, an additional five highest compensated employees (even if not officers) will also be considered “covered employees.”

C-LEVEL OFFICERS

The colloquial phrase “C-level officers” may refer to a company’s chief executive officer, chief financial officer, chief operating officer, chief accounting officer and chief legal officer (and perhaps other chiefs). These terms are sometimes used—but not defined—in SEC rules. ■

WHO ARE THE EXECUTIVE OFFICERS?

The determination of the company’s executive officers is often difficult. The CEO and CFO are always executive officers, but beyond that there typically is some subjectivity in applying the SEC’s definition. The “policy-making” test, for example, can be challenging to apply if the company has one or two executives who control decision-making or a management structure that treats a large group of leaders as peers. Many companies find it helpful, in applying the relevant definitions, to focus on the universe of officers who report directly to the CEO or, if the company has multiple levels of vice president, on those at or above a specified level, such as executive vice president.

Yikes! I Need to Disclose All *That*?

31 Disclosures About Directors, Officers and Stockholders in an IPO

The Form S-1 for an IPO must include specified information about a company's directors, officers, 5% stockholders and any selling stockholders. Below is an overview of the principal disclosures that are required.

BIOGRAPHICAL AND BACKGROUND INFORMATION

- The Form S-1 must include biographical and background information (perhaps including diversity characteristics) for each *director* and *executive officer*.
- The required information includes specified bankruptcy, criminal, injunction, securities violation and stock exchange matters that occurred during the past ten years and that are material to an evaluation of the ability or integrity of a *director* or *executive officer*.

COMPENSATION

- The Form S-1 must include extensive compensation information for each of the company's *named executive officers* (NEOs).
- Compensation disclosures are for the fiscal year preceding the initial Form S-1 submission plus subsequently completed fiscal years prior to effectiveness of the Form S-1.
- The Form S-1 must disclose *director* compensation (including consulting arrangements).

STOCK OWNERSHIP

- The Form S-1 must disclose the beneficial stock ownership of each *director*, *NEO*, *5% stockholder* and *selling stockholder*. For this purpose, a person is considered to have beneficial ownership of all company securities over which the person has or shares (or has the right to acquire within 60 days) voting or investment power.
- Each *director*, *officer* and *10% stockholder* must file Form 3 with the SEC to report beneficial stock ownership (based on "pecuniary interest") as of the IPO and, post-IPO, must file Forms 4 and 5 to report all changes in beneficial ownership.

- Post-IPO, each *5% stockholder* must also file a Schedule 13D or 13G to report beneficial stock ownership (based on voting or investment power) and must amend such filings to report certain changes.

RELATED PERSON TRANSACTIONS

- The Form S-1 must disclose all transactions in which the company was a participant since the beginning of its third preceding full fiscal year that involved an amount in excess of \$120,000 and in which a *director* or *executive officer* (or any immediate family member of the foregoing) had or will have a direct or indirect material interest.
- The Form S-1 must disclose all transactions in which the company was a participant since the beginning of its third preceding full fiscal year that involved an amount in excess of \$120,000 and in which a then-*5% stockholder* (or any immediate family member of the *5% stockholder*) had or will have a direct or indirect material interest.

SELLING STOCKHOLDERS

- The Form S-1 must disclose the name and beneficial stock ownership of each *selling stockholder*, state the number of shares to be sold by each *selling stockholder*, and indicate the nature of any position, office or other material relationship that any *selling stockholder* has had with the company or any of its predecessors or affiliates within the past three years.
- If a *selling stockholder* is not a natural person, the Form S-1 must also identify any persons (entities or natural persons) who control the *selling stockholder*, and who have had a material relationship with the company or any of its predecessors or affiliates within the past three years, and describe the nature of any such relationships.
- The company may make beneficial ownership disclosures for *selling stockholders* on an unnamed group basis, as opposed to an individual basis, where the aggregate holding of the

group is less than 1% of the company's outstanding shares prior to the IPO.

FINRA RELATIONSHIPS

In order to obtain approval of the IPO's underwriting arrangements from the Financial Industry Regulatory Authority (FINRA), the managing underwriters must provide representations and information to FINRA relating to arrangements, relationships and affiliations between the company or its *stockholders* and FINRA members. This information is not publicly disclosed, but the Form S-1 must disclose any relationship between the company and a FINRA member participating in the IPO that gives rise to a "conflict of interest" under FINRA rules.

FinCEN CERTIFICATIONS

Under Financial Crimes Enforcement Network (FinCEN) rules, financial institutions (including underwriters) are required to identify and verify the identity of the individuals who own or control legal entity customers. As a result, a FinCEN certification form, together with copies of identifying documentation, must be provided by each *selling stockholder* that is a legal entity. FinCEN certifications must also be obtained from the company; a single individual (such as the CEO) with significant responsibility to control, manage or direct the company; and each individual (if any) who directly or indirectly owns 25% or more of the equity interests of the company. ■

OBTAINING REQUIRED INFORMATION

Required information is elicited from the company's directors, officers and 5% stockholders through the use of a questionnaire (commonly called the "D&O questionnaire"). These same persons, along with the company and anyone else who acquired company securities (including warrants, options or other equity-based awards) within the 180 days preceding the date of the initial Form S-1 submission, complete a separate "FINRA questionnaire." If the offering includes selling stockholders, a separate questionnaire eliciting required selling stockholder disclosures

8 IPO Market by the Numbers

PROFILE OF SUCCESSFUL IPO CANDIDATES

What does it really take to go public? There is no single profile of a successful IPO company, but in general, the most attractive candidates share the following attributes:

- **Outstanding Management:** An investment truism is that investors invest in people, and this is even truer for IPO companies. Every company going public needs experienced and talented management with high integrity, a vision for the future, plenty of energy to withstand the rigors of the IPO process and public company life, and a proven ability to execute. An IPO is not the best time for a fledgling CEO or CFO to cut their teeth.
- **Market Differentiation:** IPO candidates need a superior technology, product or service in a large and growing market. Ideally, they are viewed as market leaders in their industry. Appropriate intellectual property protection is expected of technology companies, and in some sectors, such as life sciences and medical devices, patents are *de rigueur*.
- **Substantial Revenue:** Substantial revenue is generally expected—at least \$50 million to \$75 million annually—in order to provide a platform for attractive levels of profitability and market capitalization.
- **Revenue Growth:** Consistent and strong revenue growth—25% or more annually—is usually needed, unless the company has other compelling features. The company should have visibility into sustained expansion to avoid the market punishment that can accompany revenue or earnings surprises.
- **Profitability:** Strong IPO candidates generally have track records of earnings and a demonstrated ability to enhance margins over time, although IPO investors often appear to value growth more highly than near-term profitability.
- **Market Capitalization:** The company's potential market capitalization should be at least \$200 million to \$250 million in order to facilitate development of a liquid trading market. Substantial post-IPO ownership by insiders may mean a larger market cap is required to provide ample float.

Other factors can vary based on a company's industry and size. For example, many life sciences companies will have much less revenue and not be profitable. More mature

HOW DO YOU COMPARE?

The characteristics of the IPO market in 2022 and 2023 were vastly different than in the preceding three years. Deal flow fell by more than one-half, offering sizes were much smaller and IPO companies had far less annual revenue. US-incorporated issuers completing US IPOs in 2022 and 2023 were significantly less likely to include selling stockholders, utilize a directed share program or engage a "Big 4" accounting firm, and their IPOs generally received more SEC comments and took longer to complete.

METRIC	2019–2021	2022–2023
Annual number of IPOs	249	98
IPO companies qualifying as EGCs under the JOBS Act	92%	89%
Median offering size	\$163.9 million (18% < \$50 million and 17% > \$500 million)	\$15.0 million (73% < \$50 million and 6% > \$500 million)
Median annual revenue of IPO companies	\$59.0 million (48% < \$50 million and 15% > \$500 million)	\$6.2 million (72% < \$50 million and 10% > \$500 million)
IPO companies that are profitable	27%	41%
IPOs with selling stockholders and median percentage of offering represented by those shares	Percentage of IPOs—20% Percentage of offering—32%	Percentage of IPOs—9% Percentage of offering—16%
IPOs with directed share programs and median percentage of offering represented by those shares	Percentage of IPOs—44% Percentage of offering—5%	Percentage of IPOs—18% Percentage of offering—5%
IPO companies disclosing adoption of an ESPP	69%	25%
IPO companies using a "Big 4" accounting firm	74%	32%
Stock exchange on which the company's common stock is listed	Nasdaq—78% NYSE—22%	Nasdaq—82% NYSE—18%
Median underwriting discount	7%	7%
Number of SEC comments contained in initial comment letter	Median—16 25th percentile—12 75th percentile—21	Median—20 25th percentile—16 75th percentile—26
Median number of Form S-1 amendments filed before effectiveness	Four	Seven
Number of days from initial submission to effectiveness of Form S-1	Median—104 25th percentile—83 75th percentile—158	Median—239 25th percentile—154 75th percentile—371

companies are likely to have greater revenue and market caps but slower growth rates. High-growth companies are likely to be smaller and usually have a shorter history of profitability.

Beyond these objective measures, IPO candidates need to be ready for public

ownership in a range of other areas, including accounting preparation, corporate governance, financial and disclosure controls and procedures, external communications, legal and regulatory compliance, and a variety of corporate housekeeping tasks. ■

Prevalence of EGC Elections

One of the most successful efforts to encourage capital formation as an engine of economic growth was the passage of the JOBS Act in 2012. The cornerstone of the JOBS Act is the creation of an “IPO on-ramp” that provides emerging growth companies (EGCs) with a phase-in period to come into full compliance with certain disclosure and accounting requirements. The phase-in period can continue until the last day of the fiscal year following the fifth anniversary of an IPO but will be shorter for many companies.

The prevalence of elections for some items of EGC relief—such as the ability to submit a draft Form S-1 registration statement for confidential SEC review and to provide reduced executive compensation disclosure—has remained consistently high across different types of EGCs.

Practices with respect to other items of relief—particularly those related to financial disclosure and the application of new or revised accounting standards—have varied, often reflecting the company’s size, maturity or industry, and have exhibited strong trends over time as investor expectations and market practices have evolved.

CONFIDENTIAL SUBMISSION OF FORM S-1

— **Description:** An EGC is able to submit a draft Form S-1 registration statement to the SEC for confidential review instead of filing it publicly on the SEC’s EDGAR system (and in 2017, a similar nonpublic review process became available to all companies going public). A confidentially submitted Form S-1 need not be filed publicly until 15 days before the road show commences, enabling an EGC to delay disclosure of its IPO plans and sensitive information to competitors and employees. Confidential review can also enable an EGC to abandon its IPO plans without requiring public disclosure if market conditions preclude an offering.

— **Prevalence:** Overall rates of adoption have consistently remained very high—96% of all EGCs since enactment of the JOBS Act.

REDUCED EXECUTIVE COMPENSATION DISCLOSURE

— **Description:** An EGC is allowed to provide “scaled” executive compensation disclosure and therefore need not provide Compensation Discussion and Analysis (CD&A); compensation information is required only for three named executive officers (including the CEO); and only three of the seven compensation tables otherwise required must be provided.

— **Prevalence:** EGCs have uniformly and overwhelmingly embraced the ability to provide reduced executive compensation disclosure. Overall, 99% of all EGCs (including all EGCs since 2020) have excluded CD&A from their Form S-1.

REDUCED FINANCIAL DISCLOSURE

— **Description:** An EGC is required to provide only two years of audited financial statements (instead of three years), plus unaudited interim financial statements, and is only required to include MD&A for the periods presented in the required financial statements.

— **Prevalence:** Overall, the percentage of EGCs electing to provide only two years of audited financial statements has increased dramatically, from 27% in 2012 to 93% in 2023. From the outset, life sciences companies—for which older financial information is often irrelevant—were likely to provide only two years of audited financial statements, with the percentage choosing this option reaching 100% in both 2022 and 2023. Technology companies—which generally have substantial revenue and often have profitable operations—were slower to adopt this practice, but the percentage providing only two years of audited financial statements grew from 22% in 2012 to 91% in 2022 and 100% in 2023.

Two Years of Audited Financial Statements

	2012– 2016	2017– 2019	2020– 2023	Overall
Life Sciences	87%	97%	99%	94%
Technology	37%	63%	89%	64%
All EGCs	65%	84%	93%	80%

ACCOUNTING STANDARDS ELECTION

— **Description:** An EGC may elect not to be subject to any accounting standards that are adopted or revised on or after April 5, 2012, until these standards are required to be applied to nonpublic companies.

— **Prevalence:** Through 2016, the vast majority of EGCs opted out of the extension of time to comply with new or revised accounting standards. At that time, the decision appears to have been motivated by the uncertain value of the deferred application of future, unknown accounting standards and concerns that a company’s election to take advantage of the extended transition period could make it more difficult for investors to compare the company’s financial statements to those of its peers. Starting in 2017, a major shift has occurred, with the percentage of EGCs adopting the extended transition period jumping from 11% for the period through 2016 to 50% between 2017 and 2019 and to 93% between 2020 and 2023. This trend appears to have been motivated by the desire of many EGCs to delay the application of new revenue recognition and lease accounting standards (which became mandatory for public companies in 2018–2019) or, at a minimum, to take more time to evaluate the effects of these standards before adopting them. ■

Delayed Application of New or Revised Accounting Standards

	2012– 2016	2017– 2019	2020– 2023	Overall
Life Sciences	10%	45%	92%	51%
Technology	12%	62%	93%	57%
All EGCs	11%	50%	93%	52%

EXITING EGC STATUS

In many cases, a company exiting EGC status qualifies as a “smaller reporting company” (SRC) under SEC rules and can continue to enjoy most of the disclosure and financial reporting accommodations that are available to EGCs. Generally, a company qualifies as an SRC if it has:

- Public float of less than \$250 million; or
- Less than \$100 million in annual revenues and either no public float or a public float of less than \$700 million.

Duty of Oversight Applies to Directors (and Officers, Too)

While the fiduciary duties of directors and officers are the same whether a company is privately owned or publicly traded, the risk of claims by dissatisfied stockholders alleging breaches of these fiduciary duties becomes much more significant once a company is public.

One particular type of breach of fiduciary duty claims—those based on an alleged failure of the duty of oversight—has become especially common in recent years against directors. In 2023, Delaware courts explicitly held for the first time that officers also have a duty of oversight and, therefore, face exposure to claims for alleged failure to fulfill their oversight duties. These developments highlight how important it is for the directors and officers of an IPO company to ensure the company has appropriate reporting systems and controls in place from its first day as a public company.

WHAT IS REQUIRED?

The duty of oversight requires directors and officers to make good faith efforts to implement an oversight system and then monitor it. Allegations that directors and officers violated their duty of oversight are often referred to as *Caremark* claims, referring to a landmark 1996 case involving that company.

THE FIDUCIARY DUTIES OF BOARDS AND MANAGEMENT

The fiduciary duties of directors and officers under Delaware law generally consist of:

- The *duty of care*—an obligation to act on an informed basis after due consideration of relevant materials and appropriate deliberations; and
- The *duty of loyalty*—an obligation to refrain from deriving a benefit from a transaction not generally available to all stockholders, and to otherwise act in good faith.

While almost every company going public will include in its charter a provision eliminating the personal monetary liability of directors and officers for violations of the duty of care, breaches of the duty of oversight are considered to be non-exculpable breaches of the duty of loyalty, and directors and officers who violate the duty of oversight may therefore face personal liability.

Oversight liability can arise if directors or officers either:

- utterly fail to implement any reporting or information systems or controls (“information-systems claims”); or
- having implemented such systems or controls, consciously fail to monitor or oversee the operation of those systems or controls, thus disabling themselves from being informed of risks or problems requiring their attention (“red-flag claims”).

While *Caremark* claims have frequently been described as “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment,” since mid-2019 Delaware courts have allowed *Caremark* claims in at least 10 cases to proceed past the motion to dismiss stage, meaning that plaintiffs adequately alleged that directors or officers had failed in implementing or monitoring an oversight system.

MORE CAREMARK CLAIMS SURVIVING DISMISSAL – MARCHAND THROUGH 2022

Since the 2019 Delaware Supreme Court ruling reviving claims in *Marchand v. Barnhill*, several plaintiffs’ claims have survived motions to dismiss. In *Marchand*, a listeria outbreak that contaminated Blue Bell ice cream resulted in three deaths and caused the company to recall all of its products, cease production at all plants and dismiss over a third of its employees. These catastrophes caused the Delaware Supreme Court to reverse the Delaware Chancery Court’s dismissal, allowing an information-systems claim against directors to proceed because:

- Food safety was a mission-critical compliance issue for Blue Bell, an ice cream maker;
- The board did not have a committee- or board-level process to oversee and address food safety issues; and
- Board minutes did not mention discussion about food safety concerns existing prior to the listeria outbreak or generally reflect discussion of food safety matters.

Since *Marchand*, and through 2022, the Chancery Court allowed *Caremark* claims

BOARD ACTIONS TO FULFILL OVERSIGHT OBLIGATIONS

Some of the actions a board of directors can take to help fulfill and document its oversight obligations and minimize the risk of liability under the *Caremark* standards of liability are summarized below.

To address its obligation to implement appropriate reporting or information systems or controls, the board (or designated board committee) may:

- Ensure both management and the board have installed processes for identifying and regularly reviewing mission-critical risks, and document those processes;
- Explicitly assign responsibility for oversight of key risks to the full board or a specific committee, being sure to include corresponding proxy disclosure once public;
- Not rely solely on the existence of regulatory requirements—such as SEC or FDA requirements—as a basis for assuming an adequate reporting system exists;
- Avoid being completely dependent on senior management reporting, including by hearing directly from chief compliance and risk officers, and ensure there are systems in place for employees and corporate partners to raise concerns; and
- Establish protocols for management to promptly elevate significant regulatory or compliance developments.

To address its obligation to monitor or oversee the operation of the implemented systems or controls, the board (or designated board committee) may:

- Be vigilant for warning signs (often referred to as yellow or red flags) and follow up when identified, including giving consideration to the engagement of outside advisors;
- Receive regular reports on mission-critical risks and regulatory issues;
- Ensure that meeting minutes demonstrate regular oversight and follow-up on potential concerns; and
- Exercise care in informal communications (such as emails and texts), because such materials may in some situations be discoverable in response to a books and records request.

against directors to proceed in cases involving, among others, a life sciences company whose lead product candidate suffered from a low confirmed success rate and ultimately ran into FDA problems; an

Duty of Oversight Applies to Directors (and Officers, Too)

11 Recent Cases Clarify Caremark Duties of Officers and Focus on Legal Compliance Risks

OFFICER ACTIONS TO FULFILL OVERSIGHT OBLIGATIONS

Some of the actions officers can take to help fulfill and document their oversight obligations under the *Caremark* standards of liability include:

- Ensure reporting or information systems or controls are in place and well-documented, for matters within a specific officer's areas of responsibility;
- Identify and understand the company's key risks in order to be better able to recognize and respond to red flags, including those that do not relate to direct areas of responsibility; and
- Escalate any significant inadequacies in the information systems, as well as red flags.

auto parts manufacturer that had persistent problems with internal controls and oversight of related person transactions ultimately requiring it to restate its financial statements; and a pharmaceutical company whose subsidiary pleaded guilty to criminal charges related to inappropriate repacking of oncology drugs into syringes.

MCDONALD'S CLARIFIES THAT OFFICERS ALSO HAVE CAREMARK DUTIES – 2023 AND THE ROAD AHEAD

In 2023, for the first time, the Chancery Court explicitly held that officers also have *Caremark* duties. Despite ultimately dismissing the suit on other grounds, in *In re: McDonald's Corp. Stockholder Derivative Litigation*, the Court found plaintiffs adequately pled a red-flag claim against the chief people officer, concluding a litany of HR and EEOC complaints, as well as employee strikes and letters from US Senators, constituted awareness of an allegedly harassment-friendly company culture. The chief people officer was also personally alleged to have committed sexual harassment.

The *McDonald's* opinion noted that an officer's duty of oversight will typically be limited to the officer's areas of responsibility but also noted that "particularly egregious red flag[s]" may trigger an officer's duty to act, even if it is outside the officer's domain.

Following *McDonald's*, *Caremark* claims against officers have been allowed to proceed in at least three cases, including one involving a dispenser of opioids whose management of its controlled substance compliance programs allegedly violated a DEA settlement and the Controlled Substances Act.

To close out a whirlwind year for *Caremark* claims, a December 2023 Chancery Court decision clarified that officer claims are held to the same standard as director claims. In *Segway v. Cai*, the Court considered *Caremark* claims against a corporate officer for alleged failure to escalate substantial financial performance issues to the board. In dismissing the plaintiffs' claims, the Court explained that the standard for *Caremark* claims against officers is the same as for directors, and to think, as the plaintiffs had argued, that *McDonald's* created a lower standard for claims against officers is "a distressing reading of our law."

NO ONE-SIZE-FITS-ALL APPROACH TO OVERSEEING RISK

Discharging the duty of oversight requires directors and officers to demonstrate that they have used good faith efforts to put in place a reasonable system of monitoring and reporting the company's key risks, especially those that relate to mission-critical regulatory, legal compliance and public safety matters.

There is no one-size-fits-all approach. Boards and management have discretion to implement context-dependent and industry-specific approaches to risk oversight tailored to the activities and resources of the businesses they oversee, which may include delegating oversight of specific market or industry risks to board committees. That said, it is not sufficient to solely rely on government regulation of a company's industry or simply hold general discussions with management about operational issues at periodic board and committee meetings.

Other cases in 2023 helped clarify the focus of *Caremark* on legal compliance risks rather than on general business risks, as the Delaware courts have consistently drawn the distinction between these two

types of risks when determining whether a breach of the duty of oversight has occurred. The facts underlying the October 2023 Chancery Court dismissal in *In re: ProAssurance Corp. Stockholder Derivative Litigation* offer a helpful illustration. In that case, an insurance company deviated from its typical practice of underwriting policies for smaller physician groups and agreed to underwrite a policy for a national provider, which created increased risk that loss reserves held by the company would become inadequate. The Court ruled that the board's decision to pursue a higher-risk strategy did not result in *Caremark* liability because "[t]he only so-called red flags were of business risks—not illegality." This distinction was echoed in *Segway*, with the Court stating that *Caremark* was not intended to create officer liability for "everyday business problems" like the financial discrepancies in that case.

At a minimum, directors and officers should ensure that key regulatory, legal compliance and public safety risks are monitored at the company level and included in the agenda for every regular board meeting, and that the board itself includes directors who have sufficient experience in those key risk areas or consults independent external experts who do.

DO YOUR WORK AND DOCUMENT IT

Practically speaking, directors and officers need to be able to demonstrate that they have been proactive in discharging their risk oversight responsibilities. This generally means being able to show that:

- the company has sufficient reporting and compliance systems;
- regulatory and compliance issues are effectively reported up; and
- when issues are reported, actions are taken to investigate and, if appropriate, address such issues.

It is important to contemporaneously document oversight activities, including in board meeting minutes, given that it is now common for plaintiffs' lawyers to use information gathered through books and records requests in an effort to craft a complaint that is more likely to withstand a company's motion to dismiss. ■

The Reverse Merger Alternative to an IPO

14 Technique Continuing to Gain Traction in Life Sciences Sector Despite SEC Scrutiny

In recent years, a variety of alternative paths to public ownership and trading liquidity have emerged. The reverse merger is one of the newest—and among the oldest—alternatives to a conventional IPO for a private company seeking to become publicly traded, and, due to a confluence of factors, we have seen a marked uptick in reverse merger activity, as well as important legal and business developments impacting this transaction structure.

THE NEW REVERSE MERGER

Despite historical abuses of the technique, reverse mergers remain a potentially attractive transaction structure for private companies with significant cash needs, such as life sciences companies that, for various reasons, may not be able to immediately access the IPO market. But it takes two parties to make a reverse merger, and private companies look for public companies with the following attributes:

- material net cash, replicating the proceeds that would be raised in a traditional IPO;
- limited operations and limited and known (and quantifiable) liabilities;

BASIC STRUCTURE OF A REVERSE MERGER

In a typical reverse merger:

- a privately held company merges with a publicly listed company;
- the pre-merger stockholders of the private company own a majority of the stock of the combined company;
- the management and other employees of the private company become the management and employees of the combined company;
- the composition of the combined company board reflects representation proportional to the post-closing ownership split;
- the business of the private company becomes the business of the public company; and
- the combined company changes its name to that of the private company.

In many cases, the combined company will seek to raise additional capital (either privately, concurrently with the completion of the merger, or publicly, following the merger) to extend its cash runway.

- a reasonably high degree of confidence that it can deliver the requisite stockholder votes to approve the transaction, given its stockholder base; and
- a national securities exchange listing (preferably Nasdaq or the NYSE) that will remain following completion of the transaction.

The trend of declining public company valuations (including a surprising number of companies trading at values below their net cash), coupled with challenging conditions in the traditional IPO market, has led to a significant uptick in reverse mergers with publicly held life sciences companies since the beginning of 2022. These transactions have originated most frequently with pre-commercial life sciences companies that are listed on a major exchange and suffer a scientific setback or other disruption leading to a restructuring (or winding down) of operations—often while holding significant amounts of cash. In these circumstances, the reverse merger transaction results in the public company effectively reinvesting its cash into the business of the private company, giving the public company's legacy stockholders the opportunity to continue to hold stock in a new business while the formerly private company takes advantage of the public company's existing cash and stock exchange listing.

TRANSACTION CONSIDERATIONS

Exchange Ratio

The exchange ratio for a reverse merger transaction is typically based on the relative valuations of the public and private companies. Although the private company's valuation is often tethered to its valuation from its most recent private financing, the final value ascribed to the private company will ultimately be the product of negotiations between the parties, including feedback from any investors providing capital to the combined company. The public company's valuation, by contrast, will typically be based on its anticipated available net cash at closing (after customary deductions and excluding any capital concurrently raised by the combined company) plus a negotiated premium for its public stock listing. As noted below, little to no value is often ascribed to the public company's legacy assets, which fact raises its own set of considerations.

BACKGROUND

In a typical "reverse merger," a private company merges with and into a publicly traded company, with the combined company remaining publicly held. The mechanism is referred to as a "reverse" merger because, while the public company is the legal acquirer, the private company's *stockholders* acquire the public company, as the pre-merger stockholders of the private company own a majority of the stock of the combined company.

SEC Filing and Review

A reverse merger transaction typically requires a merger proxy statement and/or a Form S-4 registration statement to be prepared and filed with the SEC, although as noted below there are certain structures that offer some hope for increased speed. The merger proxy/Form S-4 is at least as complicated as—and is often more complicated and time intensive than—the Form S-1 for a conventional IPO for several reasons:

- The merger proxy/Form S-4 must include separate audited financial statements for each company, plus pro forma combined financial statements reflecting the combination of the two companies.
- The merger proxy/Form S-4 must include detailed descriptions of each company's process leading up to execution of the merger agreement and its board's reasons for recommending approval of the merger. A description of the fairness analysis provided by the public company's financial advisor to the board (including relevant inputs to the fairness analysis, such as financial projections for the private company) must also be included.
- Scrutiny by the Staff of the SEC of merger proxy/Form S-4 filings for reverse mergers has been increasing, particularly in the background, fairness analysis and financial projections sections. The Staff often focuses on the process undertaken by each company, including measures taken by the public company to mitigate potential conflicts of interest, the reasons the public company elected to pursue a reverse merger rather than a liquidation, wind-down or other alternative, and the reasons the private company decided to pursue a reverse merger rather than a traditional IPO.

The Reverse Merger Alternative to an IPO

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— Merger proxy/Form S-4 filings often attract strike lawsuits claiming deficient disclosures and/or an inadequate board process, and activist investors sometimes publicly state that they intend to vote against the transaction unless the terms are modified or that the transaction should be abandoned altogether—in either case introducing delays until a resolution is reached.

These factors can contribute to a longer timeline than that for a conventional IPO, with the period between signing and closing often ranging from three to six months (and sometimes longer).

SIMULTANEOUS SIGNING AND CLOSING

Parties to reverse merger transactions in the life sciences sector often seek to maximize the speed to closing, as the public company's net cash is directly related to both the exchange ratio (and the resulting ownership percentages of each party) and the post-closing public company's cash runway, and every day that goes by means more cash burned prior to the closing of a transaction. As a result, parties often consider whether it is feasible to simultaneously sign and close such a transaction.

Generally, Nasdaq and NYSE rules require pre-closing stockholder approval (i) in respect of the issuance of securities in connection with an acquisition of the stock or assets of another company if the shares of common stock to be issued in the transaction exceed 20% of the issuer's total shares outstanding or represent more than 20% of the voting power of the issuer's total voting securities outstanding prior to the transaction and/or (ii) if the transaction would result in a "change of control" of the issuer. Neither Nasdaq nor the NYSE specifically defines the parameters in which a transaction will constitute a "change of control." For example, in determining whether a "change of control" has occurred, Nasdaq considers "all relevant factors including, but not limited to, changes in the management, board of directors, voting power, ownership, and financial structure of the company."

Under the "sign and close" structure, the need for stockholder approval of the transaction prior to closing is avoided by

first, limiting the amount of common stock issued in the transaction to up to 19.9% of the outstanding common stock and issuing any remaining balance of shares as non-voting convertible preferred stock that does not convert until stockholder approval of the issuance is obtained, and second, ensuring that the transaction does not constitute a change of control for Nasdaq purposes.

The issuer (i.e., the public company) agrees to seek stockholder approval of the conversion of the preferred stock following the closing. Typically, if stockholder approval is not obtained, the issuer would be required to continue to seek stockholder approval and, in certain circumstances (generally beginning six months after closing), various adverse consequences would attach, including that the preferred stock would become redeemable for cash. The shares of preferred stock are issued in a private placement, and so, following closing, a resale registration statement is filed. The "sign and close" structure also assumes that there is no new listing process on Nasdaq required.

Determination of a change of control is a facts and circumstances analysis that considers:

- voting power;
- continuity of management;
- board continuity;
- consistency in corporate headquarters;
- corporate name (no current plan to change the company's name/stock symbol); and
- accounting treatment (that the public company is the "acquirer" of the private company for accounting purposes).

The parties will need to approach the applicable securities exchange prior to the execution of definitive agreements to seek input on whether the proposed transaction structure requires stockholder approval. Frequently, the parties will determine in dialogue with the exchange and each other that the transaction would constitute a change of control and the parties are unwilling to alter the business arrangements to avoid that conclusion; for example, the purpose of these transactions is often to effectively bring the private company public—such that the combined company will reflect the board,

management, operations and even name of the private company—factors that are all indicia of the occurrence of a change of control. Nevertheless, there are times, for example in transactions that constitute more traditional "mergers" or where the private company is more of an asset than a standalone business, that the simultaneous "sign and close" structure can be a viable and speedy alternative.

SHELL COMPANY CONSIDERATIONS

Typically, the parties to a reverse merger have taken the view that the public company is not, as a technical matter, a "shell company," even if it is actively looking for a merger partner and not prioritizing its historical business. A "shell company" is defined as a registrant that has: "(1) no or nominal operations; and (2) either: (i) no or nominal assets; (ii) assets consisting solely of cash and cash equivalents; or (iii) assets consisting of any amount of cash and cash equivalents and nominal other assets." Because the public companies involved in reverse mergers typically have more than "no or nominal" operations or assets, generally still employ a management team and other personnel, and own assets, including intellectual property assets, most recent reverse merger transactions proceeded on the basis that the public company was not a "shell company."

The SEC has begun to challenge those assumptions, however, with significant consequences. In the adopting release for the SEC's final rules related to "Special Purpose Acquisition Companies, Shell Companies and Projections," issued in January 2024, the Staff specifically stated that shell companies will include any "company that has assumed the appearance of having more than 'nominal' assets or operations," and further that the applicable rules will apply "in situations where, in substance, a shell company business combination is used to convert a private company into a public company," including to "any company that sells or otherwise disposes of its historical assets or operations in connection with or as part of a plan to combine with a non-shell private company in order to convert the private company into a public one." This would include the increasingly common "fire sale CVR," in which the public company issues,

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in a pre-closing dividend to its pre-closing stockholders, a contingent value right (CVR) in respect of the right to receive the proceeds of the sale or other monetization of any and all legacy assets of the public company. The Staff has indicated it views this sort of arrangement as essentially ensuring that the public company is a shell company.

If one of the parties in a business combination transaction is deemed to be a “shell company,” other than a “business combination related shell company” (i.e., a SPAC), then there are a number of consequences, including:

- **Form S-3:** The combined company will not be eligible to use a registration statement on Form S-3 until 12 months after the business combination/reverse merger, meaning the combined company must use a registration statement on Form S-1 within the first 12 months.
- **Form S-8:** The combined company will not be eligible to use a registration statement on Form S-8 for any equity plans or awards until at least 60 calendar days after the closing of the transaction.
- **Financial Statements:** The combined company must file the financial statements for the acquired company within four business days of completion of the business combination/reverse merger (with no available extensions).
- **“Ineligible Issuer”:** The combined company will be an “ineligible issuer” for three years following closing of the business combination/reverse merger. During that three-year period, the combined company cannot, among other things, (i) qualify as a well-known seasoned issuer (WKSI), meaning it may not file an automatically effective shelf registration statement on Form S-3 even if the combined company had a public equity float greater than \$700 million; (ii) rely on the safe harbor under Rule 163A, which establishes a broad exemption from quiet period restrictions for certain communications made more than 30 days prior to the public filing of a registration statement; or (iii) use a free writing prospectus.
- **Rules 144/145:** Importantly, affiliates of the private company that receive shares of the public company in the merger are presumptively deemed to be statutory

underwriters with respect to resales of those securities, and as a result those securities may not be included in the Form S-1 resale registration statement and would not be eligible for resale until one year after closing, other than in a fixed price offering in which such investors are named as underwriters in the prospectus.

Care must be taken early in the structuring discussions regarding a potential reverse merger transaction to avoid being deemed a “shell company.” For example, the parties should consider what personnel and operations are at the public company, how the value of the public company is determined in the transaction (including whether any value is ascribed to the company’s legacy assets and operations), and whether the combined company will retain any of the legacy assets or operations following the closing, rather than including a CVR that contemplates all legacy assets being liquidated with the proceeds distributed to pre-closing stockholders.

MERGER AGREEMENT

In a typical reverse merger transaction, the merger agreement is structured as a “public style” agreement, in which there are no post-closing remedies for either party and the representations and warranties and covenants are, to a large degree, reciprocal. However, the following points typically are the subject of particular focus in negotiations:

- **Minimum Net Cash Closing Condition:** Most merger agreements for reverse mergers require the public company to

have at closing a specified minimum amount of “net cash” (below which the private company could refuse to close), a mechanism to adjust the exchange ratio if net cash is below a specified threshold, or both.

- **Net Cash Definition:** Given the minimum net cash closing condition and the importance of the amount of net cash to the premise and economics of a reverse merger transaction, the parties typically spend significant time understanding and negotiating the specific liabilities and obligations—including contingent or potential liabilities—that will be deducted from available cash to determine the amount of “net” cash at closing.
- **CVRs/Dividends:** Because the valuation of the public company in a reverse merger transaction often ascribes no value to its legacy assets, it is not uncommon for the public company to issue to its pre-closing stockholders CVRs representing the right to receive proceeds, if any, from the post-closing monetization of its legacy assets. Depending on the amount of its available cash, the public company may also negotiate the right to pay a cash dividend to its stockholders prior to closing, subject to the minimum net cash closing condition.
- **Termination Fees; Reimbursement of Expenses:** The circumstances in which one party to a reverse merger must pay a termination fee and/or reimburse the other party’s expenses are broader than in the typical public M&A context. ■

REVERSE MERGERS ON MAJOR US EXCHANGES BY INDUSTRY SECTOR AND YEAR

INDUSTRY	2019	2020	2021	2022	2023	TOTAL
Healthcare and Life Sciences	14	12	13	6	14	59
Technology	2	4	4	1	3	14
Consumer Goods and Services	2	3	4	1	—	10
Energy	1	2	4	2	1	10
Financials	1	1	2	2	2	8
Other	5	2	5	3	3	18
Total	25	24	32	15	23	119

Source: S&P Global Market Intelligence

Do I Really Need to Disclose That?

17 Recent SEC Enforcement Actions Highlight Importance of D&O Questionnaires

The Form S-1 for an IPO must include specified information about a company's directors, officers and 5% stockholders. The required information is elicited from these parties through a questionnaire (commonly called the D&O Questionnaire). D&O Questionnaires typically are timed so that they will be completed and returned shortly before the initial Form S-1 filing or submission to avoid the need for immediate updates.

A number of recent SEC enforcement actions alleging failure of companies to disclose perquisites and related party transactions highlight the importance of D&O Questionnaires, including the care taken by directors and officers in completing, and by companies in reviewing, D&O Questionnaires.

SEPTEMBER 2023

- The SEC settled charges against a rideshare company for allegedly failing to disclose a director's role in a stockholder's private sale of approximately \$424 million of shares prior to the company's IPO in March 2019. According to the SEC's order, a director of the rideshare company arranged for a stockholder to sell its shares to a special purpose vehicle (SPV) set up by an investment adviser affiliated with the director; then the director contacted an investor interested in purchasing the shares through the SPV. The company allegedly approved the sale and secured a number of terms in the contract. The director (who left the board at the time of the transaction) received millions of dollars in compensation from the investment adviser for his role in structuring and negotiating the deal. The SEC order stated that the director did not disclose his compensation or his material interest in the transaction to the company. As a result, the company failed to disclose information regarding the sale in its Form 10-K for 2019. Without admitting or denying the SEC's allegations, the company agreed to pay a \$10 million fine.
- The SEC settled charges against a government contractor for allegedly failing to make required disclosures related to its employment of an executive officer's siblings. According to the SEC's order, the company appointed

a longtime employee as an executive officer in 2019. The officer's two siblings were also longtime employees of the company who each received annual compensation in excess of \$120,000 (the threshold amount for disclosure of related party transactions). The company filed annual reports and proxy statements for 2019 through 2021 that did not disclose this information. Without admitting or denying the SEC's allegations, the company agreed to pay a \$500,000 fine.

JUNE 2023

- The SEC settled charges against Stanley Black & Decker Inc. for allegedly failing to disclose perquisites provided to executives, as well as charges against a former Stanley Black & Decker executive for his role in the company's alleged failure to disclose perquisites and personal benefits provided to him. In charging the former executive, the SEC focused on the company's D&O Questionnaire and claimed that the former executive failed to disclose certain of his perquisites and benefits in response to questions relating to compensation. These undisclosed perquisites and benefits were comprised of chauffeur services, other travel items, meals, apparel, car repair services, approved use of the corporate aircraft, personal services provided to the former executive by company employees, and certain gifts and products. The SEC also noted the former executive's receipt of various drafts of the company's proxy statement to highlight that he had the opportunity to correct any misstatements made in his D&O Questionnaire but failed to do so. Neither the company nor the former executive admitted or denied the SEC's allegations. The company's remedial measures, which included an internal investigation, cooperation with the SEC's investigation and disclosure in its Form 10-K, were sufficient to prevent monetary penalties against the company. However, the former executive was ordered to pay a \$75,000 fine.

MARCH 2023

- The SEC settled charges against The Greenbrier Companies, Inc., for allegedly failing to disclose perquisites given to its named executive officers (NEOs)

and certain information regarding related party transactions, and against its founder and former CEO for his role in the company's alleged failure to disclose such information. In the SEC's orders against both the company and the former CEO, the SEC focused on the D&O Questionnaires that the former CEO completed from 2017 to 2021 and, in each such questionnaire, the former CEO's alleged failure to disclose (a) some of his perquisites, including travel expenses for his spouse and personal security expenses, and (b) the dollar amount of his related party transactions. In accepting the settlement offer, the SEC considered the company's training of NEOs and employees on the D&O Questionnaires as a remedial measure. However, despite remedial measures, the company was ordered to pay a \$1 million fine, and the former CEO was ordered to pay a \$100,000 fine, in each case, without admitting or denying the SEC's allegations.

These actions demonstrate the need for careful review of the questions included in D&O Questionnaires, to ensure that they prompt fulsome responses, and careful review of the answers to completed D&O Questionnaires, to ensure that all required information is properly disclosed in the Form S-1. ■

THE REQUIRED INFORMATION

The D&O Questionnaire gathers information that is required to be included in the Form S-1, including biographical and background information for each director and executive officer; compensation information for the company's NEOs and directors; beneficial stock ownership of each director, NEO and 5% stockholder; and information regarding related party transactions.

Other important information is collected through separate questionnaires including (a), a FINRA Questionnaire provided to directors, officers, 10% stockholders and the company in order to support the required representations and disclosures made by the managing underwriters to FINRA and (b), a Selling Stockholder Questionnaire provided to all selling stockholders in order to elicit beneficial stock ownership information, the nature of any material relationship that the selling stockholder has with the company and other required disclosures.

The Pros and Cons of an ESPP

OVERVIEW

An employee stock purchase plan (ESPP) that satisfies the requirements of Section 423 of the Internal Revenue Code (Section 423) permits employees (but not non-employee directors, consultants or advisors) of a public company to purchase shares of common stock at a discount from the market price with favorable tax treatment.

Among other requirements, Section 423:

- requires that substantially all employees (excluding 5% stockholders) be allowed to participate in the ESPP;
- requires that all employees granted options under the ESPP have the same rights and privileges;
- imposes an annual limit of \$25,000 per employee on the value of the stock purchased under the ESPP;
- requires the company's stockholders to approve the ESPP; and
- sets the minimum purchase price at 85% of the lesser of the fair market value of the stock at the beginning of the offering period and the fair market value of the stock on the purchase date.

Accounting rules (ASC Topic 718) require companies to recognize compensation expense over the requisite service period for rights to purchase stock granted under an ESPP, unless the discount is 5% or less and there is no "lookback" feature allowing the discount to be taken from the market price at the beginning of the offering period (rather than the purchase date).

Notwithstanding the compensation charges, the incidence of ESPPs among IPO companies has grown significantly over the past 15 years, with ESPPs generally including a 15% discount and a lookback feature. For example, the percentage of all IPO companies adopting an ESPP increased from 33% in the years from 2010 to 2013 to 60% in the years from 2020 to 2023. All but two of the ESPPs adopted by companies going public since the start of 2020 had a 15% discount, and all but eight had a lookback feature.

Some of the key pros and cons of an ESPP are summarized as follows:

PROS

- An ESPP can encourage broad-based employee ownership of company stock.
- Through the use of payroll deductions, purchases under an ESPP are convenient and typically avoid brokers' commissions.
- Although not a perfect substitute for a directed share program (DSP), an ESPP structured to commence at the time of the IPO may help reduce employee disappointment if the company decides not to make IPO shares available to employees in a DSP.
- Participants can acquire shares at a discount from the market price. With proper structuring, an ESPP can even be used as a means to permit employees to invest at a discount from the IPO price.
- If the ESPP complies with Section 423, participants receive favorable tax treatment for the shares purchased under the ESPP, including deferral of any tax on the discount until the shares are sold, and the possibility of long-term capital gains treatment for further appreciation if applicable holding periods are met.
- If other employers with which the company regularly competes for employees offer ESPPs and the company does not, it may be at a competitive disadvantage in hiring.

CONS

- In practice, many employees immediately sell the shares received under an ESPP, defeating the goal of encouraging employee stock ownership in the company.
- Unless the ESPP is structured with a discount of 5% or less and there is no lookback feature, the company

will incur stock-based compensation charges, which will reduce its GAAP income (though this is less important to companies that report EBITDA measures from which stock-based compensation charges have been removed).

- If the ESPP is structured to avoid compensation charges, the attractiveness of the plan to employees is substantially reduced.
- Legal requirements may force foreign employees to be excluded from the ESPP, potentially alienating a portion of the company's workforce.
- To the extent employees hold the stock acquired under the ESPP and the market price declines below the purchase price, ill will and disappointment among employees may result.
- The ESPP creates administrative obligations for the company, including annual IRS reporting requirements, and administrative foot faults can be costly and time-consuming to remedy.
- Special arrangements are required if the company desires to have the first offering period commence upon effectiveness of the Form S-1 at the IPO price. The company may enroll employees in the ESPP prior to the effectiveness of the Form S-8 (pursuant to which the shares will be registered) only if no money is collected before such effectiveness and if the initial deemed election for all participants is set at the highest permitted level. Ensuring that the arrangement is appropriately structured at a time when the company may not yet have engaged with a third-party plan administrator may create a significant administrative burden on management at an already demanding time. ■

PREVALENCE AND TERMS OF ESPPs IN IPOs

YEAR	COMPANIES WITH ESPP	ESPP DISCOUNT EQUALS 15%	ESPP INCLUDES LOOKBACK FEATURE	INITIAL ESPP OFFERING PERIOD COMMENCES UPON IPO
2014 to 2016	47%	95%	97%	25%
2017 to 2019	57%	97%	97%	20%
2020 to 2023	60%	99%	97%	9%

Source: WilmerHale analysis of SEC filings

An IPO closing heralds the start of Exchange Act reporting obligations, which apply not only to companies but also to their directors, officers and significant stockholders. In October 2023, the SEC amended the rules governing beneficial ownership reporting obligations under Regulation 13D-G. These amendments impact stockholders by accelerating the filing deadlines for initial and amended beneficial ownership reports on Schedules 13D and 13G, among other changes, and stockholders will need to adjust their reporting processes accordingly.

BACKGROUND

Section 13 of the Exchange Act imposes reporting obligations on beneficial owners of more than 5% of any class of equity securities registered under the Exchange Act. For most public companies, their “covered class” is their common stock. Stockholders must make a Schedule 13D or 13G filing with the SEC to publicly report their initial acquisition of the company’s common stock and must amend this filing if material changes occur in the disclosed information. While there is overlap in the disclosure required by the two forms, Schedule 13G is shorter and easier to complete than Schedule 13D. In general, Schedule 13G is available to any stockholder that falls within one of the following three groups:

- **Qualified institutional investors** (QIIs) include investors that fall into one of several enumerated categories (such as banks and broker-dealers), where the acquisition that triggered the filing obligation was made in the ordinary course of business and not to influence the control of the company, and where the investor gave prompt notice if the acquisition was made on behalf of other specified persons.
- **Exempt investors** (EIs) include investors that beneficially owned more than 5% of the company’s common stock prior to the registration of the company’s common stock under the Exchange Act in connection with the IPO (such as founders and pre-IPO investors) and that do not subsequently acquire additional shares representing more than 2% of the company’s common stock in a 12-month period.

SCHEDULE 13D AND 13G FILING REQUIREMENTS UNDER THE AMENDED RULES

Filing Type	Schedule 13D Filing Deadlines	Schedule 13G Filing Deadlines
Initial Filing	Within 5 business days after acquiring beneficial ownership of more than 5% or losing eligibility to file on Schedule 13G	QII & EI: 45 days after calendar quarter-end in which beneficial ownership exceeds 5% QII: 5 business days after month-end in which beneficial ownership exceeds 10% PI: Within 5 business days after acquiring beneficial ownership of more than 5%
Amendment Filing	Within 2 business days after the occurrence of a “material change”* in the facts set forth in the previous Schedule 13D	QII, EI & PI: 45 days after calendar quarter-end in which a material change in the facts set forth in the previous Schedule 13G occurred QII: 5 business days after month-end in which beneficial ownership exceeds 10% or a 5% increase or decrease in beneficial ownership PI: 2 business days after exceeding 10% beneficial ownership or a 5% increase or decrease in beneficial ownership

** Although Regulation 13D-G does not define “material,” the SEC has indicated that a material change includes any acquisition or disposition of 1% or more of the company’s common stock.*

- **Passive investors** (PIs) include investors that beneficially own between 5% and 20% of the company’s common stock and that do not seek to acquire influence or control over the company.

FILING MECHANICS

Section 13 filings are made electronically via the SEC’s EDGAR system. The recent amendments extend the cutoff time for Schedule 13D and 13G filings to 10 p.m. ET, which aligns with the cutoff time for Section 16(a) ownership reports (i.e., Forms 3, 4 and 5), and require use of a new Schedule 13D- or 13G-specific extensible markup language (XML).

SELECTED OTHER CHANGES

Other key rule changes in the SEC’s October 2023 adopting release include:

- **Item 6:** The amendments revise Rule 13d-101 to expressly state that under Item 6 of Schedule 13D, stockholders must disclose any contracts, arrangements, understandings and relationships with respect to any company securities, including derivative securities that use a covered class as their reference security (such as call options, put options or security-based swaps).
- **Rule 13d-5:** The amendments revise Rule 13d-5 to clarify that a “group”—which is formed when two or more persons

agree to act together for the purpose of acquiring, holding, voting, or disposing of a company’s securities—is deemed to acquire any additional equity securities acquired by a group member after the group’s formation, although the rule includes a carve-out for certain intragroup securities transfers.

- **Technical Amendments:** The SEC also adopted a number of technical amendments to reflect the impact of the substantive rule changes (e.g., updating titles and designations and incorporating conforming changes, as well as utilizing gender-neutral phrasing).

The SEC also provided guidance regarding its views on certain nuanced aspects of beneficial ownership reporting, including group formation and the application of existing rules to cash-settled derivative securities. ■

IMPLEMENTATION TIMELINE

The amendments became effective on February 5, 2024, with compliance generally required as of that date, subject to the following exceptions:

- Compliance with the XML requirement is mandatory beginning on December 18, 2024.
- Compliance with the revised Schedule 13G filing deadlines, for both initial and amended filings, is required beginning September 30, 2024.

Accounting Developments in the Spotlight

OVERVIEW

2023 marked a busy year for public company accounting and auditing standard setting, and audit committees and IPO companies should take note. Importantly, the Financial Accounting Standards Board (FASB) published two Accounting Standards Updates that are expected to meaningfully affect public company disclosures regarding segment reporting and income taxes. The Public Company Accounting Oversight Board (PCAOB) also issued a proposal on auditor responsibilities with respect to noncompliance with laws and regulations (NOCLAR) that, if adopted, will likely have sweeping effects on existing audit systems and processes. Plus, SEC Chief Accountant Paul Munter made remarks expressing concern around internal control over financial reporting (ICFR), particularly about strengthening companies' and auditors' risk assessments.

FASB ACCOUNTING STANDARDS UPDATES

Segments. Described by FASB Chair Richard Jones as "FASB's most significant change to segment reporting since 1997," the amended segment reporting standard will require that companies:

- Disclose significant segment expenses that are both regularly provided to the chief operating decision maker (CODM) and included in reported segment profit or loss, along with certain other significant expense items.
- Disclose the title and position of the CODM and explain how the CODM uses reported measure(s) of segment profit or loss in assessing segment performance and allocating resources. Multiple measures may be reported if actually used by the CODM as long as the measure most consistent with US GAAP is disclosed.
- Provide all annual disclosures about a reportable segment's profit or loss and assets in interim periods.
- Make all required segment disclosures even if there is only one reportable segment.

Amended Segment Standard (ASU 2023-07)

Effective for annual periods beginning after December 15, 2023 and for interim periods within fiscal years beginning after December 15, 2024

Amended Income Taxes Standard (ASU 2023-09)

Effective for annual periods beginning after December 15, 2024 for public companies

Taxes. The FASB has responded to investor requests for additional transparency concerning income tax information. Under the amended income tax disclosure requirement, companies will be required to provide more granular detail in the financial statement footnotes, explaining the difference between their effective tax rate and statutory tax rate while highlighting tax risks, opportunities and management in a global context. This disclosure will include a new tax rate reconciliation table with a number of reconciling items, including state, local and foreign taxes by jurisdiction, tax credits, changes in valuation allowances, and nontaxable/nondeductible items, among others.

AUDITING DEVELOPMENTS

2023 was one of the PCAOB's busiest years in recent memory. Of note, its NOCLAR proposal has attracted significant public attention and aims to expand auditors' responsibilities for considering a company's noncompliance with laws and regulations, including fraud. The current audit guidance, AS 2405 *Illegal Acts by Clients*, works in conjunction with Section 10A of the Exchange Act, which establishes investigation procedures and required communications for when an auditor "detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements of the issuer) has or may have occurred."

The NOCLAR proposal would significantly expand auditors' obligations to plan and perform specific procedures for identifying laws and regulations with which noncompliance could reasonably have a material effect on the financial statements,

whether directly or indirectly, which goes beyond the current auditing requirements and Section 10A. The proposal may result in increased auditor fees, changes to the way audits are conducted, and increased pressure on maintaining a client's attorney-client privilege and other legal protections. The PCAOB is reviewing comments on the proposal and is targeting adoption of a NOCLAR auditing standard in 2024.

ICFR RISK ASSESSMENTS

SEC Chief Accountant Paul Munter noted in a public statement released in August 2023 that members of the Office of the Chief Accountant "are troubled by instances in which management and auditors appear too narrowly focused on information and risks that directly impact financial reporting, while disregarding broader, entity-level issues that may also impact financial reporting and internal controls." The statement signals an expectation for a broader consideration of, and even greater disclosure around, risks to a company's ICFR.

Speaking to risk assessments specifically, the statement emphasized the need for management to monitor for new or changing business risks, including loss of financing, customer concentrations, declining conditions affecting the company's industry, and changes in technology. Consideration of these risks could be viewed as potentially expanding the matters to be considered by management in assessing the effectiveness of a company's ICFR.

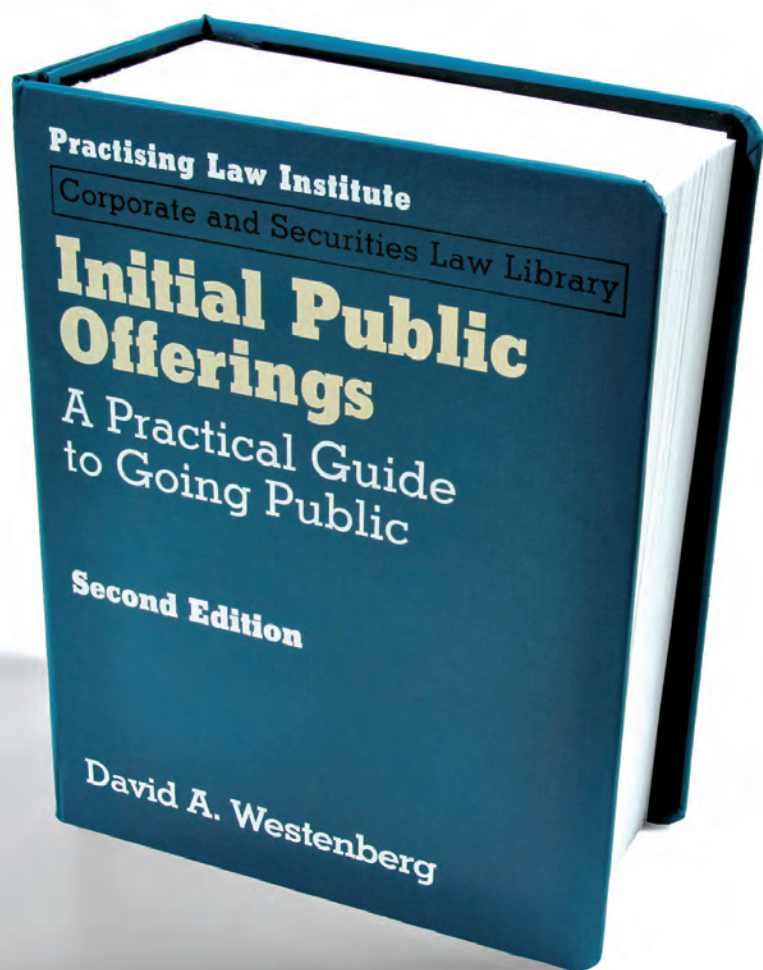
The statement implored that when ICFR control deficiencies are identified, management and auditors take a comprehensive approach to consider not only the actual misstatement but also the magnitude of potential misstatement which can extend to a wider population of potential misstatements beyond the identified misstatement. ■

EGC RELIEF

The ability of EGCs to elect not to be subject to new or revised accounting standards until those standards are required to be applied to nonpublic companies, and to provide only two years of audited financial statements (instead of three years), is discussed on page 9.

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(*The Deal Professor*, January 19, 2010)

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“CEOs should keep this book at their side from the moment they first seriously consider an IPO ... and will soon find it dog-eared with sections that inspire clarity and confidence.”

— *Don Bulens, CEO of EqualLogic at the time it pursued a dual-track IPO*

“A must-read for company executives, securities lawyers and capital markets professionals alike.”

— *John Tyree, Managing Director, Morgan Stanley*



More information at IPOguidebook.com
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The Road to IPO: Legal and Regulatory Insights into Going Public

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Data Sources: WilmerHale compiled all data in this report unless otherwise indicated. Direct listings and offerings by special purpose acquisition companies, REITs, bank conversions, closed-end investment trusts, oil & gas limited partnerships and unit trusts are excluded from IPO data, except as otherwise indicated. Offering proceeds generally exclude proceeds from exercise of underwriters' over-allotment options, if applicable. Venture capital data is sourced from SEC filings and PitchBook. Private equity-backed IPO data is sourced from SEC filings and Refinitiv.

Venture Capital Report

2024

2024 Venture Capital Report – What’s Inside

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2 US Market Review and Outlook

Venture capital financing activity in 2023 contracted for the second consecutive year in the face of rising interest rates, concerns regarding the trajectory of the economy and continued geopolitical tension.

VC-backed company liquidity results were more mixed in 2023. VC-backed IPOs increased from 2022 but remain well below other recent years, and the number of acquisitions of VC-backed companies declined to its lowest since 2017, although 2023 is likely to be commensurate with the average levels from 2018 to 2020 once all deals have been reported.

EQUITY FINANCING ACTIVITY

The number of reported venture capital financings decreased by 22%, from 17,625 in 2022 to 13,701 in 2023. Total reported financing proceeds dropped 31% from \$242.1 billion in 2022 to \$166.8 billion in 2023. Despite the steep decline, the total proceeds for 2023 are the fourth-highest annual figure on record.

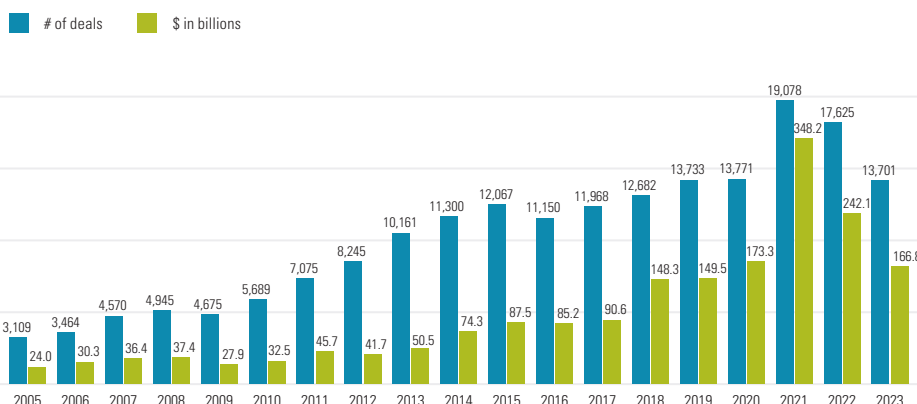
Overall, the median size of venture capital financings declined by 8%, from \$4.0 million in 2022 to \$3.7 million in 2023—the third-highest median since 2007, when angel and seed financings comprised a smaller portion of the market.

The median size of angel and seed financings rose by 5% year over year, from \$2.0 million to \$2.1 million. The median size of early-stage financings declined by 23%, from \$8.0 million in 2022 to \$6.2 million in 2023. The median size of later-stage financings decreased by 30%, from \$10.0 million to \$7.0 million.

The median financing size for life sciences companies declined from \$4.9 million in 2022 to \$4.5 million in 2023—the third-highest level of financing since 2008. Among technology companies, the median financing size declined from \$4.3 million to \$4.0 million, tied with 2021 as the second-highest level of financing since 2007.

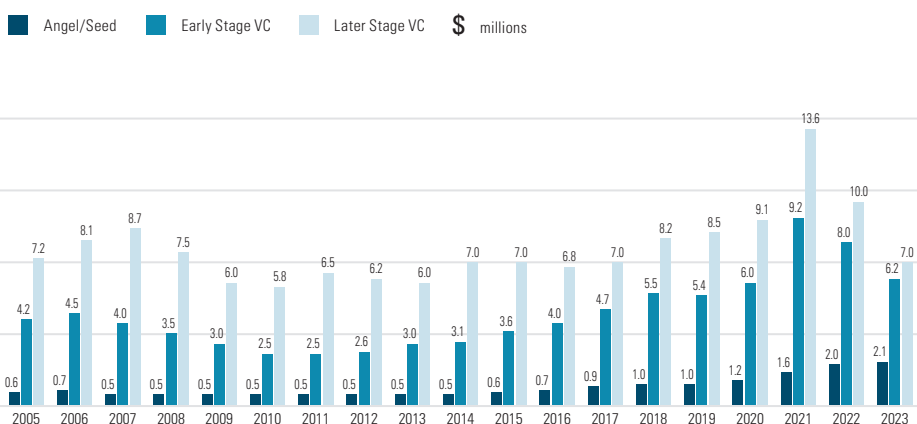
After more than quadrupling from 2017 to 2021, the number of financing rounds of \$50 million or more declined by 32%, from 1,618 in 2021 to 1,100 in 2022 and

US Venture Capital Financings – 2005 to 2023



Source: PitchBook

Median Size of US Venture Capital Financings – 2005 to 2023



Source: PitchBook

then declined a further 44% to 612 in 2023. The number of financing rounds of \$100 million or more fell by 37%, from 843 in 2021 to 532 in 2022 and then by 49% to 269 in 2023. The number of financing rounds of \$250 million or more dropped by 51%, from 210 in 2021 to 102 in 2022 and then declined by a further 31% to 70 in 2023, as interest in super-sized rounds from growth equity, crossover and hedge fund investors waned in the soft IPO market.

There were 10 billion-dollar venture financing rounds in 2023, compared to seven in 2022 and 20 in 2021. The largest rounds in 2023 came from OpenAI (\$10.0 billion), Stripe (\$6.5 billion), Anthropic (separate rounds of \$4.0 billion and \$2.0 billion), Metropolis (\$1.7 billion) and Commure (\$1.3 billion). All but three

of the billion-dollar rounds for 2023 occurred in the fourth quarter of the year.

Breaking its decade-long upward trajectory, the median pre-money valuation for all venture financings fell by 3%, from \$25.5 million in 2022 to \$24.6 million in 2023. The median pre-money valuation in angel and seed rounds increased by 5%, from \$10.0 million to \$10.5 million. The median pre-money valuation in early-stage rounds fell by 20%, from \$50.0 million to \$40.0 million, and the median pre-money valuation in later-stage rounds declined by 17%, from \$72.5 million to \$60.3 million.

The median pre-money valuation in the healthcare and life sciences sector increased by 3%, from \$27.2 million in 2022 to \$28.0 million in 2023. Among technology companies, the median

3 US Market Review and Outlook

pre-money valuation declined by 15%, from \$28.0 million to \$23.8 million.

Angel and seed financings accounted for 36% of all venture financings in 2023 (down from 41% in 2022) and represented 9% of all venture capital financing proceeds (down from 10% in 2022). Early-stage financings accounted for 31% of all financings in 2023 (up from 29% in 2022) and 24% of all proceeds (down from 29% in 2022). Later-stage financings accounted for 33% of all financings in 2023 (up from 30% in 2022) and 67% of all proceeds (up from 61% in 2022).

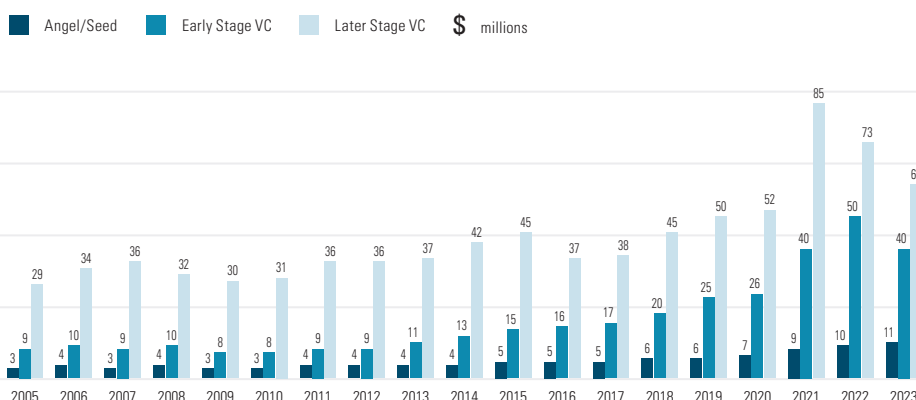
The technology sector accounted for 42% of all 2023 financings, down from 44% in 2022, followed by healthcare and life sciences, which accounted for 20% of all financings in 2023, up from 19% in 2022. Artificial intelligence and machine learning companies (which encompass companies across industries) saw their collective market share of all financings increase from 17% in 2022 to 21% in 2023 (and their share of total deal value increase markedly from 19% in 2022 to 34% in 2023).

California produced 30% of all venture financings in 2023 (4,048 financings) and 48% of the year's proceeds (\$79.9 billion). New York, home to companies with 1,856 financings raising \$19.3 billion in 2023, finished second in the state ranking. Texas (with 847 financings raising \$6.8 billion) just edged out Massachusetts (with 825 financings raising \$16.2 billion) in terms of the number of financings, although proceeds trailed far behind. The next most active states in terms of the number of financings were Florida (with 602 financings raising \$3.0 billion), Washington (with 424 financings raising \$3.7 billion) and Colorado (with 388 financings raising \$4.3 billion).

LIQUIDITY ACTIVITY

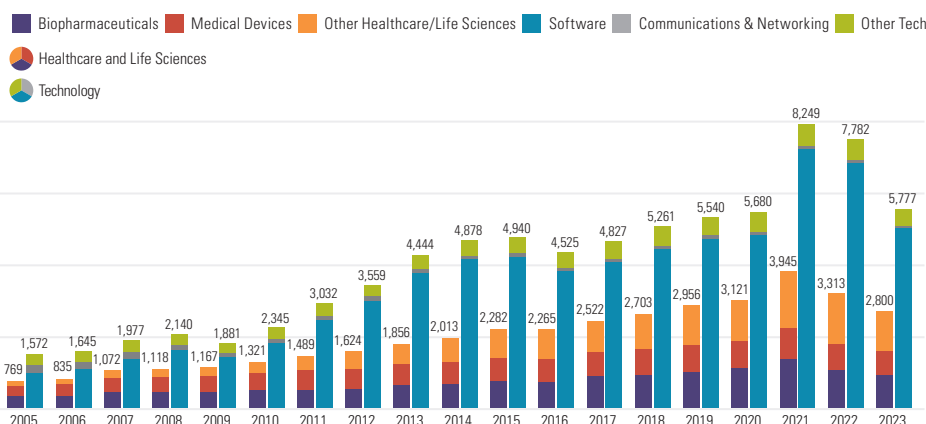
The number of US-issuer VC-backed IPOs increased to 25 in 2023 from 20 in 2022 but remains well below the median of 75 over the five-year period from 2017 to 2021. VC-backed companies accounted for 48% of all conventional IPOs (IPOs excluding SPAC IPOs and direct listings)

Median Pre-Money Valuation in US Venture Capital Financings – 2005 to 2023



Source: PitchBook

US Venture Capital Financings by Industry – 2005 to 2023



Source: PitchBook

by US issuers in 2023, up from 42% in 2022 but trailing the 58% that prevailed over the five-year period from 2017 to 2021.

Gross IPO proceeds raised by VC-backed US issuers increased to \$4.6 billion in 2023 from \$1.6 billion in 2022 but are a fraction of the median of \$25.0 billion raised over the five-year period from 2017 to 2021. For the second consecutive year, there were no billion-dollar IPOs by VC-backed US issuers. The largest VC-backed IPO in 2023 was the \$660 million offering by Instacart, followed by the IPOs of Nextracker (\$638 million), Klaviyo (\$576 million), ACELYRIN (\$540 million) and CAVA (\$318 million).

The median offering size for US VC-backed IPOs fell from \$52.3 million in 2022 to \$15.0 million in 2023.

In 2023, healthcare and life sciences companies accounted for 42% of all VC-backed IPOs, down from their 56% market share in 2022 and below the 60% market share that prevailed over the five-year period from 2017 to 2021. The VC-backed IPO market share for technology companies was 47% in 2023, up from 30% in 2022 and above their 35% share of the VC-backed IPO market between 2017 and 2021.

The median time from initial funding to IPO decreased from 5.2 years in 2022 to 3.8 years in 2023—the lowest figure since 2002, reflecting the influx of less-seasoned and smaller market-capitalization companies into the IPO market.

The median amount raised prior to an IPO dropped 15%, from \$64.6 million in

4 US Market Review and Outlook

2022 to \$54.9 million in 2023, while the median pre-IPO valuation fell by 48%, from \$212.1 million to \$110.6 million. As a result, the ratio of pre-IPO valuation to the median amount raised prior to an IPO declined from 3.3:1 in 2022 to 2.0:1 in 2023—the lowest level in more than 20 years (a higher ratio means better returns to pre-IPO investors).

VC-backed US issuer IPO companies ended 2023 down a median of 57% from their offering price, compared to a median loss of 41% in 2022 and a median loss of 11% in 2021. At the end of 2023, 33% of the year's VC-backed IPO companies were trading above their offering price, compared to 37% in 2022 and 27% in 2021.

The number of reported acquisitions of VC-backed companies decreased by 26%, from 1,286 in 2022 to 953 in 2023. Total reported acquisition proceeds fell by 15%, from \$65.2 billion to \$55.1 billion.

The median acquisition price increased by 18% from \$45.9 million in 2022 to \$54.0 million in 2023. The median time from initial funding to acquisition declined from 4.9 years in 2022 to 4.6 years—the lowest figure since 2017.

The median amount raised prior to acquisition increased by 8%, from \$7.4 million in 2022 to \$8.0 million in 2023.

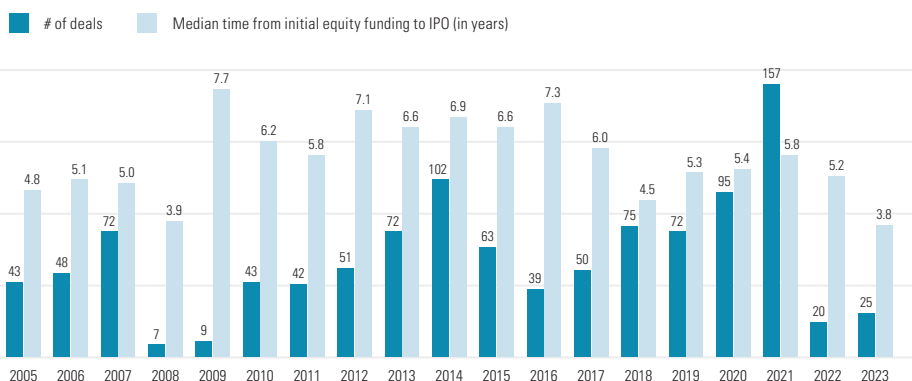
The ratio of median acquisition price to median amount raised prior to acquisition increased from 6.2:1 in 2022 to 6.8:1 in 2023 (a higher ratio means higher returns to pre-acquisition investors)—the sixth-highest ratio since 2000.

The historically high ratio in recent years is reflective of a general downward trend in pre-acquisition investments and an upward trend in acquisition prices.

There were 25 VC-backed company acquisitions of at least \$500 million in 2023, comparable to 22 in 2022 but well below the 55 in 2021.

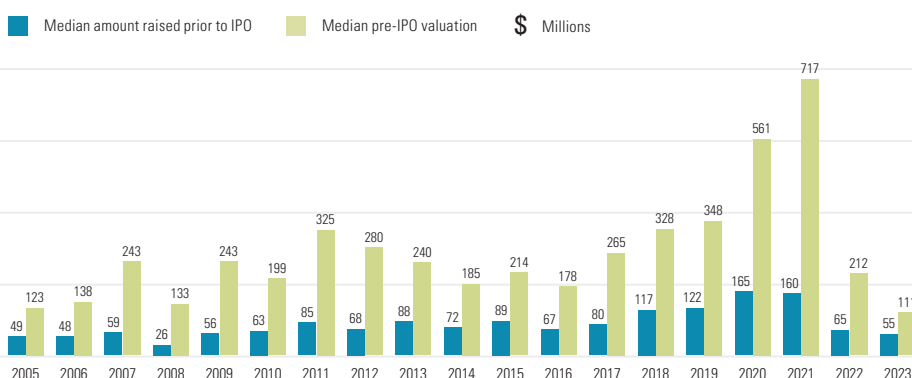
The year also produced nine billion-dollar acquisitions of VC-backed companies, up from eight in 2022 but well below the 22 in 2021. The largest deal of 2023 was the acquisition of Carmot Therapeutics by Roche for up to \$3.1 billion, followed

Venture Capital–Backed IPOs and Median Time to IPO – 2005 to 2023



Source: SEC filings and PitchBook
Based on US IPOs by VC-backed US issuers

Median Amount Raised Prior to IPO and Median Pre-IPO Valuation – 2005 to 2023



Source: PitchBook

by the acquisition of Versanis Bio by Eli Lilly for up to \$1.9 billion.

Based on the median valuations achieved in company acquisitions and IPOs compared to the median financing amounts required to achieve each type of liquidity event, 2023 marked the eleventh consecutive year in which returns to venture capital investors were higher in M&A transactions than in IPOs. Although the median time of 4.6 years from initial funding to acquisition was higher than the median time of 3.8 years from initial funding to IPO in 2023, in recent years liquidity has typically occurred more quickly from acquisitions. This pattern, combined with the tendency of M&A transactions to yield the bulk of the purchase price in cash at

closing—whereas IPOs generally involve a post-IPO lockup period and market uncertainty as to the timing and prices of subsequent stock sales—underscores why investors often prefer sales of their portfolio companies instead of IPOs.

The ratio of M&A transactions to IPOs for VC-backed companies declined from 64.3:1 in 2022 to 38.1:1 in 2023, but the 2023 ratio represents the second-highest ratio since 48.2:1 in 2009 due to historically low IPO numbers.

OUTLOOK

The US venture capital industry has weathered many cycles, with upturns and downturns alike proving unruly. Current market conditions will instill in founders the need to focus on profitability

5 US Market Review and Outlook

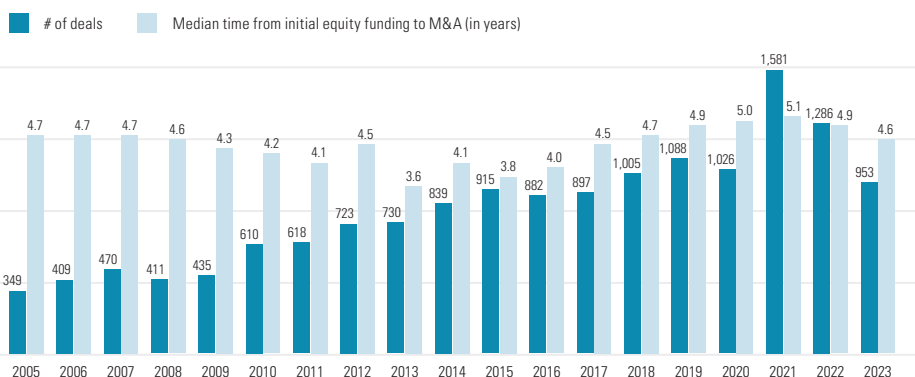
instead of the growth-at-all-costs mindset that prevailed when funding was more freely available. Results over the coming year will depend on a variety of factors, including the following:

— **Financing Activity:** When venture capital fundraising in 2022 remarkably surpassed the previous record set in 2021, many theorized this strength was attributable to commitments made before the deterioration in economic conditions. This hypothesis appears to be borne out by the slowdown in fundraising activity in 2023. Total venture capital fundraising in 2023 was \$66.9 billion, a figure 61% below the \$172.8 billion reported in 2022. Macroeconomic conditions, at least in the first half of 2024, are likely to continue to pressure valuations, especially in late-stage deals, and startups that last raised money at ebullient valuations in 2020 and 2021 will need to grow into those valuations, wait for the next valuation upswing, or accept funding on less favorable terms.

— **Attractive Sectors:** Companies capitalizing on the broad digital transformation of business processes—including changes driven by the use of artificial intelligence—should continue to be attractive financing candidates. Persistent labor shortages and wage inflation should boost opportunities for companies that leverage robotics, automation, machine learning and voice technology. Opportunities also exist for companies transforming the broader healthcare industry. Innovative life sciences companies, including those in the fields of cell therapy, gene therapy, precision medicine and machine learning-enabled drug discovery, should continue to appeal to investors. Agtech and climate tech—particularly those companies aiding the economic transition away from fossil fuels—are among the other sectors that are likely to garner investor interest.

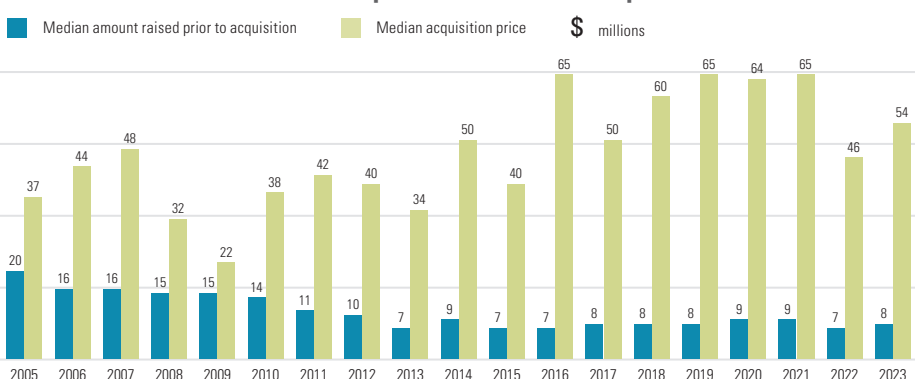
— **IPOs:** While the number of IPOs by VC-backed companies increased in 2023, the overall IPO market remained in the doldrums and the profile of the median IPO company in 2023 is far from what it was two years ago. With

Acquisitions of US Venture-Backed Companies and Median Time to M&A – 2005 to 2023



Source: PitchBook

Median Amount Raised Prior to Acquisition and Median Acquisition Price – 2005 to 2023



Source: PitchBook

private financing terms less favorable than a few years ago and public market scrutiny of valuations less forgiving, VC-backed companies may try to extend their runway and remain private as long as possible, hoping a more receptive IPO market emerges.

— **Acquisitions:** M&A activity was weighed down by the continued rise in interest rates and the uncertain trajectory of the economy in 2023. The higher cost of capital is likely to continue to temper acquisition activity by financial buyers, but the forecast of slower economic growth may also spur companies to consider augmenting organic growth through acquisitions or seeking new technologies that improve efficiency and reduce costs. The heightened scrutiny of proposed

acquisitions by US and international regulatory bodies has recently delayed or outright scuttled deals and is likely to weigh on the market.

— **Impact of SPAC IPOs, Reverse Mergers:** Despite retrenchment of the SPAC IPO market in 2023, the year ended with 127 SPACs seeking business combinations, many of which face deadlines to complete a business combination or return funds to investors. In these circumstances, some VC-backed companies may find a business combination with a SPAC a tempting alternative to a traditional IPO. Alternatively, VC-backed life sciences companies may elect to pursue reverse mergers with publicly traded companies whose clinical research programs have suffered serious setbacks or failures. ■

6 Regional Market Review and Outlook

CALIFORNIA

California-based companies reported 4,048 venture capital financings in 2023, 27% below the 2022 tally of 5,561. California was responsible for 30% of all US financing transactions in 2023, down from 32% in 2022.

Total reported proceeds raised by California-based companies declined 20%, from \$100.0 billion in 2022 to \$79.9 billion in 2023.

The number of rounds in which California-based companies raised \$100 million or more fell by 52%, from 237 in 2022 to 113 in 2023, and the number of rounds in which California-based companies raised \$250 million or more declined by 22%, from 45 to 35. The largest rounds raised by California-based companies in 2023 came from OpenAI (\$10.0 billion), Stripe (\$6.5 billion) and Anthropic (separate rounds of \$4.0 billion and \$2.0 billion, respectively).

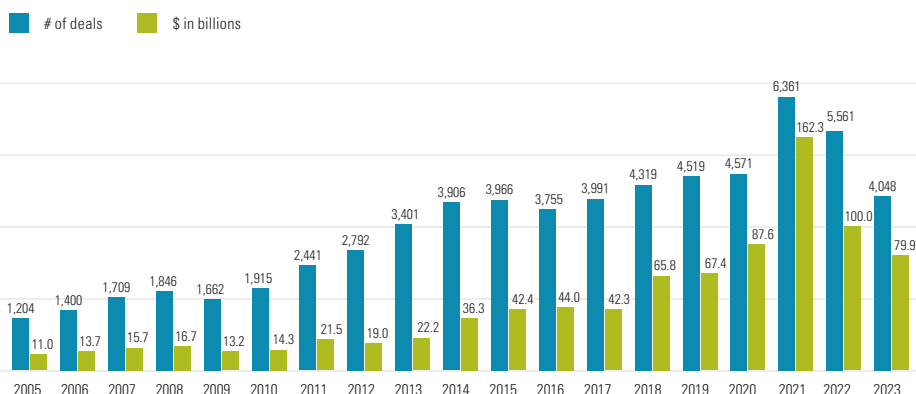
Technology was the largest sector in the state, producing 49% of all California financings in 2023, followed by healthcare and life sciences (17%), consumer goods and services (15%); and business services (13%).

The number of IPOs by California-based VC-backed companies increased from six in 2022 to 10 in 2023 but remained well below the median of 36 over the five-year period from 2017 to 2021. The state produced the two largest VC-backed IPOs of 2023, by Instacart (\$660 million) and Nextracker (\$638 million), and the largest VC-backed life sciences company IPO by ACELYRIN (\$540 million).

The number of reported acquisitions of California VC-backed companies decreased by 22%, from 418 in 2022 to 328 in 2023. The state's largest deals involving VC-backed companies were the acquisition of Carmot Therapeutics by Roche for up to \$3.1 billion and the acquisition of Versanis Bio by Eli Lilly for up to \$1.9 billion.

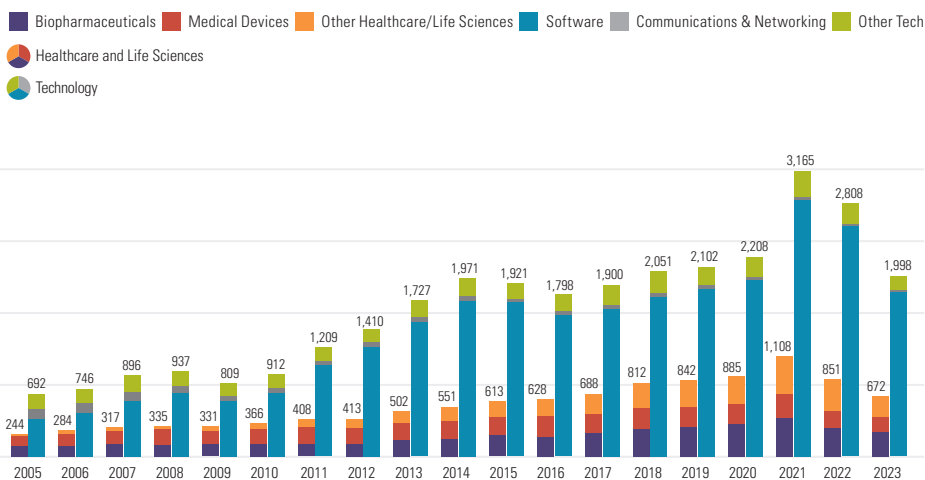
California continues to maintain its venture capital leadership and will undoubtedly do so in the coming year. The extent to which financing and liquidity activity rebounds will continue to depend on macroeconomic and IPO market conditions and the willingness of strategic buyers to pay attractive prices, among other factors.

California Venture Capital Financings – 2005 to 2023



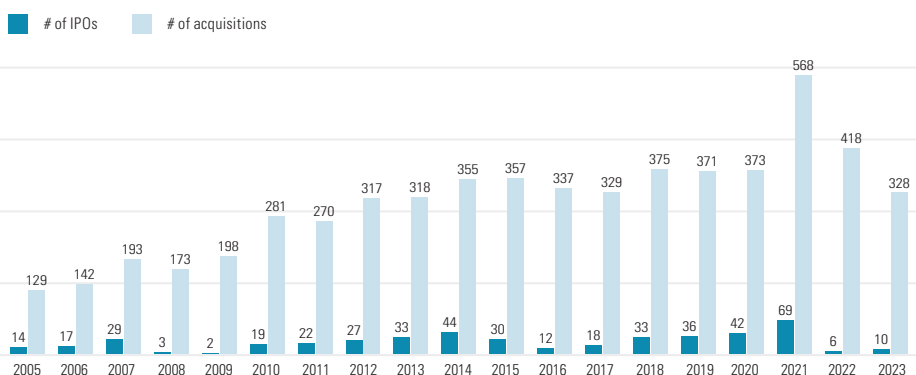
Source: PitchBook

California Venture Capital Financings by Selected Industry – 2005 to 2023



Source: PitchBook

California Venture-Backed IPOs and Acquisitions – 2005 to 2023



Source: SEC filings and PitchBook

7 Regional Market Review and Outlook

MID-ATLANTIC

The number of reported venture capital financings by companies based in the mid-Atlantic region of Virginia, Maryland, North Carolina, Delaware and the District of Columbia declined by 14%, from 1,384 in 2022 to 1,185 in 2023.

Total reported proceeds raised by companies based in the mid-Atlantic region decreased by 31%, from \$13.5 billion to \$9.3 billion. The number of rounds in which mid-Atlantic companies raised \$100 million or more fell from 23 in 2022 to 11 in 2023.

The largest rounds raised by mid-Atlantic companies in 2023 came from JUUL (\$1.3 billion), Mapbox (\$280 million), Aledade (\$260 million) and X-energy (\$235 million).

Technology companies accounted for 45% of all mid-Atlantic financings in 2023—extending the sector’s long-standing leadership in the region—followed by healthcare and life sciences (22%), and consumer goods and services and business services (each with 13%).

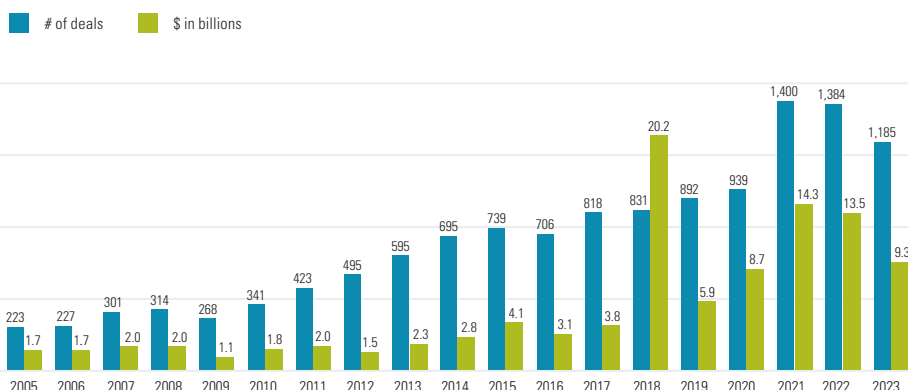
The mid-Atlantic region generated a pair of VC-backed IPOs in 2023, compared to one in 2022 and a median of four over the five-year period from 2017 to 2021. Washington DC-based CAVA Group’s \$318 million IPO was the fifth-largest VC-backed IPO of the year.

The number of reported acquisitions of mid-Atlantic VC-backed companies in 2023 was comparable to the number from 2022, decreasing slightly from 81 to 79. Virginia generated 26 deals, followed by Maryland with 15 deals and Delaware and North Carolina, each with 14 deals.

The region’s largest M&A transactions involving VC-backed companies in 2023 were the \$450 million acquisition of Haystack Oncology by Quest Diagnostics and the \$250 million acquisition of Payzer by WEX.

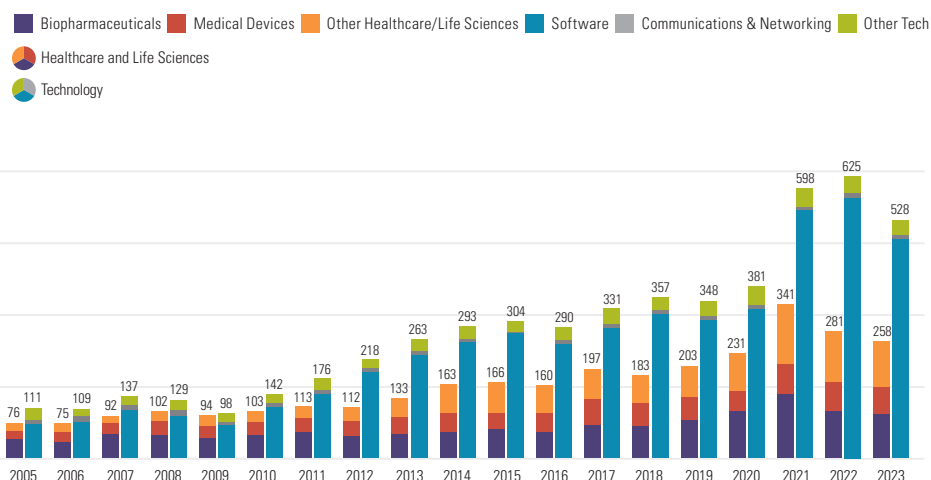
With a strong venture capital ecosystem, the mid-Atlantic region should continue to generate promising startups in the coming year, although financing and liquidity activity in the region will continue to depend on market conditions and other factors.

Mid-Atlantic Venture Capital Financings – 2005 to 2023



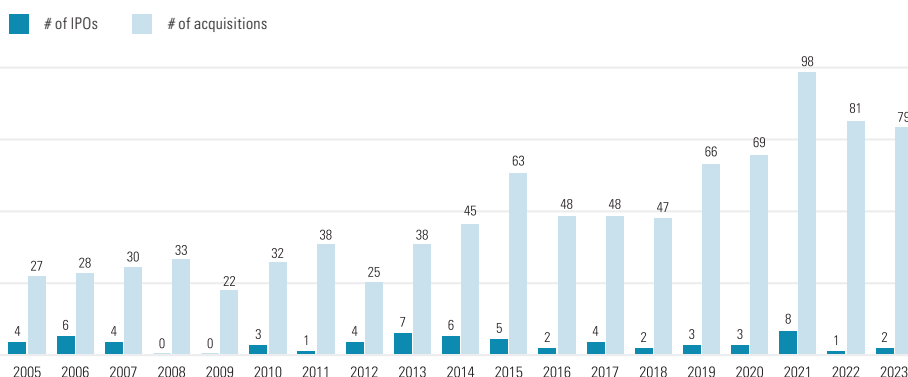
Source: PitchBook

Mid-Atlantic Venture Capital Financings by Selected Industry – 2005 to 2023



Source: PitchBook

Mid-Atlantic Venture-Backed IPOs and Acquisitions – 2005 to 2023



Source: SEC filings and PitchBook

8 Regional Market Review and Outlook

NEW ENGLAND

New England companies reported 1,092 venture capital financings in 2023, a decrease of 23% from the 1,413 financings in 2022. Total reported proceeds raised by New England companies were \$17.6 billion, down 32% from the \$25.8 billion raised in the prior year.

Massachusetts, the perennial leader in New England, produced 825 financings and \$16.2 billion in proceeds.

The number of rounds in which New England companies raised \$100 million or more declined by 30%, from 69 in 2022 to 48 in 2023, and the number of rounds in which New England companies raised \$250 million or more decreased slightly from 13 to 11. The largest rounds in 2023 came from Ascend Elements (\$542 million), Curie.Bio (\$520 million), ElevateBio (\$401 million) and Nexamp (\$400 million).

The healthcare and life sciences sector accounted for 39% of New England venture capital financings in 2023, followed by technology (28%), business services (14%), and consumer goods and services (11%).

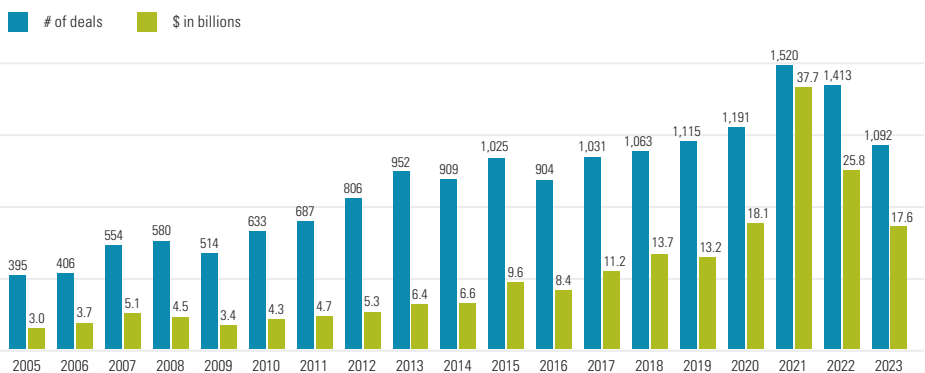
The number of VC-backed IPOs by New England-based companies declined from eight in 2022 to five in 2023. The region's largest IPO was by Klaviyo, the third-largest VC-backed IPO of the year at \$576 million. The remaining New England IPOs came from life sciences companies, led by Apogee Therapeutics (\$300 million) and Neumora Therapeutics (\$250 million).

The number of reported acquisitions of VC-backed companies in New England dropped by 47%, from 123 in 2022 to 65 in 2023.

The region's largest M&A transaction involving a VC-backed company was the acquisition of Massachusetts-based Magenta Therapeutics by Dianthus Therapeutics through a reverse merger for \$380 million.

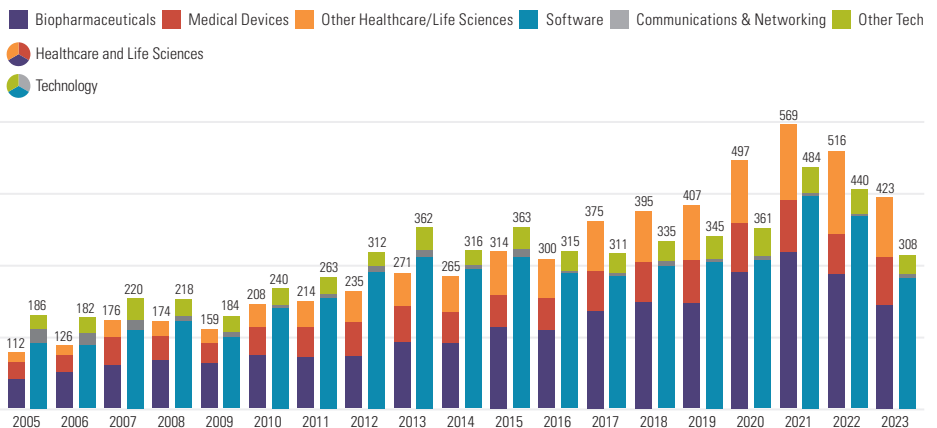
With its concentration of world-renowned universities and research institutions and consistent strength in the healthcare and life sciences sector, New England—and Massachusetts in particular—should remain a hub of financing and liquidity activity during the coming year.

New England Venture Capital Financings – 2005 to 2023



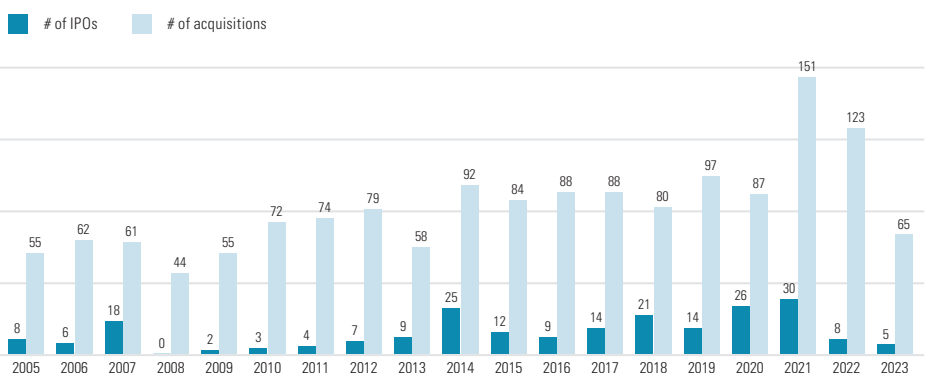
Source: PitchBook

New England Venture Capital Financings by Selected Industry – 2005 to 2023



Source: PitchBook

New England Venture-Backed IPOs and Acquisitions – 2005 to 2023



Source: SEC filings and PitchBook

9 Regional Market Review and Outlook

TRI-STATE

The number of reported venture capital financings in the tri-state region of New York, New Jersey and Pennsylvania decreased by 22%, from 3,077 in 2022 to 2,393 in 2023, while total reported proceeds declined 37%, from \$37.2 billion to \$23.5 billion.

New York, the nation's second-largest source of VC financings, led the region with 1,856 financings and \$19.3 billion in proceeds, accounting for 14% of all US financing transactions and 12% of US total reported proceeds in 2023, respectively.

The number of rounds in which tri-state companies raised \$100 million or more fell by 48%, from 83 in 2022 to 43 in 2023, and the number of rounds in which tri-state companies raised \$250 million or more contracted from 13 to nine. The region's largest financings came from Metropolis (\$1.7 billion), Clear Street (\$435 million) and CoreWeave (\$421 million).

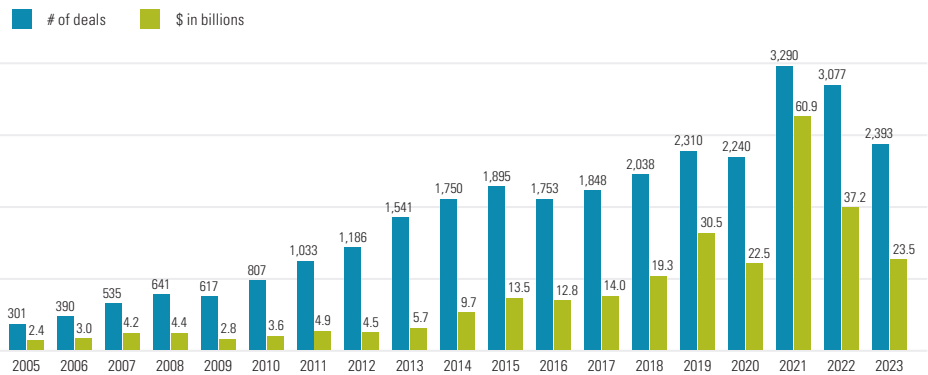
Technology companies accounted for 44% of the tri-state region's VC financings in 2023, followed by healthcare and life sciences (19%), consumer goods and services (17%), and business services (13%).

Consistent with 2022, there were two VC-backed IPOs in the tri-state region in 2023, compared to a median of 11 over the five-year period from 2017 to 2021. The region's pair of IPOs came from Pennsylvania-based Mineralys Therapeutics (\$192 million) and New York-based Lexeo Therapeutics (\$100 million).

The number of reported acquisitions of VC-backed companies in the tri-state region decreased by 33%, from 219 in 2022 to 147 in 2023. New York generated 114 of the region's deals in 2023. The largest 2023 deal was the acquisition of Tmunity by Gilead Sciences-owned Kite Pharma for approximately \$300 million (plus up to approximately \$1.0 billion in potential future payments).

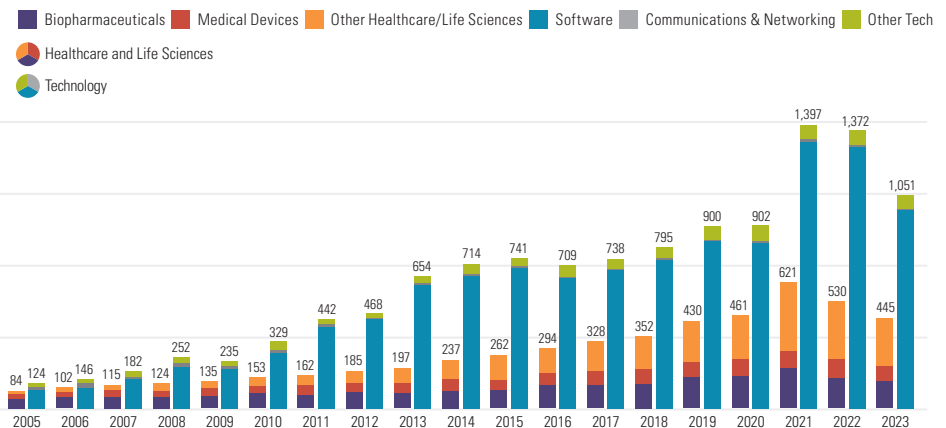
Due to its strength across a broad array of industry sectors, the tri-state region should continue to produce large numbers of financings and liquidity events. The level of deal activity in the coming year will continue to depend on macroeconomic and market conditions, among other factors. ■

Tri-State Venture Capital Financings – 2005 to 2023



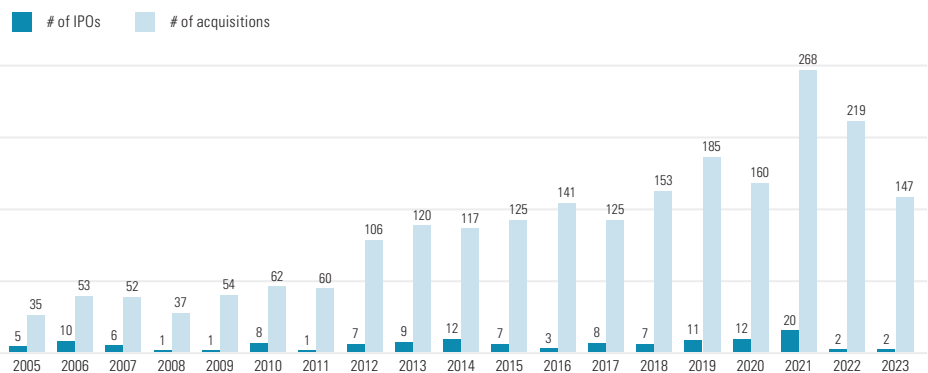
Source: PitchBook

Tri-State Venture Capital Financings by Selected Industry – 2005 to 2023



Source: PitchBook

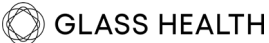
Tri-State Venture-Backed IPOs and Acquisitions – 2005 to 2023



Source: SEC filings and PitchBook

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 \$11,500,000 <i>First Round</i> September 2023	 \$10,000,000 <i>First Round</i> June 2023	 \$10,600,000 <i>Seed</i> May 2023	 \$41,500,000 <i>Second Round</i> December 2023	 \$3,000,000 <i>Seed</i> November 2022	 \$75,000,000 <i>First Round</i> August 2023	 \$68,000,000 <i>Late Stage</i> October 2023	 \$4,535,000 <i>Seed</i> February 2023	 \$19,200,000 <i>Seed</i> August 2023
 \$5,000,000 <i>Seed</i> September 2023	 \$290,000,000 <i>Second Round</i> September 2023	 \$19,800,000 <i>Second Round</i> February 2023	 \$5,500,000 <i>Seed</i> December 2023	 \$7,000,000 <i>First Round</i> October 2023	 \$60,000,000 <i>First Round</i> March 2023	 \$10,000,000 <i>First Round</i> August 2022	 \$6,000,000 <i>Seed</i> September 2022	
 \$6,000,000 <i>Seed</i> September 2022	 \$25,900,000 <i>First Round</i> November 2022	 \$24,000,000 <i>First Round</i> July 2022	 \$20,000,000 <i>First Round</i> May 2022	 \$17,250,000 <i>Second Round</i> November 2023	 \$50,000,000 <i>First Round</i> July 2022	 \$221,000,000 <i>Second Round</i> August 2022	 \$123,350,000 <i>Second Round</i> February 2023	 \$48,250,000 <i>First Round</i> July 2022
 \$19,250,000 <i>Second Round</i> May 2022	 \$27,000,000 <i>First Round</i> April 2022	 \$138,000,000 <i>Third Round</i> August 2022	 \$30,000,000 <i>Third Round</i> July 2022	 \$20,350,000 <i>Third Round</i> June 2022	 \$25,000,000 <i>Fourth Round</i> May 2022	 \$100,000,000 <i>Late Stage</i> June 2022	 \$34,000,000 <i>Second Round</i> December 2023	

The Rise and Fall of VC “Mega-Rounds”

12 Recent Trends in Large Venture Financing Rounds

Over time, there have been huge shifts in the amount of financing required to start and scale businesses. Advances such as cloud computing and open-source software have enabled technology startups to commence and grow their operations with less funding than historically required, while launching life sciences companies and AI-driven companies can remain a capital-intensive process.

2015 was the first year to see 100 rounds in which companies raised \$100 million or more in venture financing. Increased participation by growth equity, crossover and hedge funds attracted by the lure of pre-IPO companies offering the potential for outsized returns contributed to the number of rounds in which companies raised so-called “mega-rounds” of \$100 million or more jumping from 113 in 2015 to 843 in 2021.

The slowdown in the venture market since the frothy apex of valuations in 2021 has resulted in the number of rounds in which companies raised \$100 million or more falling to 269 in 2023. While this tally is approximately one-third of the 2021 total, it still remains slightly ahead of 2019. What remains unknown is whether 2023’s results are a return to historical trends or there will be continued reduction in mega-rounds in 2024.

2023 was the first year in recent history to see a greater number of financing rounds of \$100 million or more for healthcare and life sciences companies than technology companies. In 2023, healthcare and life sciences companies accounted for 34% of financing rounds of \$100 million or more, compared to 29% for technology companies. By comparison, healthcare and life sciences companies accounted for only 21% of such rounds in 2019.

Artificial intelligence and machine learning companies (which encompass companies across industries) accounted for 21% of financing rounds of \$100 million or more in both 2021 and 2022, and 25% of financing rounds of \$100 million or more in 2023.

With the number of mega-rounds unlikely to see a sizable increase in the coming year, deliberation of alternative exit strategies is likely to become more pressing for many companies. ■

Number of Large Rounds by Venture Financing Threshold

YEAR	\$50 MILLION	\$100 MILLION	\$200 MILLION	\$250 MILLION	\$500 MILLION	\$1 BILLION
2019	623	262	91	68	20	6
2020	787	340	118	80	25	5
2021	1,618	843	325	210	66	20
2022	1,100	532	169	102	27	7
2023	612	269	94	70	19	10
2019 to 2023	4,740	2,246	797	530	157	48

Number of Companies Raising Venture Financing Rounds of \$100 Million or More by State of Company Headquarters

YEAR	CALIFORNIA	NEW YORK	MASSACHUSETTS	TEXAS	WASHINGTON	COLORADO	FLORIDA	US TOTAL
2019	136	34	25	7	7	3	4	262
2020	180	39	37	14	10	5	2	340
2021	393	133	92	27	25	21	15	843
2022	237	71	64	19	16	15	16	532
2023	113	37	47	9	5	13	1	269
2019 to 2023	1,059	314	265	76	63	57	38	2,246

Number of Companies Raising Venture Financing Rounds of \$100 Million or More by Industry Group and in Artificial Intelligence & Machine Learning

YEAR	B2B	B2C	FINANCIAL SERVICES	HEALTHCARE	TECHNOLOGY	OTHER	US TOTAL	AI & MACHINE LEARNING
2019	31	55	19	56	95	6	262	51
2020	26	46	26	111	123	8	340	57
2021	80	91	66	217	363	26	843	174
2022	47	47	45	129	233	31	532	111
2023	38	19	20	92	85	15	269	68
2019 to 2023	222	258	176	605	899	86	2,246	461

13 Say Goodbye to Noncompetes?

It is an employer's worst nightmare: to learn not only that the employee who quit yesterday is joining a direct competitor but also that there is nothing the employer may legally do to stop it. Recent developments in the law have increasingly made this nightmare a reality.

BACKGROUND

A post-employment noncompete is a contractual term between an employer and an employee that prohibits the employee, for a specified time after the employee's cessation of employment, from competing with the employer.

According to the Federal Trade Commission (FTC), about one in five American workers is bound by a noncompete. And, historically, the vast majority of states (notably excluding California) have enforced these restrictions as long as they were reasonably limited in geographic scope and duration. In recent years, many states have cracked down on employee noncompetes, even beyond limiting their permitted geographic scope and duration. Now the federal government is looking to prohibit their use too.

STATE RESTRICTIONS

Noncompete Bans

A small but growing minority of states—currently California, Oklahoma, North Dakota and Minnesota—have banned noncompetes for employees and independent contractors, with only limited exceptions (such as in the sale-of-business context). These bans prohibit these restrictions and render them void and unenforceable, regardless of an individual's level of compensation, access to sensitive confidential information, and/or willingness to agree to the restriction.

The New York State Assembly also passed a bill in June 2023 that would have banned noncompetes without exception, but it was ultimately vetoed by the governor after a great amount of press attention and employer outcry. It is expected that revised noncompete legislation will be introduced.

Salary Thresholds

Several states, including Colorado, the District of Columbia, Illinois, Maryland, Maine, New Hampshire, Oregon, Rhode

Island, Virginia and Washington, have adopted laws that ban noncompetes for any employee who earns less than a salary threshold set by the state. These laws make no exception for startups, which often will not have the resources to pay employees (including founders) the required threshold amount.

Notice Requirements

Some of the salary threshold states as well as others (including the District of Columbia, Oregon, Colorado, Virginia, Illinois, Washington, Maine, New Hampshire and Massachusetts) require that employers seeking to enter into noncompetes adhere to certain strict notice obligations, and hold void and unenforceable noncompetes entered into without the required notice. For example, Massachusetts requires that an employee receive a copy of the noncompete at least 10 business days before an employee's start date.

The complexity and variation among these laws means that employers are at risk that small timing errors made at an employee's commencement of employment may result in an otherwise permissible noncompete being found void and unenforceable.

Position-Based Restrictions

Finally, certain states have opted, sometimes in addition to the above restrictions, to limit the types of employees who may be bound by a noncompete. For example, Massachusetts only permits noncompetes with exempt employees over the age of 18 who are not engaged as interns.

THE FTC'S POSITION

On January 5, 2023, the FTC jumped into the fray, proposing a new rule that would not only ban new noncompetes but also void existing ones, superseding any state statute, regulation, order or interpretation to the extent it is inconsistent with the rule. The FTC's theory is that noncompetes reduce workers' wages (even for those not subject to noncompetes) and restrain innovation and economic liberty. The Commission has concluded that, by preventing the formation of competing businesses and the creation of innovative ideas, consumers are ultimately harmed.

After having invited public comment, the FTC is scheduled to announce its decision on the proposed rule in April 2024.

THE NLRB'S POSITION

Last but not least, the National Labor Relations Board (NLRB) has also been paying close attention to noncompetes. In May 2023, the NLRB's General Counsel published a memorandum announcing her opinion that most noncompetes violate the National Labor Relations Act (NLRA). Then, in September 2023, in a first-of-its-kind action, the Regional Director of NLRB Region 9 (Cincinnati) filed a complaint against Juvly Aesthetics, alleging that the company violated the NLRA by requiring that its employees sign restrictive covenant agreements containing post-employment noncompetes. We are awaiting the decision in this case.

WHAT CAN EMPLOYERS DO?

Without a crystal ball, the future for employee noncompetes remains unknown. Employee noncompetes are under attack and are expected to continue being under attack for the foreseeable future. Employers are advised to review their existing employee arrangements and do the following:

- Re-evaluate existing noncompetes and tailor them for the employee being hired.
- Ensure that every employee signs a confidentiality and assignment of inventions agreement, which are forms enforced by courts in all states.
- Consider a non-solicitation of customers provision, which are enforced in most states.
- Consider imposing employee non-solicitation provisions, which are enforced in most states (but not always in California).
- Revisit compensation packages to ensure that employees stay loyal.

While there is no one-size-fits-all solution, employers should consult with their counsel who can guide them through the various rules to ensure that their businesses are as protected as possible. ■

14 Private Company Option Repricings

Stock options are a critical component of any venture-backed company's ability to recruit, incentivize and retain key talent. However, when options have exercise prices that are higher than the fair market value of the underlying stock (i.e., when the options are "underwater"), they lose most, if not all, of their incentive and retentive value. To avoid the loss of key employees who are instrumental in the company's future success, a company may determine that a repricing of underwater options is necessary.

For most private companies, a repricing is often as simple as reducing the exercise price of all outstanding underwater options held by current service providers to the current fair market value of the underlying stock. Generally, other than reducing the exercise price, all other terms of the repriced options—including their vesting and acceleration provisions and their original expiration dates—are left unchanged. Even in such a straightforward structure, however, there are a number of business and legal considerations that a private company must balance as it evaluates whether and how to implement a repricing, including the (often surprising) consideration that the consent of the option holders may be required.

KEY CONSIDERATIONS

Tax Considerations

Under US federal tax law, in order to get the benefit of preferential incentive stock option (ISO) tax treatment, an option holder must sell stock received upon exercise of an ISO on a date that is more than two years after the ISO was granted and more than one year after it was exercised. Because the amendment of an ISO to reduce its exercise price is treated as the grant of a new option for US tax purposes, the two-year waiting period will start over when the repricing occurs. In addition, the aggregate fair market value of all ISOs granted to an employee that become "first exercisable" in any calendar year cannot exceed \$100,000 (with fair market value for this purpose being the fair market value of the company's stock on the date of grant of the options). If an option is repriced, the \$100,000 rule requires that both (i) any portion of the original option that is or would become first exercisable

For most private companies, a repricing is often as simple as reducing the exercise price of all outstanding underwater options held by current service providers to the current fair market value of the underlying stock.

in the year of the repricing and (ii) any portion of the repriced option that is or becomes first exercisable in the year of the repricing, be applied against the \$100,000 limit for that year. The effect of this recalculation of the \$100,000 limitation can cause all or a portion of an option that previously qualified as an ISO to become a nonstatutory stock option (NSO) and, as a result, lose the potential to receive preferential tax treatment.

As long as the exercise price of the repriced option is set at or above the fair market value of the underlying stock on the effective date of repricing, the repricing should not cause any issues under Section 409A of the Internal Revenue Code. However, the company should have a recent Section 409A valuation prepared by an independent valuation firm to assist in determining the exercise price for the repriced options, and as with any determination of fair market value, the company's board must take all additional relevant factors into account as well. Further, to avoid an option being characterized as having a "floating" exercise price (and thus violating Section 409A), a company should not effect multiple or serial repricings. Therefore, before embarking on any repricing, a company should carefully consider whether it has already effected an option repricing or whether it expects the fair market value of the underlying stock to fall further, such that another repricing may become necessary in the near future.

Securities Law Compliance

A private company must ensure that the grant of the repriced options, which is treated as the grant of new options for securities law purposes, in an option repricing is exempt from registration under the Securities Act of 1933. This is typically achieved pursuant to the exemption

provided by Rule 701 (and sometimes supplemented by exemptions under Section 4(a)(2), Regulation D and/or Regulation S). The company's Rule 701 analysis should be revisited prior to completing the repricing, as Rule 701 sets specified dollar-value and share number limitations on the amount of equity awards that can be granted in any 12-month period. Large-scale repricings can sometimes result in proposed repriced options exceeding the relevant limitations imposed by Rule 701. In these situations, companies may need to consider either cutting back the scope of the repricing or finding alternative exemptions that would cover some of the newly repriced options.

Accounting Treatment

A repricing may result in significant new compensation charges, in addition to the ongoing compensation charges associated with the canceled options (which are not eliminated upon the repricing), and thus the company's accountants should be consulted before proceeding with a repricing.

Consent Considerations

Subject to review of the company's stock incentive plans and any applicable investor agreements, stockholder consent is typically not required for a private company to reprice stock options. Whether an option holder's consent to a repricing is required will generally be dictated by the terms of the company's stock incentive plans and forms of award agreement under those plans. Some plans or award agreements prohibit any amendment to options without the consent of the option holder. Other plans and agreements may permit amendment without the consent of the option holder, but only to the extent that the company's board of directors determines that the amendment will not have a material adverse effect on the option holder.

In virtually all cases where the company proposes to change the vesting schedule, the number of shares subject to the option or the plan under which the repriced option is granted, the consent of the option holder will be required. By contrast, where the only change to an outstanding NSO is that the option exercise price is to be reduced, the consent of the participant is rarely required. In most circumstances where the repricing

15 Private Company Option Repricings

will cause some or all of a participant's ISOs to cease to be ISOs by application of the \$100,000 ISO rule (described above), the consent of the participant will be required. A more nuanced question is whether the repricing's restarting of the ISO waiting period (described above) is an adverse consequence that would require the consent of the participant, because preferential ISO treatment may be more difficult to attain as a result of the repricing. Making this determination requires a careful reading of the plan and award agreements to confirm exactly what types of amendments would require the consent of the option holders, as well as an assessment by the board of directors as to the timeline to a potential liquidity event, the type of liquidity event, the likelihood of participants exercising options in advance of a liquidity event and other relevant factors. The determination of what consent, if any, will be required from eligible participants is critical to determining how the repricing will be completed.

THE REPRICING PROCESS

Preliminary Matters

Prior to obtaining board approval of any option repricing, the company should consult with its human resources team, legal counsel, accountants and third-party valuation specialists to assess the scope of any repricing and any practical impediments that could limit the company's ability to complete a repricing. A valuation can take several weeks to complete, and an updated Rule 701 analysis can also require some lead time and iteration if the facts surrounding the repricing are complicated. Appropriate involvement from human resources or equity plan administrators can help evaluate whether any changes to awards will create appropriate incentives and retention structures for the company's employees.

Board Approval

The company's board, or a duly authorized committee of the board, must approve the terms of any option repricing program. Any such approval must be made after the board (or the committee of the board) carefully considers the need for, and the costs of, the repricing. In connection with that approval, the board will need to

determine the company's fair market value in compliance with Section 409A as of the date it approves entry into the repricing to ensure that the proposed exercise price of the repriced options is at least equal to the then-current fair market value. If the repricing is structured as a tender offer, the board will also need to determine the fair market value in compliance with Section 409A again upon the close of the tender offer period.

Documenting the Repricing

The documents necessary to effect the repricing depend in large part on the extent to which participant consent is required:

- If consent from more than a limited number of option holders is required, the company will have to comply with the SEC's tender offer rules for the repricing. The company must provide adequate disclosure to eligible participants regarding the nature of the repricing and provide an offering period that is open for at least 20 business days (but, to comply with the ISO regulations, less than 30 calendar days) to elect whether to participate in the repricing. The company also cannot change certain terms of the repricing, such as the scope of the repricing or the terms of the repriced options, during the pendency of the tender offer, and the repricing itself is subject to the anti-fraud provisions of the SEC's tender offer rules. The repricing will be effective on the date of board approval of the then-current fair market value of the underlying stock following the expiration of the tender offer period.
- If consent is required from only a limited number of option holders, the company will need to provide adequate disclosure to eligible option holders, similar to the disclosure that would be required for a tender offer. Some period of time in which to consent to the repricing must be provided, but that period of time should be short enough that the fair market value is unlikely to change before its expiration. Generally, three to five business days is an appropriate window in which to allow option holders to decide whether to participate in the repricing. The repricing will be effective on the date on which the eligible participant consents to the repricing.

- If consent from an eligible participant is not required, the board may unilaterally approve the repricing of options. In such case, the company will typically provide a letter to eligible participants notifying them that their options have been repriced and the rationale for and key terms of the repricing. Some companies also choose to include additional information (such as a set of frequently asked questions) to anticipate participant questions. The repricing will be effective on the date on which the board approves the repricing or such other date as may be specified in the board approval.

The determination of what consent, if any, will be required from eligible participants is critical to determining how the repricing will be implemented.

Post-Repricing Recordkeeping

The repricing documents described above may, for those participants whose options were unilaterally repriced or who elected to consent to the repricing, serve as amendments to outstanding option award agreements. With that in mind, the company's stock option records and ledgers (whether maintained by the company or by a third party on an electronic platform) should be updated to reflect the repricing and care should be taken to ensure that any new ISO/NSO splits are properly reflected.

CONCLUSION

Unlike option repricings in the public company context, undertaking a private company repricing can be a fairly straightforward endeavor. However, care must be taken to ensure that the repricing is effected at a time when the company believes the stock has "bottomed out," that the terms of the repricing will appropriately incentivize and retain the company's key service providers, and, most critically of all, that the extent of any required participant consent is identified and obtained in accordance with the governing plan documents and applicable law. ■

Navigating the booming defense technology subsector of the emerging company ecosystem requires careful planning and execution. Beyond putting together a trusted team and developing a uniquely marketable product, defense tech startups should carefully consider how to choose potential investors, who may also become their commercial partners.

SIGNIFICANT CAPITAL INFLOWS INTO THE DEFENSE TECH SECTOR

By the numbers, the growth of defense tech within the venture capital landscape stands out.

Based on Data Provided by Pitchbook:

(i) from 2022 to 2027, the U.S. defense tech market is projected to grow to nearly \$185 billion at a compound annual growth rate of 15.9%;

(ii) from 2016 to 2022, the defense tech sector saw \$135 billion invested across 4,744 deals, with acquisitions accounting for 71% of defense tech VC exits; and

(iii) US venture investment in defense startups surged from less than \$16 billion in 2019 to \$33 billion in 2022, with an additional \$14.5 billion in Q1 2023.

The sector's expansion is partially explained by its versatility, since defense tech is often dual-use, meaning it can serve both defense and commercial purposes. Dual-use technology can broaden the financing options available to a defense tech startup, allowing for government funding options otherwise unavailable to purely commercial endeavors. Escalation of multiple global conflicts in recent years prioritized the US military's interest in funding defense-applicable technology, with a special focus on emerging dual-use technologies such as artificial intelligence, software, semiconductors, and renewable energy generation and storage.

CHOOSING YOUR FUNDING SOURCE

Founders of defense tech startups should consider including experienced advisors from the time of incorporation forward to help identify risks specific to the evolving landscape. With government funding options and institutional venture capital

as potential alternatives, startups must remember that the source of financing can be mission-critical. Beyond determining the financing instruments for raising capital, startups should seek investors experienced with government customers.

Protect Your Capitalization Table

The defense tech startup should consider how inclusion of certain investors on its capitalization table may negatively impact or prevent altogether opportunities necessary for success. For instance, startups must pay attention to regulatory issues related to foreign investment, especially considering bipartisan sensitivity around foreign investment in companies with a nexus to the defense sector. The presence of foreign investors on a company's capitalization table might negatively impact future business with government customers. Additionally, the Committee on Foreign Investment in the United States (CFIUS) has significant power to review certain types of foreign investment in US companies before or after closing, which may introduce delays or regulatory obstacles. Because CFIUS jurisdiction can be so far-reaching, it is important to consider in advance whether a particular prospective investment may generate regulatory obstacles with regard to the investment or future obstacles with regard to the US company's operations.

Further, consider whether an investor seeks purely financial returns or has strategic interests as well. While most venture capital investors will have purely financial motivations, strategic investors or investors with comparable portfolio companies may have complicated intentions. For example, if a strategic investor is contemplating a commercial arrangement as well, a company should consider the consequences of the prospective commercial arrangement going sideways, since the strategic investor would likely remain on the capitalization table, may maintain a board seat, and may even hold a right of first offer in an exit scenario. This can decrease the company's negotiating leverage or even wholly preclude interest from future strategic investors, commercial partners or potential acquirers.

Consider an Investor's Experience and Reputation

Whether considering funding from equity investors or venture lenders, companies should review an investor's experience and reputation with government customers and the defense industry and within the greater venture capital landscape. When a defense tech startup has alternatives, it should focus on investors with experience working with government customers and knowledge of the regulatory hurdles. It is desirable that the investor understand the federal acquisition process, the challenges associated with it, and the patience required to grow, including overcoming the proverbial "Valley of Death."

CERTAIN FUNDING PROGRAMS AVAILABLE TO DEFENSE TECH STARTUPS

Small Business Innovation Research

(SBIR): An R&D program that facilitates opportunities for US-owned and controlled businesses with 500 or fewer employees to propose new concepts to federal agencies.

Small Business Technology Transfer

(STTR): A federal program that partially funds cooperative R&D between small businesses and research institutions, built on a three-phase structure similar to SBIR's program.

Other Transaction Agreements (OTAs):

Research and prototype development arrangements designed to invite the participation of nontraditional government contractors.

Defense Innovation Unit (DIU): The lone DoD organization focused exclusively on fielding and scaling commercial technology across the U.S. military at commercial speeds.

In-Q-Tel: A not-for-profit venture capital firm partnered with the CIA.

Defense Innovation Accelerator for the

North Atlantic (DIANA): An accelerator program under NATO that provides companies with access to grants to support technology development and demonstration.

Investors with a solid reputation with government customers, lenders, other investors and their portfolio companies bring benefits. Those investors can attract government contractors who have worked with their other portfolio companies. Similarly, strategic investors can create immediate credibility with the government

Choose Your Investor Wisely—Financing Considerations for

17 Defense Tech Startups

customer and the investment community, along with access to the strategic investor's knowledge, technology and assets.

Funding From Government Programs—Pros and Cons

When receiving funding directly from the government, defense tech startups should consider what they want in return. Derived from taxpayers, government funds are subject to specific guidelines to ensure deployment in accordance with legal and budgetary guidelines. Further, where startups receive research and development funding from the government, they should consider how that may impact their ownership and use of intellectual property generated from those efforts. There are multiple government funding programs to consider.

Debt Options – Classic Venture Debt and Defense-Specific Lending

As with other startups, debt financing can be a viable option in the defense tech space. Loans are non-dilutive, though venture loans will typically come with a warrant exercisable for shares of common or preferred stock of the company. Further, loans may be a helpful way to extend the runway prior to a preferred stock financing. For startups that have already raised an equity financing, there may be adequate collateral to secure a loan at favorable rates. However, most startups in the early stages lack the necessary assets or revenues to favorably secure or afford the costs related to servicing such loans, making equity investments more attractive.

In recent years, industry-specific lending models have emerged, including government invoice factoring and government contract financing. Government invoice factoring is a type of financing option that allows government contractors to sell their unpaid invoices to a third party at a discount. Essentially, the factoring company advances the company a portion of the invoice amount and then collects payment from the government agency on the company's behalf. Government contract financing, unlike invoice factoring, is not based on the value of the unpaid invoices but instead based on the estimated revenue of the company's current and upcoming approved government contracts. ■

REGULATORY FOCUS ON FOREIGN INVESTMENT IS GROWING

There is greater scrutiny today on inbound and outbound foreign investment than at any time in the past several decades. CFIUS has more authorities than it enjoyed in the past and is using those authorities to scrutinize current and past investments across a range of economic sectors. At the same time, the Biden Administration has announced plans to develop an "outbound CFIUS" regime. Last summer the Biden Administration issued an Executive Order on Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern, which will create a new set of rules around "outbound investments" in certain high-technology industries focused on the People's Republic of China (PRC).

The outbound CFIUS executive order, which is the first step in the creation of an outbound investment review regime, asserts that there is a "national emergency" posed by "countries of concern" pursuing "sensitive technologies and products critical for the military, intelligence, surveillance, or cyber-enabled capabilities." It identifies China and its Special Administrative Regions of Macau and Hong Kong as the only countries of concern.

There's every reason to believe that scrutiny around foreign investment (inbound and outbound) will continue to be heightened for the foreseeable future. Indeed, there is generally bipartisan agreement that foreign investment needs to be more regulated and that Chinese investment is particularly fraught.

Other regulators are likewise taking action. The Select Committee on China recently entitled released a long-awaited report "How American Venture Capital Fuels the PRC Military and Human Rights Abuses." The report focuses on the ways in which US venture capital investments into the Chinese artificial and semiconductor sectors purportedly enhance China's People's Liberation Army, embolden "digital

authoritarianism" and "undermine American technological leadership."

The reach of attention goes beyond traditional defense technologies. In addition to its report on VC activity, the Select Committee on China is pursuing "field hearings" in the life science technology corridor around Boston to examine United States-China competition in biotech, purported US dependency on China for pharmaceuticals, and China's ambitions to dominate the advanced biotech and life science sectors. The Committee's trip to Boston underscores widespread sentiment in Washington that America's advanced life science companies need special protection from Chinese encroachment.

The Defense Department is pursuing a "name and shame" approach to highlight Chinese investment activity in the United States. For example, the Department of Defense (DoD) recently released an updated list of alleged Chinese military companies (CMC) operating in the United States. The list is part of an effort that DoD describes as critical to countering efforts by China to enhance the PLA's military capacity:

Updating the Section 1260H list of "Chinese military companies" is an important continuing effort in highlighting and countering the PRC's Military-Civil Fusion strategy. The PRC's Military-Civil Fusion strategy supports the modernization goals of the People's Liberation Army (PLA) by ensuring it can acquire advanced technologies and expertise developed by PRC companies, universities and research programs that appear to be civilian entities. Section 1260H directs the Department to begin identifying, among other things, Military-Civil Fusion contributors operating directly or indirectly in the United States.

Together, all these developments highlight an ongoing, bipartisan push in Washington to aggressively counter Chinese investment in the United States, as well as American investment in critical Chinese sectors.

18 Trends in Convertible Note and SAFE Terms

Based on hundreds of convertible note and SAFE (simple agreements for future equity) financing transactions we handled from 2019 to 2023 for companies and investors, we have compiled the following deal data:

Deals With Purchase Agreement		2019	2020	2021	2022	2023
If included, a purchase agreement typically contains representations and warranties from the company (and possibly the founders).	% of deals	63%	36%	50%	38%	53%
Term*		2019	2020	2021	2022	2023
The term of the convertible note before it matures.	Median Range	17 mos. 12–36 mos.	24 mos. 5–48 mos.	12 mos. 4–36 mos.	12 mos. 10–60 mos.	24 mos. 3–32 mos.
Interest Rate*		2019	2020	2021	2022	2023
The rate at which interest accrues during the term of the convertible note.	Median Range	6% 3%–15%	5% 0.2%–8.5%	5% 0.2%–8%	6% 1.3%–8%	8% 5%–15%
Deals With Security Interest*		2019	2020	2021	2022	2023
Convertible note investors sometimes require the company to provide a security interest in company assets.	% secured	18%	11%	0%	0%	3%
	% unsecured	82%	89%	100%	100%	97%
Deals With Conversion Discount		2019	2020	2021	2022	2023
Convertible note and SAFE investors often require that conversion in connection with an equity financing be at a discount from the price paid by new investors in the financing. A conversion discount is often coupled with a cap on the valuation at which conversion occurs.	% of deals	70%	89%	85%	63%	66%
	Range of discounts	10%–25%	15%–40%	10%–35%	10%–30%	10%–50%
	% with ≤ 20% discount	95%	92%	94%	87%	71%
	% with > 20% discount	5%	8%	6%	13%	29%
	% with valuation cap	42%	40%	35%	47%	57%
Deals With Conversion Upon Maturity*		2019	2020	2021	2022	2023
If a convertible note is outstanding at the time of maturity and is not otherwise paid upon maturity, it often converts into shares of the company’s common stock or preferred stock. This conversion is most often at the election of the investor but may be mandatory.	% of deals	55%	53%	59%	46%	77%
	% with optional conversion	92%	90%	80%	50%	88%
	% with mandatory conversion	8%	10%	20%	50%	12%
	% that convert into: common stock preferred stock	33%	11%	10%	33%	12%
		67%	89%	90%	67%	88%
Deals With Conversion Upon Company Sale		2019	2020	2021	2022	2023
If a convertible note or SAFE is outstanding at the time of a sale of the company, it often converts into shares of the company’s common stock or preferred stock. This conversion is most often at the election of the investor but may be mandatory.	% of deals*	56%	32%	50%	21%	50%
	% with optional conversion	73%	78%	90%	80%	94%
	% with mandatory conversion	27%	22%	10%	20%	6%
	% that convert into: common stock preferred stock	67%	50%	80%	60%	31%
		33%	50%	20%	40%	69%
Deals With Repayment Premium Upon Company Sale		2019	2020	2021	2022	2023
Convertible note and SAFE investors may require that they receive a multiple of the outstanding investment amount in connection with a sale of the company.	% of deals*	37%	43%	50%	29%	53%
	Median premium	2x	2x	2x	1.5x	2x
	Range of premiums	1.5x–3x	1.5x–3x	1.25x–2.5x	1.25x–2.0x	1.5x–4.0x
Deals With Warrant Coverage		2019	2020	2021	2022	2023
Investors sometimes receive a warrant in addition to their note or SAFE. The amount of company stock covered by the warrant is usually proportional to the investment amount, referred to as the warrant coverage.	% of deals	15%	0%	5%	0%	16%
	Coverage range	10%–35%	N/A	25% (one deal)	N/A	50%–100%
	% that cover common	50%	N/A	100%	N/A	60%
	% that cover preferred	25%	N/A	0%	N/A	40%
	% that cover common or preferred (depending on the circumstances)	25%	N/A	0%	N/A	0%

* Excludes SAFEs, which by their nature do not have maturity dates, interest rates or security interests.

† Excluding SAFEs, 50%, 42%, 53%, 38% and 73% of convertible note transactions included conversion upon company sale and 45%, 63%, 53%, 54% and 77% of convertible note transactions included a repayment premium upon company sale for each of the years 2019 through 2023, respectively.

19 Trends in Venture Capital Financing Terms

Based on hundreds of venture capital financing transactions we handled from 2019 to 2023 for companies and investors, we have compiled the following deal data:

Deals With Multiple Liquidation Preferences		2019	2019 Range	2020	2020 Range	2021	2021 Range	2022	2022 Range	2023	2023 Range
A “multiple liquidation preference” entitles holders of preferred stock to receive more than 1x their money back before sale or liquidation proceeds are distributed to holders of common stock.	First round	2%	1.5x (one deal)	0%	N/A	0%	N/A	0%	N/A	0%	N/A
	Post–first round	4%	1.5x–2x	3%	1.5x–2.25x	0%	N/A	2%	2x–3x	8%	1.5x–2x
Deals With Participating Preferred Stock		2019	2019 Range	2020	2020 Range	2021	2021 Range	2022	2022 Range	2023	2023 Range
“Participating preferred” stock entitles holders to receive a stated liquidation preference plus a pro rata share (on an as-converted basis) of any remaining proceeds available for distribution to holders of common stock.	First round	14%		9%		9%		4%		5%	
	Total Capped	38%	1x–3x	80%	2x–3x	20%	3x (one deal)	0%	N/A	100%	3x (one deal)
	Post–first round	11%		10%		6%		10%		16%	
	Total Capped	17%	1.6x–3.5x	22%	1.25x–2x	29%	2x–2.5x	30%	1.5x–3.5x	10%	3x (one deal)
Deals With an Accruing Dividend		2019		2020		2021		2022		2023	
“Accruing dividends” are generally payable upon liquidation or redemption of the preferred stock, effectively increasing the liquidation preference of the preferred stock.	First round	10%		9%		5%		2%		14%	
	Post–first round	15%		8%		11%		10%		18%	
Anti-Dilution Provisions		2019		2020		2021		2022		2023	
A “full ratchet” anti-dilution formula provides that the conversion price of the preferred stock will be reduced to the price paid in the dilutive issuance, regardless of how many shares are involved in the dilutive issuance. In contrast, a “weighted average” anti-dilution formula takes into account the dilutive impact based upon the number of shares and the price involved in the dilutive issuance and the number of shares outstanding before and after the dilutive issuance.	First round										
	Full ratchet	0%		2%		0%		2%		0%	
	Weighted average	100%		98%		100%		98%		100%	
	Post–first round										
	Full ratchet	2%		0%		0%		3%		2%	
	Weighted average	98%		100%		100%		97%		98%	
Deals With Pay-to-Play Provisions		2019		2020		2021		2022		2023	
“Pay-to-play” provisions provide an incentive to investors to invest in future rounds of financing. Investors that do not purchase their full pro rata share in a future round lose certain rights (e.g., their shares of preferred stock may be converted into common stock at the then-applicable conversion rate or a more punitive rate, and they may lose director designation, registration or other rights).	Total	8%		3%		3%		2%		12%	
	% of total that convert into common stock	92%		100%		83%		100%		100%	
	% of total that convert into another series of preferred stock	8%		0%		17%		0%		0%	

Explanatory Note: “First round” refers to a company’s first-priced preferred stock financing regardless of round designation.

20 Trends in VC-Backed Company M&A Deal Terms

We reviewed all merger transactions between 2019 and 2023 involving VC-backed targets (as reported in PitchBook after 2019 and in Dow Jones VentureSource or PitchBook for 2019) in which the merger documentation was publicly available and the deal value was \$25 million or more. Based on this review, we have compiled the following deal data:¹

Characteristics of Deals Reviewed		2019	2020	2021	2022	2023
The number of deals we reviewed and the type of consideration paid in each	Sample Size	20	25	45	22	15
	Cash	60%	60%	24%	41%	40%
	Stock	0%	8%	18%	5%	20%
	Cash and Stock	40%	32%	58%	54%	40%
Deals With Earnout		2019	2020	2021	2022	2023
Deals that provided contingent consideration based upon post-closing performance of the target, achievement of milestones by the target or other contingencies concerning the value of target (other than balance sheet adjustments)	With Earnout	40%	28%	42%	41%	27%
	Without Earnout	60%	72%	58%	59%	73%
Deals With Indemnification		2019	2020	2021	2022	2023
Deals where the target's shareholders or the buyer indemnified the other post-closing for breaches of representations, warranties and covenants	With Indemnification					
	By Target's Shareholders	80%	88%	76% ²	86%	67%
	By Buyer	45%	32%	29%	68%	47%
Deals With Representation and Warranty Insurance		2019	2020	2021	2022	2023
Deals that expressly contemplate representation and warranty insurance	With Representation and Warranty Insurance	25%	68%	47%	50%	33%
Survival of Representations and Warranties		2019	2020	2021	2022	2023
Length of time that representations and warranties survived the closing for indemnification purposes (subset: deals where representations and warranties survived the closing for indemnification purposes) ³	Shortest	12 Mos.	12 Mos.	12 Mos.	12 Mos.	12 Mos.
	Longest	24 Mos.	18 Mos.	24 Mos.	24 Mos.	24 Mos.
	Most Frequent	18 Mos.	12 Mos.	12 Mos.	12 Mos.	12 & 18 Mos. (tie)
Caps on Indemnification Obligations		2019	2020	2021	2022	2023
Upper limits on indemnification obligations where representations and warranties survived the closing for indemnification purposes	With Cap	100%	100%	100%	100%	100%
	Limited to Escrow ⁴	86%	81%	90%	78%	80%
	Limited to Purchase Price	0%	0%	0%	0%	0%
	Exceptions to Limits ⁵	100%	95%	100%	89%	100%
	Without Cap	0%	0%	0%	0%	0%

¹ For certain transactions, certain deal terms have been redacted from the publicly available documentation and are not reflected in the data compiled in this table.

² Excludes two transactions that do not provide for indemnification but permit setoff against contingent consideration.

³ Measured for representations and warranties generally; specified representations and warranties may survive longer.

⁴ Includes two transactions in 2021 and one transaction in 2023 where the limit was below the escrow amount.

⁵ Generally, exceptions were for fraud, willful misrepresentation and certain "fundamental" representations commonly including capitalization, authority and validity. In a limited number of transactions, exceptions also included intellectual property representations.

21 Trends in VC-Backed Company M&A Deal Terms

Escrows		2019	2020	2021	2022	2023
Deals having escrows securing indemnification obligations of the target's shareholders (subset: deals with indemnification obligations of the target shareholders)	With Escrow	94%	90%	91%	89%	90%
	% of Deal Value					
	Lowest ⁶	10%	8%	5%	7%	5%
	Highest	13%	15%	18%	15%	10%
	Most Frequent	12%	15%	10%	8%	6%
	Length of Time ⁷					
	Shortest	12 Mos.	12 Mos.	12 Mos.	12 Mos.	12 Mos.
	Longest	36 Mos.	24 Mos.	36 Mos.	30 Mos.	24 Mos.
	Most Frequent	12 Mos.	12 Mos.	12 Mos.	12 Mos.	12 & 18 Mos. (tie)
	Exclusive Remedy	64%	68%	53%	73%	56%
Exceptions to Escrow Limit Where Escrow Was Exclusive Remedy ⁵		100%	92%	100%	91%	100%
Baskets for Indemnification		2019	2020	2021	2022	2023
Deals with indemnification only for amounts above a specified "deductible" or only after a specified "threshold" amount is reached	Deductible	56%	52% ⁸	71% ⁹	53% ⁸	80%
	Threshold	44%	29% ⁸	26% ⁹	32% ⁸	10%
MAE Closing Condition		2019	2020	2021	2022	2023
Deals with closing condition for the absence of a "material adverse effect" with respect to the other party, either explicitly or through representation brought down to closing	Condition in Favor of Buyer	100%	100%	97%	100%	91%
	Condition in Favor of Target	35%	24%	37%	29%	18%
Exceptions to MAE		2019	2020	2021	2022	2023
Deals where the definition of "material adverse effect" for the target contained specified exceptions	With Exception ¹⁰	100%	100%	95% ¹¹	100%	100%

⁶ Excludes transactions that also specifically referred to representation and warranty insurance as recourse for the buyer.

⁷ Length of time does not include transactions where such time period cannot be ascertained from publicly available documentation.

⁸ A "hybrid" approach with both a deductible and a threshold was used in another 10% of these transactions in 2020 and 11% of these transactions in 2022.

⁹ A 50/50 cost sharing approach was used in another 3% of these transactions in 2021.

¹⁰ Generally, exceptions were for general economic and industry conditions.

¹¹ The only transaction(s) not including such exceptions provided for a closing on the same day the definitive agreement was signed.

Choose Your Investor Wisely—Financing Considerations for

17 Defense Tech Startups

customer and the investment community, along with access to the strategic investor's knowledge, technology and assets.

Funding From Government Programs—Pros and Cons

When receiving funding directly from the government, defense tech startups should consider what they want in return. Derived from taxpayers, government funds are subject to specific guidelines to ensure deployment in accordance with legal and budgetary guidelines. Further, where startups receive research and development funding from the government, they should consider how that may impact their ownership and use of intellectual property generated from those efforts. There are multiple government funding programs to consider.

Debt Options – Classic Venture Debt and Defense-Specific Lending

As with other startups, debt financing can be a viable option in the defense tech space. Loans are non-dilutive, though venture loans will typically come with a warrant exercisable for shares of common or preferred stock of the company. Further, loans may be a helpful way to extend the runway prior to a preferred stock financing. For startups that have already raised an equity financing, there may be adequate collateral to secure a loan at favorable rates. However, most startups in the early stages lack the necessary assets or revenues to favorably secure or afford the costs related to servicing such loans, making equity investments more attractive.

In recent years, industry-specific lending models have emerged, including government invoice factoring and government contract financing. Government invoice factoring is a type of financing option that allows government contractors to sell their unpaid invoices to a third party at a discount. Essentially, the factoring company advances the company a portion of the invoice amount and then collects payment from the government agency on the company's behalf. Government contract financing, unlike invoice factoring, is not based on the value of the unpaid invoices but instead based on the estimated revenue of the company's current and upcoming approved government contracts. ■

REGULATORY FOCUS ON FOREIGN INVESTMENT IS GROWING

There is greater scrutiny today on inbound and outbound foreign investment than at any time in the past several decades. CFIUS has more authorities than it enjoyed in the past and is using those authorities to scrutinize current and past investments across a range of economic sectors. At the same time, the Biden Administration has announced plans to develop an "outbound CFIUS" regime. Last summer the Biden Administration issued an Executive Order on Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern, which will create a new set of rules around "outbound investments" in certain high-technology industries focused on the People's Republic of China (PRC).

The outbound CFIUS executive order, which is the first step in the creation of an outbound investment review regime, asserts that there is a "national emergency" posed by "countries of concern" pursuing "sensitive technologies and products critical for the military, intelligence, surveillance, or cyber-enabled capabilities." It identifies China and its Special Administrative Regions of Macau and Hong Kong as the only countries of concern.

There's every reason to believe that scrutiny around foreign investment (inbound and outbound) will continue to be heightened for the foreseeable future. Indeed, there is generally bipartisan agreement that foreign investment needs to be more regulated and that Chinese investment is particularly fraught.

Other regulators are likewise taking action. The Select Committee on China recently entitled released a long-awaited report "How American Venture Capital Fuels the PRC Military and Human Rights Abuses." The report focuses on the ways in which US venture capital investments into the Chinese artificial and semiconductor sectors purportedly enhance China's People's Liberation Army, embolden "digital

authoritarianism" and "undermine American technological leadership."

The reach of attention goes beyond traditional defense technologies. In addition to its report on VC activity, the Select Committee on China is pursuing "field hearings" in the life science technology corridor around Boston to examine United States-China competition in biotech, purported US dependency on China for pharmaceuticals, and China's ambitions to dominate the advanced biotech and life science sectors. The Committee's trip to Boston underscores widespread sentiment in Washington that America's advanced life science companies need special protection from Chinese encroachment.

The Defense Department is pursuing a "name and shame" approach to highlight Chinese investment activity in the United States. For example, the Department of Defense (DoD) recently released an updated list of alleged Chinese military companies (CMC) operating in the United States. The list is part of an effort that DoD describes as critical to countering efforts by China to enhance the PLA's military capacity:

Updating the Section 1260H list of "Chinese military companies" is an important continuing effort in highlighting and countering the PRC's Military-Civil Fusion strategy. The PRC's Military-Civil Fusion strategy supports the modernization goals of the People's Liberation Army (PLA) by ensuring it can acquire advanced technologies and expertise developed by PRC companies, universities and research programs that appear to be civilian entities. Section 1260H directs the Department to begin identifying, among other things, Military-Civil Fusion contributors operating directly or indirectly in the United States.

Together, all these developments highlight an ongoing, bipartisan push in Washington to aggressively counter Chinese investment in the United States, as well as American investment in critical Chinese sectors.

18 Trends in Convertible Note and SAFE Terms

Based on hundreds of convertible note and SAFE (simple agreements for future equity) financing transactions we handled from 2019 to 2023 for companies and investors, we have compiled the following deal data:

Deals With Purchase Agreement		2019	2020	2021	2022	2023
If included, a purchase agreement typically contains representations and warranties from the company (and possibly the founders).	% of deals	63%	36%	50%	38%	53%
Term*		2019	2020	2021	2022	2023
The term of the convertible note before it matures.	Median Range	17 mos. 12–36 mos.	24 mos. 5–48 mos.	12 mos. 4–36 mos.	12 mos. 10–60 mos.	24 mos. 3–32 mos.
Interest Rate*		2019	2020	2021	2022	2023
The rate at which interest accrues during the term of the convertible note.	Median Range	6% 3%–15%	5% 0.2%–8.5%	5% 0.2%–8%	6% 1.3%–8%	8% 5%–15%
Deals With Security Interest*		2019	2020	2021	2022	2023
Convertible note investors sometimes require the company to provide a security interest in company assets.	% secured	18%	11%	0%	0%	3%
	% unsecured	82%	89%	100%	100%	97%
Deals With Conversion Discount		2019	2020	2021	2022	2023
Convertible note and SAFE investors often require that conversion in connection with an equity financing be at a discount from the price paid by new investors in the financing. A conversion discount is often coupled with a cap on the valuation at which conversion occurs.	% of deals	70%	89%	85%	63%	66%
	Range of discounts	10%–25%	15%–40%	10%–35%	10%–30%	10%–50%
	% with ≤ 20% discount	95%	92%	94%	87%	71%
	% with > 20% discount	5%	8%	6%	13%	29%
	% with valuation cap	42%	40%	35%	47%	57%
Deals With Conversion Upon Maturity*		2019	2020	2021	2022	2023
If a convertible note is outstanding at the time of maturity and is not otherwise paid upon maturity, it often converts into shares of the company’s common stock or preferred stock. This conversion is most often at the election of the investor but may be mandatory.	% of deals	55%	53%	59%	46%	77%
	% with optional conversion	92%	90%	80%	50%	88%
	% with mandatory conversion	8%	10%	20%	50%	12%
	% that convert into: common stock preferred stock	33%	11%	10%	33%	12%
		67%	89%	90%	67%	88%
Deals With Conversion Upon Company Sale		2019	2020	2021	2022	2023
If a convertible note or SAFE is outstanding at the time of a sale of the company, it often converts into shares of the company’s common stock or preferred stock. This conversion is most often at the election of the investor but may be mandatory.	% of deals*	56%	32%	50%	21%	50%
	% with optional conversion	73%	78%	90%	80%	94%
	% with mandatory conversion	27%	22%	10%	20%	6%
	% that convert into: common stock preferred stock	67%	50%	80%	60%	31%
		33%	50%	20%	40%	69%
Deals With Repayment Premium Upon Company Sale		2019	2020	2021	2022	2023
Convertible note and SAFE investors may require that they receive a multiple of the outstanding investment amount in connection with a sale of the company.	% of deals*	37%	43%	50%	29%	53%
	Median premium	2x	2x	2x	1.5x	2x
	Range of premiums	1.5x–3x	1.5x–3x	1.25x–2.5x	1.25x–2.0x	1.5x–4.0x
Deals With Warrant Coverage		2019	2020	2021	2022	2023
Investors sometimes receive a warrant in addition to their note or SAFE. The amount of company stock covered by the warrant is usually proportional to the investment amount, referred to as the warrant coverage.	% of deals	15%	0%	5%	0%	16%
	Coverage range	10%–35%	N/A	25% (one deal)	N/A	50%–100%
	% that cover common	50%	N/A	100%	N/A	60%
	% that cover preferred	25%	N/A	0%	N/A	40%
	% that cover common or preferred (depending on the circumstances)	25%	N/A	0%	N/A	0%

* Excludes SAFEs, which by their nature do not have maturity dates, interest rates or security interests.

† Excluding SAFEs, 50%, 42%, 53%, 38% and 73% of convertible note transactions included conversion upon company sale and 45%, 63%, 53%, 54% and 77% of convertible note transactions included a repayment premium upon company sale for each of the years 2019 through 2023, respectively.

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Based on hundreds of venture capital financing transactions we handled from 2019 to 2023 for companies and investors, we have compiled the following deal data:

Deals With Multiple Liquidation Preferences		2019	2019 Range	2020	2020 Range	2021	2021 Range	2022	2022 Range	2023	2023 Range
A “multiple liquidation preference” entitles holders of preferred stock to receive more than 1x their money back before sale or liquidation proceeds are distributed to holders of common stock.	First round	2%	1.5x (one deal)	0%	N/A	0%	N/A	0%	N/A	0%	N/A
	Post–first round	4%	1.5x–2x	3%	1.5x–2.25x	0%	N/A	2%	2x–3x	8%	1.5x–2x
Deals With Participating Preferred Stock		2019	2019 Range	2020	2020 Range	2021	2021 Range	2022	2022 Range	2023	2023 Range
“Participating preferred” stock entitles holders to receive a stated liquidation preference plus a pro rata share (on an as-converted basis) of any remaining proceeds available for distribution to holders of common stock.	First round	14%		9%		9%		4%		5%	
	Total Capped	38%	1x–3x	80%	2x–3x	20%	3x (one deal)	0%	N/A	100%	3x (one deal)
	Post–first round	11%		10%		6%		10%		16%	
	Total Capped	17%	1.6x–3.5x	22%	1.25x–2x	29%	2x–2.5x	30%	1.5x–3.5x	10%	3x (one deal)
Deals With an Accruing Dividend		2019		2020		2021		2022		2023	
“Accruing dividends” are generally payable upon liquidation or redemption of the preferred stock, effectively increasing the liquidation preference of the preferred stock.	First round	10%		9%		5%		2%		14%	
	Post–first round	15%		8%		11%		10%		18%	
Anti-Dilution Provisions		2019		2020		2021		2022		2023	
A “full ratchet” anti-dilution formula provides that the conversion price of the preferred stock will be reduced to the price paid in the dilutive issuance, regardless of how many shares are involved in the dilutive issuance. In contrast, a “weighted average” anti-dilution formula takes into account the dilutive impact based upon the number of shares and the price involved in the dilutive issuance and the number of shares outstanding before and after the dilutive issuance.	First round										
	Full ratchet	0%		2%		0%		2%		0%	
	Weighted average	100%		98%		100%		98%		100%	
	Post–first round										
	Full ratchet	2%		0%		0%		3%		2%	
	Weighted average	98%		100%		100%		97%		98%	
Deals With Pay-to-Play Provisions		2019		2020		2021		2022		2023	
“Pay-to-play” provisions provide an incentive to investors to invest in future rounds of financing. Investors that do not purchase their full pro rata share in a future round lose certain rights (e.g., their shares of preferred stock may be converted into common stock at the then-applicable conversion rate or a more punitive rate, and they may lose director designation, registration or other rights).	Total	8%		3%		3%		2%		12%	
	% of total that convert into common stock	92%		100%		83%		100%		100%	
	% of total that convert into another series of preferred stock	8%		0%		17%		0%		0%	

Explanatory Note: “First round” refers to a company’s first-priced preferred stock financing regardless of round designation.

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The number of deals we reviewed and the type of consideration paid in each	Sample Size	20	25	45	22	15
	Cash	60%	60%	24%	41%	40%
	Stock	0%	8%	18%	5%	20%
	Cash and Stock	40%	32%	58%	54%	40%
Deals With Earnout		2019	2020	2021	2022	2023
Deals that provided contingent consideration based upon post-closing performance of the target, achievement of milestones by the target or other contingencies concerning the value of target (other than balance sheet adjustments)	With Earnout	40%	28%	42%	41%	27%
	Without Earnout	60%	72%	58%	59%	73%
Deals With Indemnification		2019	2020	2021	2022	2023
Deals where the target's shareholders or the buyer indemnified the other post-closing for breaches of representations, warranties and covenants	With Indemnification					
	By Target's Shareholders	80%	88%	76% ²	86%	67%
	By Buyer	45%	32%	29%	68%	47%
Deals With Representation and Warranty Insurance		2019	2020	2021	2022	2023
Deals that expressly contemplate representation and warranty insurance	With Representation and Warranty Insurance	25%	68%	47%	50%	33%
Survival of Representations and Warranties		2019	2020	2021	2022	2023
Length of time that representations and warranties survived the closing for indemnification purposes (subset: deals where representations and warranties survived the closing for indemnification purposes) ³	Shortest	12 Mos.	12 Mos.	12 Mos.	12 Mos.	12 Mos.
	Longest	24 Mos.	18 Mos.	24 Mos.	24 Mos.	24 Mos.
	Most Frequent	18 Mos.	12 Mos.	12 Mos.	12 Mos.	12 & 18 Mos. (tie)
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Upper limits on indemnification obligations where representations and warranties survived the closing for indemnification purposes	With Cap	100%	100%	100%	100%	100%
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	Limited to Purchase Price	0%	0%	0%	0%	0%
	Exceptions to Limits ⁵	100%	95%	100%	89%	100%
	Without Cap	0%	0%	0%	0%	0%

¹ For certain transactions, certain deal terms have been redacted from the publicly available documentation and are not reflected in the data compiled in this table.

² Excludes two transactions that do not provide for indemnification but permit setoff against contingent consideration.

³ Measured for representations and warranties generally; specified representations and warranties may survive longer.

⁴ Includes two transactions in 2021 and one transaction in 2023 where the limit was below the escrow amount.

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	% of Deal Value					
	Lowest ⁶	10%	8%	5%	7%	5%
	Highest	13%	15%	18%	15%	10%
	Most Frequent	12%	15%	10%	8%	6%
	Length of Time ⁷					
	Shortest	12 Mos.	12 Mos.	12 Mos.	12 Mos.	12 Mos.
	Longest	36 Mos.	24 Mos.	36 Mos.	30 Mos.	24 Mos.
	Most Frequent	12 Mos.	12 Mos.	12 Mos.	12 Mos.	12 & 18 Mos. (tie)
	Exclusive Remedy	64%	68%	53%	73%	56%
Exceptions to Escrow Limit Where Escrow Was Exclusive Remedy ⁵		100%	92%	100%	91%	100%
Baskets for Indemnification		2019	2020	2021	2022	2023
Deals with indemnification only for amounts above a specified "deductible" or only after a specified "threshold" amount is reached	Deductible	56%	52% ⁸	71% ⁹	53% ⁸	80%
	Threshold	44%	29% ⁸	26% ⁹	32% ⁸	10%
MAE Closing Condition		2019	2020	2021	2022	2023
Deals with closing condition for the absence of a "material adverse effect" with respect to the other party, either explicitly or through representation brought down to closing	Condition in Favor of Buyer	100%	100%	97%	100%	91%
	Condition in Favor of Target	35%	24%	37%	29%	18%
Exceptions to MAE		2019	2020	2021	2022	2023
Deals where the definition of "material adverse effect" for the target contained specified exceptions	With Exception ¹⁰	100%	100%	95% ¹¹	100%	100%

⁶ Excludes transactions that also specifically referred to representation and warranty insurance as recourse for the buyer.

⁷ Length of time does not include transactions where such time period cannot be ascertained from publicly available documentation.

⁸ A "hybrid" approach with both a deductible and a threshold was used in another 10% of these transactions in 2020 and 11% of these transactions in 2022.

⁹ A 50/50 cost sharing approach was used in another 3% of these transactions in 2021.

¹⁰ Generally, exceptions were for general economic and industry conditions.

¹¹ The only transaction(s) not including such exceptions provided for a closing on the same day the definitive agreement was signed.

16 Trends in VC-Backed Company M&A Deal Terms

We reviewed all merger transactions between 2019 and 2023 involving VC-backed targets (as reported in PitchBook after 2019 and in Dow Jones VentureSource or PitchBook for 2019) in which the merger documentation was publicly available and the deal value was \$25 million or more. Based on this review, we have compiled the following deal data:¹

Characteristics of Deals Reviewed		2019	2020	2021	2022	2023
The number of deals we reviewed and the type of consideration paid in each	Sample Size	20	25	45	22	15
	Cash	60%	60%	24%	41%	40%
	Stock	0%	8%	18%	5%	20%
	Cash and Stock	40%	32%	58%	54%	40%
Deals With Earnout		2019	2020	2021	2022	2023
Deals that provided contingent consideration based upon post-closing performance of the target, achievement of milestones by the target or other contingencies concerning the value of target (other than balance sheet adjustments)	With Earnout	40%	28%	42%	41%	27%
	Without Earnout	60%	72%	58%	59%	73%
Deals With Indemnification		2019	2020	2021	2022	2023
Deals where the target's shareholders or the buyer indemnified the other post-closing for breaches of representations, warranties and covenants	With Indemnification					
	By Target's Shareholders	80%	88%	76% ²	86%	67%
	By Buyer	45%	32%	29%	68%	47%
Deals With Representation and Warranty Insurance		2019	2020	2021	2022	2023
Deals that expressly contemplate representation and warranty insurance	With Representation and Warranty Insurance	25%	68%	47%	50%	33%
Survival of Representations and Warranties		2019	2020	2021	2022	2023
Length of time that representations and warranties survived the closing for indemnification purposes (subset: deals where representations and warranties survived the closing for indemnification purposes) ³	Shortest	12 Mos.	12 Mos.	12 Mos.	12 Mos.	12 Mos.
	Longest	24 Mos.	18 Mos.	24 Mos.	24 Mos.	24 Mos.
	Most Frequent	18 Mos.	12 Mos.	12 Mos.	12 Mos.	12 & 18 Mos. (tie)
Caps on Indemnification Obligations		2019	2020	2021	2022	2023
Upper limits on indemnification obligations where representations and warranties survived the closing for indemnification purposes	With Cap	100%	100%	100%	100%	100%
	Limited to Escrow ⁴	86%	81%	90%	78%	80%
	Limited to Purchase Price	0%	0%	0%	0%	0%
	Exceptions to Limits ⁵	100%	95%	100%	89%	100%
	Without Cap	0%	0%	0%	0%	0%

¹ For certain transactions, certain deal terms have been redacted from the publicly available documentation and are not reflected in the data compiled in this table.

² Excludes two transactions that do not provide for indemnification but permit setoff against contingent consideration.

³ Measured for representations and warranties generally; specified representations and warranties may survive longer.

⁴ Includes two transactions in 2021 and one transaction in 2023 where the limit was below the escrow amount.

⁵ Generally, exceptions were for fraud, willful misrepresentation and certain "fundamental" representations commonly including capitalization, authority and validity. In a limited number of transactions, exceptions also included intellectual property representations.

17 Trends in VC-Backed Company M&A Deal Terms

Escrows		2019	2020	2021	2022	2023
Deals having escrows securing indemnification obligations of the target's shareholders (subset: deals with indemnification obligations of the target shareholders)	With Escrow	94%	90%	91%	89%	90%
	% of Deal Value					
	Lowest ⁶	10%	8%	5%	7%	5%
	Highest	13%	15%	18%	15%	10%
	Most Frequent	12%	15%	10%	8%	6%
	Length of Time ⁷					
	Shortest	12 Mos.	12 Mos.	12 Mos.	12 Mos.	12 Mos.
	Longest	36 Mos.	24 Mos.	36 Mos.	30 Mos.	24 Mos.
	Most Frequent	12 Mos.	12 Mos.	12 Mos.	12 Mos.	12 & 18 Mos. (tie)
	Exclusive Remedy	64%	68%	53%	73%	56%
Exceptions to Escrow Limit						
Where Escrow Was Exclusive Remedy ⁵		100%	92%	100%	91%	100%
Baskets for Indemnification		2019	2020	2021	2022	2023
Deals with indemnification only for amounts above a specified "deductible" or only after a specified "threshold" amount is reached	Deductible	56%	52% ⁸	71% ⁹	53% ⁸	80%
	Threshold	44%	29% ⁸	26% ⁹	32% ⁸	10%
MAE Closing Condition		2019	2020	2021	2022	2023
Deals with closing condition for the absence of a "material adverse effect" with respect to the other party, either explicitly or through representation brought down to closing	Condition in Favor of Buyer	100%	100%	97%	100%	91%
	Condition in Favor of Target	35%	24%	37%	29%	18%
Exceptions to MAE		2019	2020	2021	2022	2023
Deals where the definition of "material adverse effect" for the target contained specified exceptions	With Exception ¹⁰	100%	100%	95% ¹¹	100%	100%

⁶ Excludes transactions that also specifically referred to representation and warranty insurance as recourse for the buyer.

⁷ Length of time does not include transactions where such time period cannot be ascertained from publicly available documentation.

⁸ A "hybrid" approach with both a deductible and a threshold was used in another 10% of these transactions in 2020 and 11% of these transactions in 2022.

⁹ A 50/50 cost sharing approach was used in another 3% of these transactions in 2021.

¹⁰ Generally, exceptions were for general economic and industry conditions.

¹¹ The only transaction(s) not including such exceptions provided for a closing on the same day the definitive agreement was signed.

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See our *2024 M&A Report* for a global M&A market review and outlook, plus an update on takeover defenses for public companies. We review key developments in US antitrust enforcement, look at the recently announced Department of Justice M&A safe harbor policy, compare public and private company M&A deal terms and review deal term trends in VC-backed company sales.

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Data Sources: WilmerHale compiled all data in this report from PitchBook, except as otherwise indicated.

Special note on data: Due to delayed reporting of some transactions, the venture capital financing and M&A data discussed in this report is likely to be adjusted over time as additional deals are reported. Based on historical experience, the number of reported venture capital financing and M&A transactions is likely to increase by approximately 5%–10% in the first year following the initial release of data and by smaller amounts in succeeding years, and other venture capital financing and M&A data is likely to be adjusted to reflect the inclusion of additional deals.



IPO Report

2024

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REVIEW

Pessimism surrounding the Federal Reserve's interest rate hikes, combined with subdued business and consumer confidence as well as geopolitical concerns, weighed heavily on the IPO market in 2023.

With 117 IPOs in 2023 (excluding IPOs by special purpose acquisition companies (SPACs) and direct listings), deal activity increased 48% from the mere 79 IPOs completed in 2022, but still accounted for less than one-third of the 2021 total of 381 IPOs. Total gross proceeds in 2023 were \$19.0 billion, up 144% from the \$7.8 billion in 2022.

The gross proceeds figure in 2023 was buoyed by the \$4.9 billion offering by Arm Holdings—the fourth-largest US IPO in the past 10 years behind the IPOs of Alibaba (\$21.8 billion), Rivian (\$11.9 billion) and Uber (\$8.1 billion)—and the \$3.8 billion Kenvue offering, which was the seventh-largest IPO in the past 10 years.

IPOs by emerging growth companies (EGCs) accounted for 91% of the year's IPOs, up from 87% in 2022 and above the 89% average that has prevailed since enactment of the JOBS Act in 2012.

In addition to the overall pace of new offerings being well below the median of 183 over the five-year period from 2017 to 2021, the profile of the average IPO in 2022 and 2023 was also markedly different.

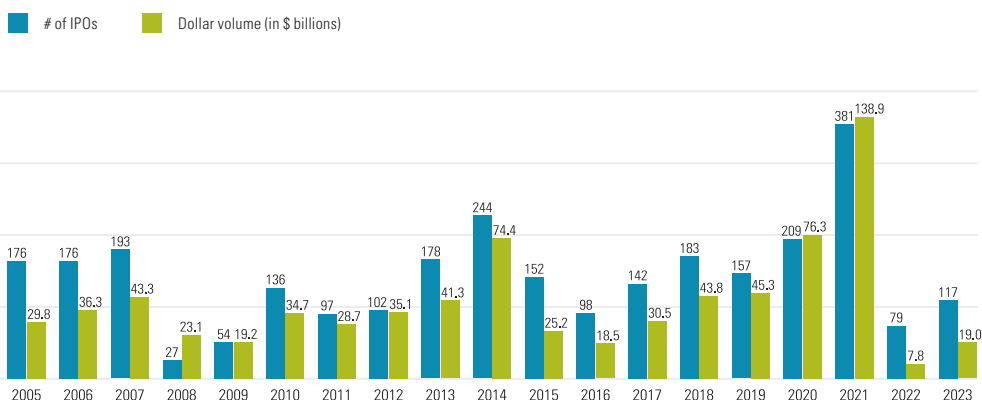
The median offering size for IPOs in 2023 was \$10.0 million, 43% lower than the \$17.6 million for 2022 and a fraction of the \$144.2 million median that prevailed over the five-year period from 2017 to 2021.

The percentage of IPOs raising gross proceeds of less than \$25 million increased to 68% in 2023 from 61% in 2022. In comparison, IPOs of that size accounted for only 8% of all IPOs between 2017 and 2021.

The median annual revenue of IPO companies in 2023 was \$9.0 million, up from \$4.7 million for 2022, but well below the \$66.9 million median that prevailed during the five-year period from 2017 to 2021.

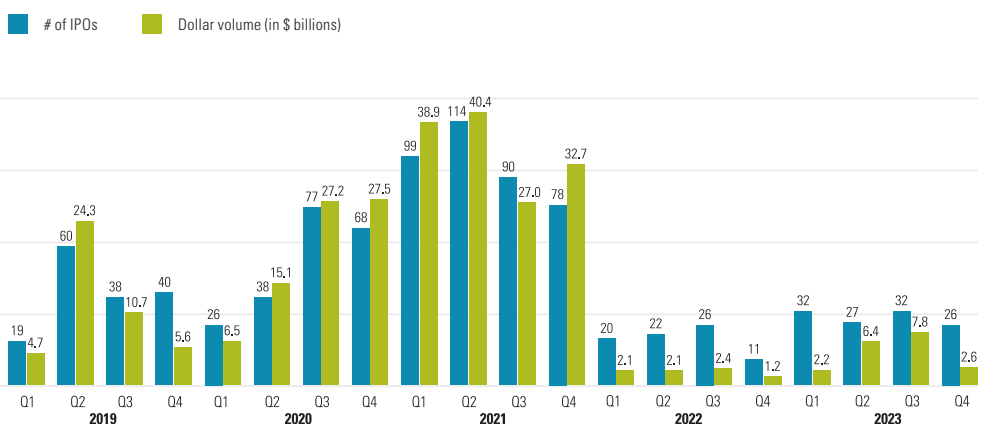
In 2023, only 33% of life sciences IPO companies had revenue—nearly double

US IPOs by Year – 2005 to 2023



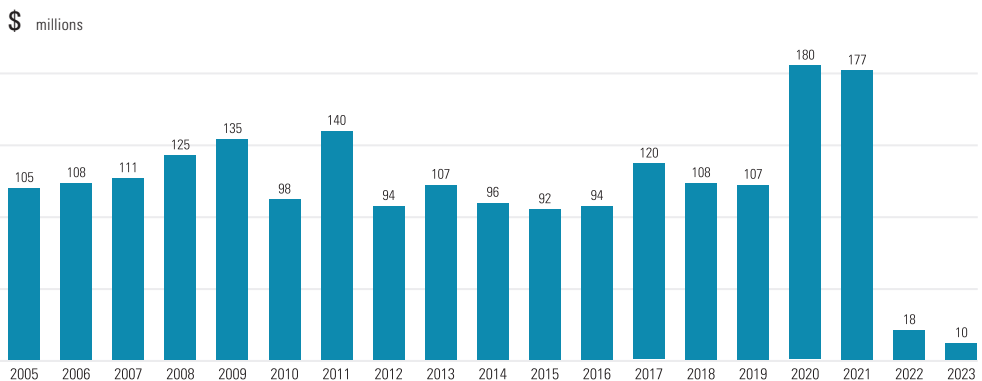
Source: SEC filings

US IPOs by Quarter – 2019 to 2023



Source: SEC filings

Median IPO Offering Size – 2005 to 2023



Source: SEC filings

3 US Market Review and Outlook

the 17% figure for 2022, but down from 46% over the five-year period from 2017 to 2021. At \$21.9 million, the median annual revenue of non-life sciences IPO companies in 2023 was almost double the \$12.0 million in 2022 but well short of the \$192.7 million median from 2017 to 2021.

The percentage of profitable IPO companies increased to 42% in 2023 from 34% in 2022 and from 28% of all IPO companies between 2017 and 2021. None of the 21 life sciences IPO companies in 2023 were profitable, compared to 56% of the non-life sciences IPO companies—the highest percentage for non-life sciences IPO companies since the 61% in 2012.

The median IPO company in 2023 ended its first day of trading unchanged from its offering price, compared to a gain of 8% in 2022 and a gain of 16% in 2021. The 2023 median first-day gain figure is the second-lowest annual figure in the past 25 years.

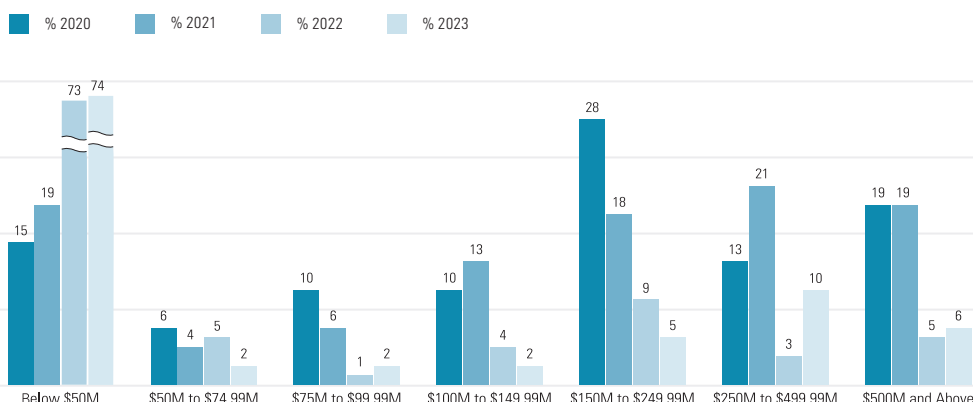
There were six “moonshots” (IPOs in which the stock price doubles on the opening day) in 2023, compared to 20 in 2022 (an anomaly given the small number of 2022 IPOs). Similar to 2022, only one 2023 moonshot ended the year above its offering price. The other five ended the year down a median of 83% from their offering price.

The percentage of “broken” IPOs (in which the stock closes below the offering price on the first trading day) rose to 50% in 2023 from 37% in 2022 and 24% over the five-year period from 2017 to 2021. The 2023 figure represents the highest level of broken IPOs since 2008, when almost two-thirds of the year’s IPOs were broken. A slightly lower percentage of 2023 life sciences IPOs (48%) than non-life sciences IPOs (50%) were broken.

2023 IPO companies ended the year trading a median of 56% below their offering price, only slightly down from 2022 IPO companies, which ended that year down 55%. In comparison, 2021 IPO companies were only down 19% in the year of their debut.

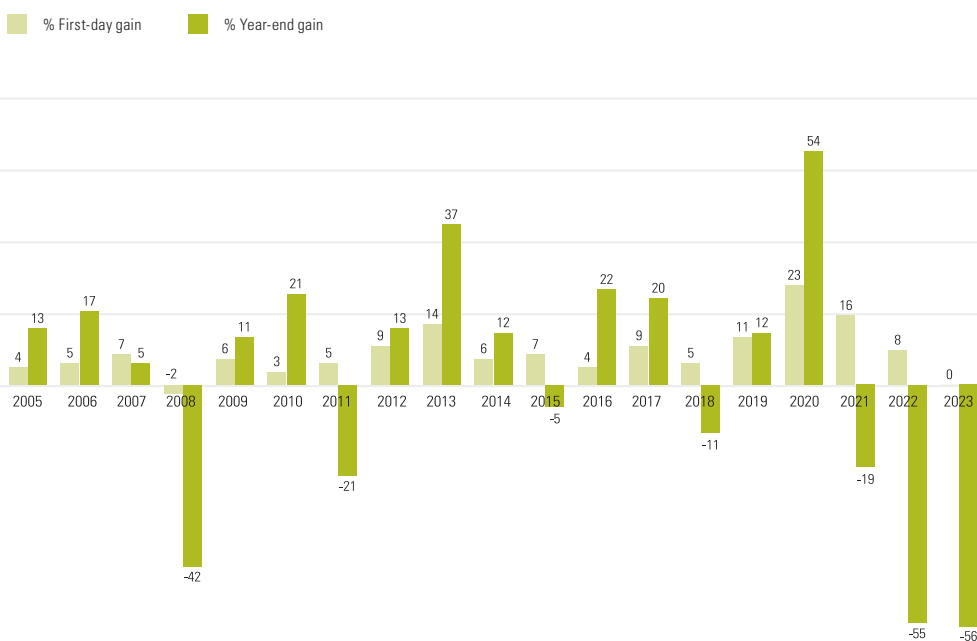
The year’s best-performing IPOs were by Jin Medical International (trading an astounding 3,000% above its offering price at year-end), Atlas Lithium (up 421%), RayzeBio (up 245%), Alpha Technology Group (up 218%) and Structure Therapeutics (up 172%).

Distribution of IPO Offering Size – 2020 to 2023

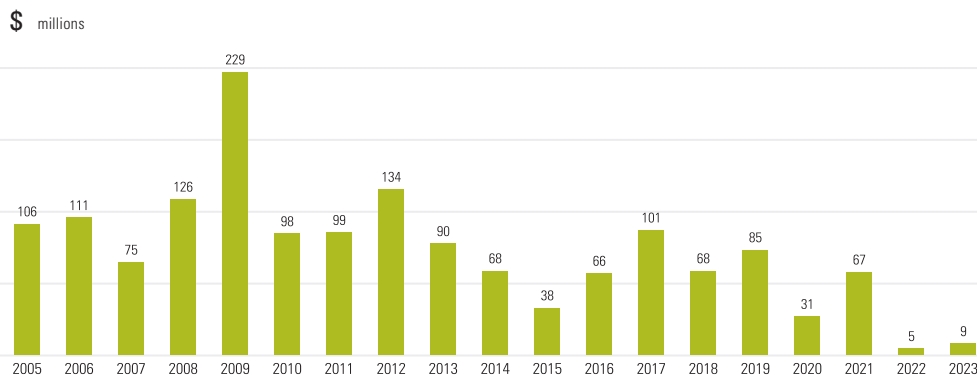


Source: SEC filings

Median IPO First-Day and Year-End Gain by Year – 2005 to 2023



Median Annual Revenue of IPO Companies – 2005 to 2023



Source: SEC filings and IPO Vital Signs

4 US Market Review and Outlook

At the end of 2023, 73% of the year's IPO companies were trading below their offering price. While this figure represents an improvement from the 80% of 2022 IPO companies that ended the year below their offering price, 2023 was the second-worst year for this metric since 2008, when 81% of IPO companies ended the year trading below their offering price. Life sciences companies fared better than their non-life sciences counterparts, with 57% trading below their offering price at year-end, compared to 76% of other companies.

While the overall performance of the IPO market was lackluster, IPOs with gross proceeds of at least \$100 million fared better, producing a median year-end gain of 6%, with 59% of such IPOs ending the year above their offering price.

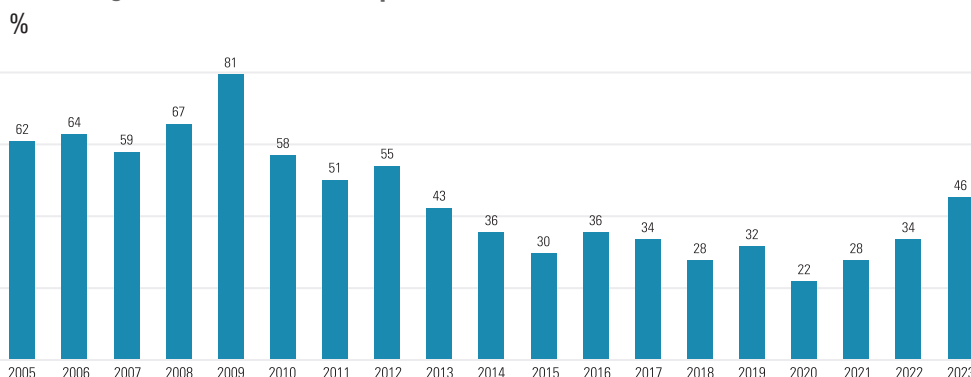
Individual components of the IPO market fared as follows in 2023:

- **VC-Backed IPOs:** The number of IPOs by VC-backed US issuers increased to 25 in 2023 from 20 in 2022, but the figures for both years are well below the median of 75 over the five-year period from 2017 to 2021 and represent the two lowest annual figures since 2009. The market share of this segment increased to 48% in 2023 from 42% in 2022 but lags behind the 58% total market share for the five-year period from 2017 to 2021. The median offering size for US-issuer VC-backed IPOs in 2023 was \$15.0 million, compared to \$52.3 million in 2022 and \$132.3 million over the five-year period from 2017 to 2021. At year-end, US-issuer VC-backed IPO companies were trading down a median of 56% from their offering price.
- **PE-Backed IPOs:** After almost tripling from 30 in 2020 to 86 in 2021, the number of private equity-backed IPOs shrank to just two in 2022 and four in 2023. PE-backed issuers accounted for only 4% of all US-issuer IPOs in 2022 and 8% in 2023, compared to 23% over the five-year period from 2017 to 2021. The median

DIRECT LISTINGS

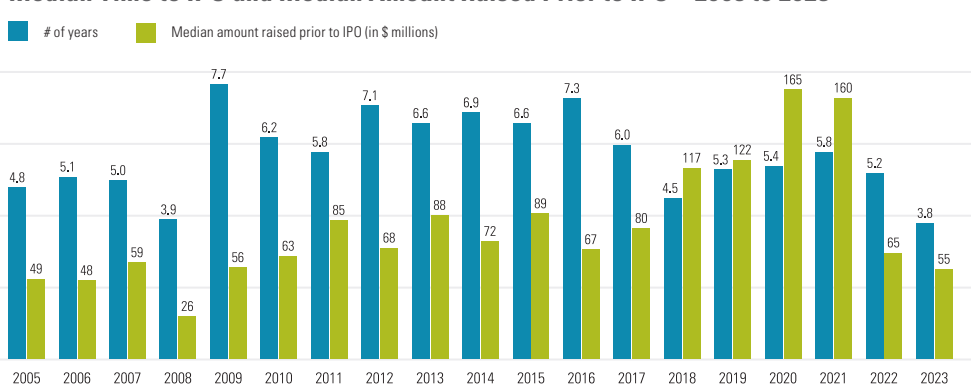
There were four direct listings in 2023, up from one in 2022 and the second-highest annual tally behind the six in 2021, but median proceeds in 2023 were well below the preceding years since 2018—the year of the first direct listing.

Percentage of Profitable IPO Companies – 2005 to 2023



Source: SEC filings and IPO Vital Signs

Median Time to IPO and Median Amount Raised Prior to IPO – 2005 to 2023



Source: PitchBook

offering size for PE-backed IPOs in 2023 was \$240.5 million, compared to \$336.0 million in 2021 and \$335.9 million over the five-year period from 2017 to 2021. PE-backed IPO companies ended the year a median of 3% above their offering price.

- **Life Sciences IPOs:** There were 21 life sciences company IPOs in 2023, two fewer than the 23 in 2022—the two lowest annual tallies in the past 10 years—down from 138 in 2021. The life sciences company share of the IPO market was 18% in 2023, down from 29% in 2022 and 39% for the five-year period from 2017 to 2021. At \$80.0 million, the median offering size for life sciences IPOs in 2023 was more than double the \$36.0 million median offering size for life sciences IPOs in 2022 and 7% higher than the \$74.8 million median from 2017 to 2021. At year-end, life sciences IPO companies were trading a

median of 46% below their offering price, compared to the median loss of 58% for non-life sciences IPO companies.

- **Tech IPOs:** Deal flow in the technology sector increased to 34 IPOs in 2023 from 25 IPOs in 2022 but remains well below the median of 59 over the five-year period from 2017 to 2021. The tech sector's share of the US IPO market declined to 30% in 2023, from 32% in 2022 and 35% over the five-year period from 2017 to 2021. The median offering size for tech IPOs in 2023 was \$8.4 million, compared to \$15.0 million in 2022 and \$227.3 million over the five-year period from 2017 to 2021. Tech IPO companies ended the year a median of 62% below their offering price.
- **Foreign-Issuer IPOs:** The number of US IPOs by foreign issuers more than doubled from 31 in 2022 to 65 in 2023. Foreign-issuer IPOs accounted for 56% of the US market in 2023, up from 39%

5 US Market Review and Outlook

in 2022, and 2023 represents the first year on record where foreign-issuer IPOs outpaced those by US issuers. Among foreign issuers, companies from China led the year with 17 IPOs, followed by companies from Hong Kong (with nine IPOs), Singapore (with seven IPOs), Japan (with six IPOs) and Malaysia (with five IPOs). Foreign-issuer IPO companies ended the year down a median of 53% from their offering price.

OUTLOOK

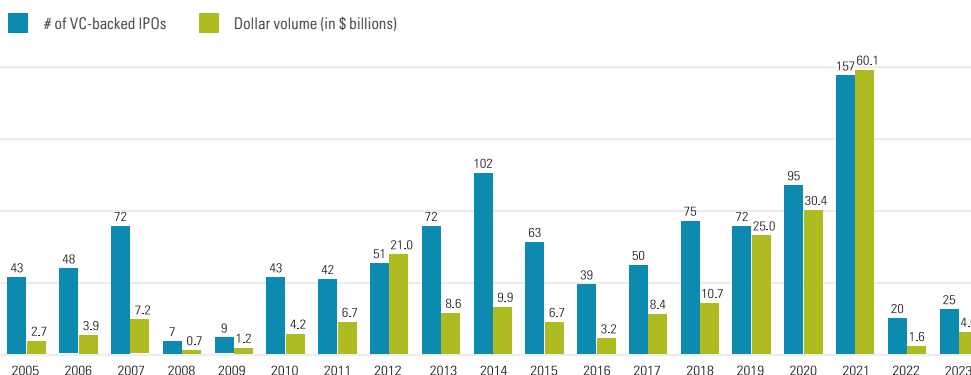
IPO market activity in the coming year will depend on a number of factors, including the following:

- **Economic Growth:** The advance estimate indicates US GDP increased by 2.5% in 2023, despite predictions that US GDP growth would slow from the 2.1% in 2022. The labor market continued to post strong overall job growth, with total nonfarm employment exceeding the pre-pandemic high of 152.4 million jobs by over 4.5 million jobs. Despite the strong job growth figures, inflation trended downward over the course of 2023, although it remained above the Fed's target 2% level. The elusive soft landing that looked like a pipe dream at the start of 2023 seems more realistic one year later, although low levels of business investment, weak home sales and depressed US exports all point to structural challenges that remain.
- **Capital Market Conditions:** Stable capital market conditions absent volatile swings have historically been a precursor to a buoyant IPO market. The Dow, Nasdaq Composite Index and S&P 500 ended the year up 14%, 43% and 24%, respectively. Continued capital market growth and stability will be building blocks for a healthy IPO market in the

SPAC IPOs

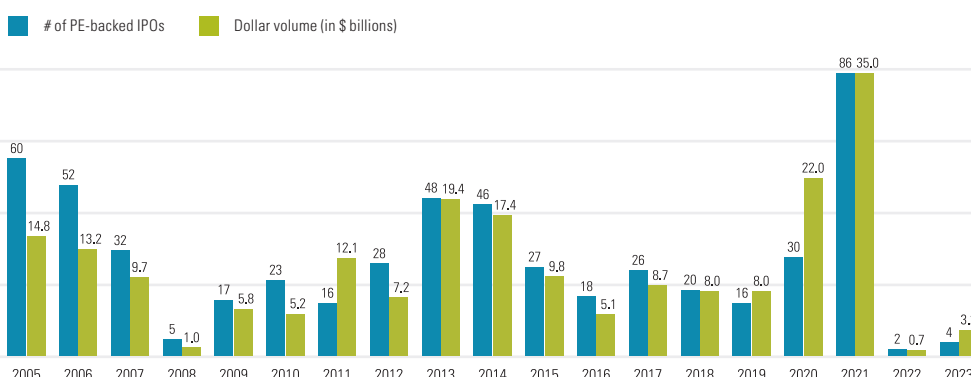
In 2023, there were 31 SPAC IPOs with total proceeds of \$3.45 billion, continuing the decline from 86 SPAC IPOs in 2022 and 613 in 2021. The 2023 count represents the lowest annual tally since the 12 in 2016. Despite the decline, at year-end there were 127 SPACs still searching for a business combination and 140 that had entered into a definitive agreement but not yet finalized the merger.

Venture Capital–Backed IPOs – 2005 to 2023



Source: SEC filings
Based on US IPOs by VC-backed US issuers

Private Equity–Backed IPOs – 2005 to 2023



Source: Refinitiv and SEC filings
Based on US IPOs by PE-backed US issuers

coming year, but interest rates may need to come down for momentum to remain.

- **Venture Capital Pipeline:** The overall level of venture capital investment declined to \$166.8 billion in 2023 from \$242.1 billion in 2022 and \$348.2 billion in 2021. The number of VC-backed companies raising rounds of at least \$100 million fell to 269 in 2023 from 532 in 2022 and 843 in 2021. Despite these declines, the ability of companies to continue raising “IPO-sized” private rounds will give them some flexibility as to when they seek to enter the public market. That said, VCs invest with an expectation of a liquidity event, and their demands for returns are likely to increase when favorable market windows emerge. When private market valuations meet the harsher reality of public markets, some companies may choose to delay their IPO plans.

- **Private Equity Impact:** While PE-backed companies largely stayed on the sidelines of the IPO market for the second consecutive year and fundraising dipped to \$556.1 billion in 2023 from \$528.8 billion in 2022, private equity firms continue to sit on enormous amounts of “dry powder.” As uncertainty subsides and interest rates decline, one can expect private equity firms to reengage.

Despite economic and geopolitical challenges that remain, the IPO market enters 2024 with expectations for a revival, especially in the latter half of the year if anticipated interest rate cuts by the Fed come to fruition. There are a wide array of qualified companies in the IPO pipeline, but market conditions need to improve sufficiently to see a significant resumption in deal flow. ■

6 Regional Market Review and Outlook

CALIFORNIA

IPO activity by California-based companies in 2023 remained well below its historic level. The state produced 18 IPOs, up from 11 in 2022 but considerably less than the median of 48 that prevailed over the five-year period from 2017 to 2021.

Gross proceeds increased to \$2.9 billion in 2023 from a paltry \$209.7 million in 2022, but the total for 2023 represents the fourth-lowest annual amount since 2010. The largest California IPOs in 2023 came from Instacart (\$660 million), Nexttracker (\$638 million) and ACELYRIN (\$540 million).

Technology and life sciences companies accounted for 61% of the state's IPO total in 2023—down from their 73% share in 2022 and lower than their 84% share in the five-year period between 2017 and 2021.

The number of VC-backed California IPOs increased from six in 2022 to 10 in 2023. The 2023 tally represents 40% of all US-issuer VC-backed IPOs, up from the state's 30% share in 2022 but trailing the 44% share that prevailed during the five-year period from 2017 to 2021.

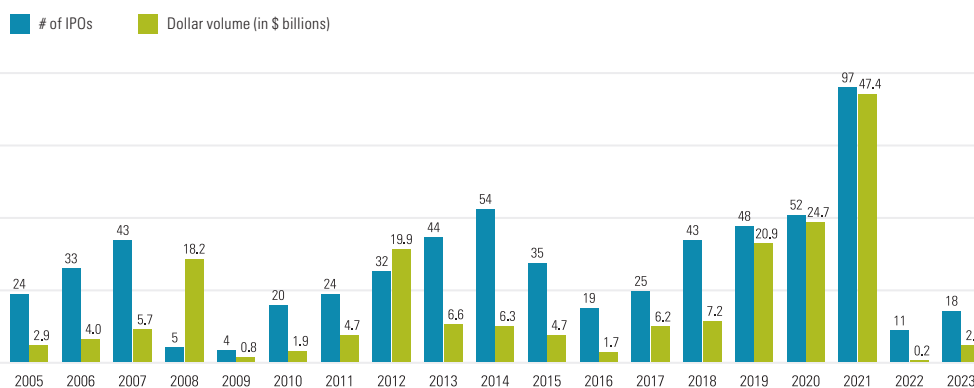
California IPO companies produced a median first-day gain of 5% in 2023. Sacks Parente Golf was the state's top performer, with a first-day gain of 624%, followed by specialty Asian grocer Maison Solutions (up 124%) and a trio of biotech companies—Structure Therapeutics (up 73%), RayzeBio (up 33%) and ACELYRIN (up 31%).

At year-end, California IPO companies were trading down a median of 45% from their offering price, with only one-third of California IPO companies trading above their offering price.

The best-performing California IPOs of the year were RayzeBio (up 245% at year-end), Structure Therapeutics (up 172%) and Genelux (up 134%).

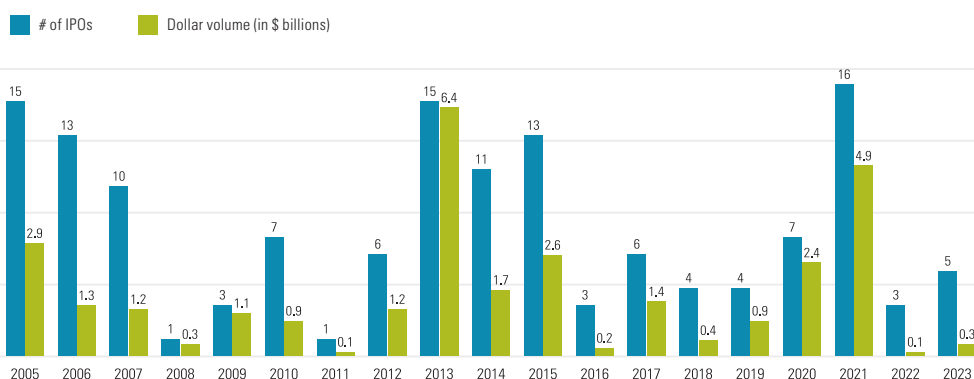
With the largest pool of VC-backed companies in the United States and a wealth of entrepreneurial talent, California should remain a major source of strong IPO candidates in the coming year, with deal flow dependent on market conditions.

California IPOs – 2005 to 2023



Source: SEC filings

Mid-Atlantic IPOs – 2005 to 2023



Source: SEC filings

MID-ATLANTIC

The Mid-Atlantic region of Virginia, Maryland, North Carolina, Delaware and the District of Columbia produced five IPOs in 2023, up from three in 2022 but below the median of six that prevailed over the five-year period from 2017 to 2021.

North Carolina accounted for two of the region's IPOs in 2023, with the District of Columbia, Maryland and Virginia each adding one.

While gross proceeds in the Mid-Atlantic region more than doubled from \$130.8 million in 2022 to \$342.1 million in 2023, almost all of the region's proceeds came from CAVA Group's \$318 million IPO; the remaining four IPOs each had gross proceeds below \$10 million.

There were two VC-backed IPOs in the region in 2023, compared to one in 2022 and a median of three over the five-year period from 2017 to 2021.

Mid-Atlantic IPO companies produced a median first-day gain of 6% in 2023. CAVA just missed out on a moonshot, ending its first day of trading up 99% from its offering price; and Cheetah Net Supply Chain Service had a 73% first-day gain.

At year-end, the median 2023 Mid-Atlantic IPO company was down 68% from its offering price, with CAVA as the only one up from its offering price (shedding part of its first-day gain to end the year up 95%).

The region's traditional strengths in the life sciences, technology, financial services and defense sectors should continue to produce attractive IPO candidates as market conditions improve.

7 Regional Market Review and Outlook

NEW ENGLAND

The New England IPO market produced five IPOs in 2023, down from eight in 2022.

Massachusetts produced three of the region's IPOs in 2023, with Connecticut adding the remaining two.

Gross proceeds in the region declined by 7% from \$1.24 billion in 2022 to \$1.15 billion in 2023.

The largest New England IPO in 2023 was by Klaviyo (\$576 million), the region's only non-life sciences company IPO, followed by Apogee Therapeutics (\$300 million) and Neumora Therapeutics (\$250 million).

The region's share of all US-issuer life sciences IPOs in the country declined from 42% in 2022 to 24% in 2023 and trails the 29% that prevailed over the five-year period from 2017 to 2021.

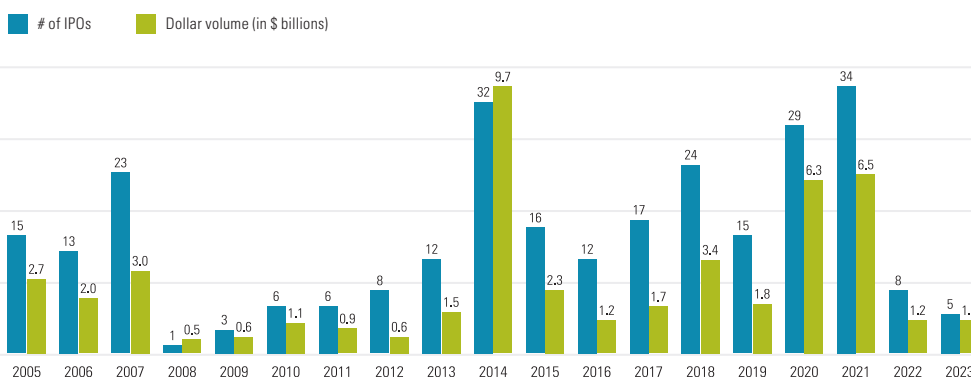
For the second consecutive year, all of New England's IPOs came from VC-backed companies. The region accounted for 20% of all US-issuer VC-backed IPOs in 2023, down from 40% in 2022 but only slightly lower than the 23% over the five-year period from 2017 to 2021.

New England IPO companies produced a median first-day gain of 9% in 2023. The region's top performers in first-day trading were Apogee Therapeutics (up 25% from its offering price), Intensity Therapeutics (up 19%) and Klaviyo (up 9%).

At year-end, New England's 2023 IPO companies were up a median of less than 1% from their offering price, with 60% of the region's IPO companies trading above their offering price. The best-performing New England IPOs at year-end were Intensity Therapeutics (up 71%) and Apogee Therapeutics (up 64%).

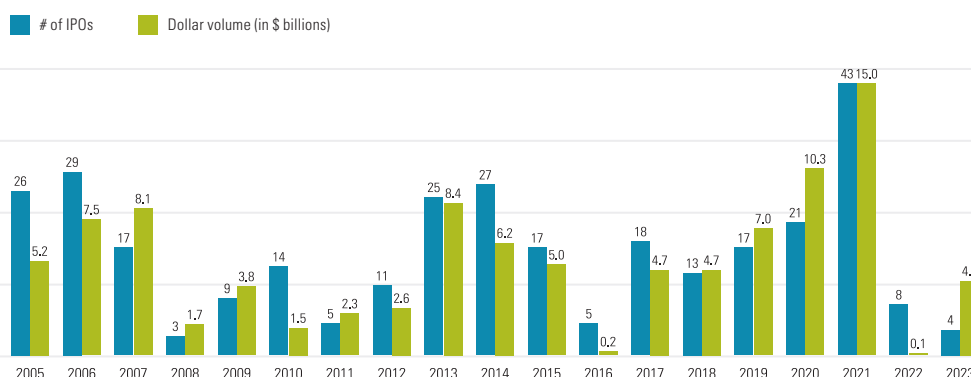
With the region's world-renowned universities and research institutions continuing to spawn tech and life sciences companies, and with strong levels of venture capital investment, New England should continue to generate compelling IPO candidates in the coming year, with the pace of deal flow dependent on market conditions.

New England IPOs – 2005 to 2023



Source: SEC filings

Tri-State IPOs – 2005 to 2023



Source: SEC filings

TRI-STATE

The number of IPOs in the tri-state region of New York, New Jersey and Pennsylvania fell from eight in 2022 to four in 2023.

New Jersey produced two of the region's 2023 IPOs, while New York and Pennsylvania each accounted for one.

Gross proceeds from tri-state IPOs increased from \$145.2 million in 2022 to \$4.1 billion in 2023, bolstered by Kenvue's \$3.8 billion IPO.

The tri-state region produced a pair of VC-backed IPOs in 2023, the same count as 2022 but well below the median of 11 over the five-year period from 2017 to 2021.

As in 2022, both of the region's VC-backed IPOs were also life sciences companies—Mineralys Therapeutics produced a \$192 million IPO, and Lexeo Therapeutics produced a \$100 million IPO.

Tri-state IPO companies in 2023 gained a median of 6% in first-day trading. Only two of the region's IPO companies ended their first day of trading above their offering price, led by Kenvue (with a first-day gain of 22%) and Mineralys Therapeutics (up 15%).

At year-end, tri-state IPO companies were down a median of 24% from their offering price. The best-performing tri-state IPO, and the only one to end the year in positive territory, was Lexeo Therapeutics (up 22% from its offering price at year-end).

With its high level of venture capital activity and its sophisticated capital markets ecosystem, the tri-state region can be expected to produce IPOs from emerging life sciences and technology companies as well as larger, private equity-backed companies when market conditions improve. ■

8 IPO Market by the Numbers

PROFILE OF SUCCESSFUL IPO CANDIDATES

What does it really take to go public? There is no single profile of a successful IPO company, but in general, the most attractive candidates share the following attributes:

- **Outstanding Management:** An investment truism is that investors invest in people, and this is even truer for IPO companies. Every company going public needs experienced and talented management with high integrity, a vision for the future, plenty of energy to withstand the rigors of the IPO process and public company life, and a proven ability to execute. An IPO is not the best time for a fledgling CEO or CFO to cut their teeth.
- **Market Differentiation:** IPO candidates need a superior technology, product or service in a large and growing market. Ideally, they are viewed as market leaders in their industry. Appropriate intellectual property protection is expected of technology companies, and in some sectors, such as life sciences and medical devices, patents are *de rigueur*.
- **Substantial Revenue:** Substantial revenue is generally expected—at least \$50 million to \$75 million annually—in order to provide a platform for attractive levels of profitability and market capitalization.
- **Revenue Growth:** Consistent and strong revenue growth—25% or more annually—is usually needed, unless the company has other compelling features. The company should have visibility into sustained expansion to avoid the market punishment that can accompany revenue or earnings surprises.
- **Profitability:** Strong IPO candidates generally have track records of earnings and a demonstrated ability to enhance margins over time, although IPO investors often appear to value growth more highly than near-term profitability.
- **Market Capitalization:** The company's potential market capitalization should be at least \$200 million to \$250 million in order to facilitate development of a liquid trading market. Substantial post-IPO ownership by insiders may mean a larger market cap is required to provide ample float.

Other factors can vary based on a company's industry and size. For example, many life sciences companies will have much less revenue and not be profitable. More mature

HOW DO YOU COMPARE?

The characteristics of the IPO market in 2022 and 2023 were vastly different than in the preceding three years. Deal flow fell by more than one-half, offering sizes were much smaller and IPO companies had far less annual revenue. US-incorporated issuers completing US IPOs in 2022 and 2023 were significantly less likely to include selling stockholders, utilize a directed share program or engage a "Big 4" accounting firm, and their IPOs generally received more SEC comments and took longer to complete.

METRIC	2019–2021	2022–2023
Annual number of IPOs	249	98
IPO companies qualifying as EGCs under the JOBS Act	92%	89%
Median offering size	\$163.9 million (18% < \$50 million and 17% > \$500 million)	\$15.0 million (73% < \$50 million and 6% > \$500 million)
Median annual revenue of IPO companies	\$59.0 million (48% < \$50 million and 15% > \$500 million)	\$6.2 million (72% < \$50 million and 10% > \$500 million)
IPO companies that are profitable	27%	41%
IPOs with selling stockholders and median percentage of offering represented by those shares	Percentage of IPOs—20% Percentage of offering—32%	Percentage of IPOs—9% Percentage of offering—16%
IPOs with directed share programs and median percentage of offering represented by those shares	Percentage of IPOs—44% Percentage of offering—5%	Percentage of IPOs—18% Percentage of offering—5%
IPO companies disclosing adoption of an ESPP	69%	25%
IPO companies using a "Big 4" accounting firm	74%	32%
Stock exchange on which the company's common stock is listed	Nasdaq—78% NYSE—22%	Nasdaq—82% NYSE—18%
Median underwriting discount	7%	7%
Number of SEC comments contained in initial comment letter	Median—16 25th percentile—12 75th percentile—21	Median—20 25th percentile—16 75th percentile—26
Median number of Form S-1 amendments filed before effectiveness	Four	Seven
Number of days from initial submission to effectiveness of Form S-1	Median—104 25th percentile—83 75th percentile—158	Median—239 25th percentile—154 75th percentile—371

companies are likely to have greater revenue and market caps but slower growth rates. High-growth companies are likely to be smaller and usually have a shorter history of profitability.

Beyond these objective measures, IPO candidates need to be ready for public

ownership in a range of other areas, including accounting preparation, corporate governance, financial and disclosure controls and procedures, external communications, legal and regulatory compliance, and a variety of corporate housekeeping tasks. ■

Prevalence of EGC Elections

9 Practices Continue to Evolve Regarding Financial Disclosure and Adoption of New or Revised Accounting Standards

One of the most successful efforts to encourage capital formation as an engine of economic growth was the passage of the JOBS Act in 2012. The cornerstone of the JOBS Act is the creation of an “IPO on-ramp” that provides emerging growth companies (EGCs) with a phase-in period to come into full compliance with certain disclosure and accounting requirements. The phase-in period can continue until the last day of the fiscal year following the fifth anniversary of an IPO but will be shorter for many companies.

The prevalence of elections for some items of EGC relief—such as the ability to submit a draft Form S-1 registration statement for confidential SEC review and to provide reduced executive compensation disclosure—has remained consistently high across different types of EGCs.

Practices with respect to other items of relief—particularly those related to financial disclosure and the application of new or revised accounting standards—have varied, often reflecting the company’s size, maturity or industry, and have exhibited strong trends over time as investor expectations and market practices have evolved.

CONFIDENTIAL SUBMISSION OF FORM S-1

— **Description:** An EGC is able to submit a draft Form S-1 registration statement to the SEC for confidential review instead of filing it publicly on the SEC’s EDGAR system (and in 2017, a similar nonpublic review process became available to all companies going public). A confidentially submitted Form S-1 need not be filed publicly until 15 days before the road show commences, enabling an EGC to delay disclosure of its IPO plans and sensitive information to competitors and employees. Confidential review can also enable an EGC to abandon its IPO plans without requiring public disclosure if market conditions preclude an offering.

— **Prevalence:** Overall rates of adoption have consistently remained very high—96% of all EGCs since enactment of the JOBS Act.

REDUCED EXECUTIVE COMPENSATION DISCLOSURE

— **Description:** An EGC is allowed to provide “scaled” executive compensation disclosure and therefore need not provide Compensation Discussion and Analysis (CD&A); compensation information is required only for three named executive officers (including the CEO); and only three of the seven compensation tables otherwise required must be provided.

— **Prevalence:** EGCs have uniformly and overwhelmingly embraced the ability to provide reduced executive compensation disclosure. Overall, 99% of all EGCs (including all EGCs since 2020) have excluded CD&A from their Form S-1.

REDUCED FINANCIAL DISCLOSURE

— **Description:** An EGC is required to provide only two years of audited financial statements (instead of three years), plus unaudited interim financial statements, and is only required to include MD&A for the periods presented in the required financial statements.

— **Prevalence:** Overall, the percentage of EGCs electing to provide only two years of audited financial statements has increased dramatically, from 27% in 2012 to 93% in 2023. From the outset, life sciences companies—for which older financial information is often irrelevant—were likely to provide only two years of audited financial statements, with the percentage choosing this option reaching 100% in both 2022 and 2023. Technology companies—which generally have substantial revenue and often have profitable operations—were slower to adopt this practice, but the percentage providing only two years of audited financial statements grew from 22% in 2012 to 91% in 2022 and 100% in 2023.

Two Years of Audited Financial Statements

	2012– 2016	2017– 2019	2020– 2023	Overall
Life Sciences	87%	97%	99%	94%
Technology	37%	63%	89%	64%
All EGCs	65%	84%	93%	80%

ACCOUNTING STANDARDS ELECTION

— **Description:** An EGC may elect not to be subject to any accounting standards that are adopted or revised on or after April 5, 2012, until these standards are required to be applied to nonpublic companies.

— **Prevalence:** Through 2016, the vast majority of EGCs opted out of the extension of time to comply with new or revised accounting standards. At that time, the decision appears to have been motivated by the uncertain value of the deferred application of future, unknown accounting standards and concerns that a company’s election to take advantage of the extended transition period could make it more difficult for investors to compare the company’s financial statements to those of its peers. Starting in 2017, a major shift has occurred, with the percentage of EGCs adopting the extended transition period jumping from 11% for the period through 2016 to 50% between 2017 and 2019 and to 93% between 2020 and 2023. This trend appears to have been motivated by the desire of many EGCs to delay the application of new revenue recognition and lease accounting standards (which became mandatory for public companies in 2018–2019) or, at a minimum, to take more time to evaluate the effects of these standards before adopting them. ■

Delayed Application of New or Revised Accounting Standards

	2012– 2016	2017– 2019	2020– 2023	Overall
Life Sciences	10%	45%	92%	51%
Technology	12%	62%	93%	57%
All EGCs	11%	50%	93%	52%

EXITING EGC STATUS

In many cases, a company exiting EGC status qualifies as a “smaller reporting company” (SRC) under SEC rules and can continue to enjoy most of the disclosure and financial reporting accommodations that are available to EGCs. Generally, a company qualifies as an SRC if it has:

- Public float of less than \$250 million; or
- Less than \$100 million in annual revenues and either no public float or a public float of less than \$700 million.

Duty of Oversight Applies to Directors (and Officers, Too)

While the fiduciary duties of directors and officers are the same whether a company is privately owned or publicly traded, the risk of claims by dissatisfied stockholders alleging breaches of these fiduciary duties becomes much more significant once a company is public.

One particular type of breach of fiduciary duty claims—those based on an alleged failure of the duty of oversight—has become especially common in recent years against directors. In 2023, Delaware courts explicitly held for the first time that officers also have a duty of oversight and, therefore, face exposure to claims for alleged failure to fulfill their oversight duties. These developments highlight how important it is for the directors and officers of an IPO company to ensure the company has appropriate reporting systems and controls in place from its first day as a public company.

WHAT IS REQUIRED?

The duty of oversight requires directors and officers to make good faith efforts to implement an oversight system and then monitor it. Allegations that directors and officers violated their duty of oversight are often referred to as *Caremark* claims, referring to a landmark 1996 case involving that company.

THE FIDUCIARY DUTIES OF BOARDS AND MANAGEMENT

The fiduciary duties of directors and officers under Delaware law generally consist of:

- The *duty of care*—an obligation to act on an informed basis after due consideration of relevant materials and appropriate deliberations; and
- The *duty of loyalty*—an obligation to refrain from deriving a benefit from a transaction not generally available to all stockholders, and to otherwise act in good faith.

While almost every company going public will include in its charter a provision eliminating the personal monetary liability of directors and officers for violations of the duty of care, breaches of the duty of oversight are considered to be non-exculpable breaches of the duty of loyalty, and directors and officers who violate the duty of oversight may therefore face personal liability.

Oversight liability can arise if directors or officers either:

- utterly fail to implement any reporting or information systems or controls (“information-systems claims”); or
- having implemented such systems or controls, consciously fail to monitor or oversee the operation of those systems or controls, thus disabling themselves from being informed of risks or problems requiring their attention (“red-flag claims”).

While *Caremark* claims have frequently been described as “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment,” since mid-2019 Delaware courts have allowed *Caremark* claims in at least 10 cases to proceed past the motion to dismiss stage, meaning that plaintiffs adequately alleged that directors or officers had failed in implementing or monitoring an oversight system.

MORE CAREMARK CLAIMS SURVIVING DISMISSAL – MARCHAND THROUGH 2022

Since the 2019 Delaware Supreme Court ruling reviving claims in *Marchand v. Barnhill*, several plaintiffs’ claims have survived motions to dismiss. In *Marchand*, a listeria outbreak that contaminated Blue Bell ice cream resulted in three deaths and caused the company to recall all of its products, cease production at all plants and dismiss over a third of its employees. These catastrophes caused the Delaware Supreme Court to reverse the Delaware Chancery Court’s dismissal, allowing an information-systems claim against directors to proceed because:

- Food safety was a mission-critical compliance issue for Blue Bell, an ice cream maker;
- The board did not have a committee- or board-level process to oversee and address food safety issues; and
- Board minutes did not mention discussion about food safety concerns existing prior to the listeria outbreak or generally reflect discussion of food safety matters.

Since *Marchand*, and through 2022, the Chancery Court allowed *Caremark* claims

BOARD ACTIONS TO FULFILL OVERSIGHT OBLIGATIONS

Some of the actions a board of directors can take to help fulfill and document its oversight obligations and minimize the risk of liability under the *Caremark* standards of liability are summarized below.

To address its obligation to implement appropriate reporting or information systems or controls, the board (or designated board committee) may:

- Ensure both management and the board have installed processes for identifying and regularly reviewing mission-critical risks, and document those processes;
- Explicitly assign responsibility for oversight of key risks to the full board or a specific committee, being sure to include corresponding proxy disclosure once public;
- Not rely solely on the existence of regulatory requirements—such as SEC or FDA requirements—as a basis for assuming an adequate reporting system exists;
- Avoid being completely dependent on senior management reporting, including by hearing directly from chief compliance and risk officers, and ensure there are systems in place for employees and corporate partners to raise concerns; and
- Establish protocols for management to promptly elevate significant regulatory or compliance developments.

To address its obligation to monitor or oversee the operation of the implemented systems or controls, the board (or designated board committee) may:

- Be vigilant for warning signs (often referred to as yellow or red flags) and follow up when identified, including giving consideration to the engagement of outside advisors;
- Receive regular reports on mission-critical risks and regulatory issues;
- Ensure that meeting minutes demonstrate regular oversight and follow-up on potential concerns; and
- Exercise care in informal communications (such as emails and texts), because such materials may in some situations be discoverable in response to a books and records request.

against directors to proceed in cases involving, among others, a life sciences company whose lead product candidate suffered from a low confirmed success rate and ultimately ran into FDA problems; an

Duty of Oversight Applies to Directors (and Officers, Too)

11 Recent Cases Clarify Caremark Duties of Officers and Focus on Legal Compliance Risks

OFFICER ACTIONS TO FULFILL OVERSIGHT OBLIGATIONS

Some of the actions officers can take to help fulfill and document their oversight obligations under the *Caremark* standards of liability include:

- Ensure reporting or information systems or controls are in place and well-documented, for matters within a specific officer's areas of responsibility;
- Identify and understand the company's key risks in order to be better able to recognize and respond to red flags, including those that do not relate to direct areas of responsibility; and
- Escalate any significant inadequacies in the information systems, as well as red flags.

auto parts manufacturer that had persistent problems with internal controls and oversight of related person transactions ultimately requiring it to restate its financial statements; and a pharmaceutical company whose subsidiary pleaded guilty to criminal charges related to inappropriate repackaging of oncology drugs into syringes.

MCDONALD'S CLARIFIES THAT OFFICERS ALSO HAVE CAREMARK DUTIES – 2023 AND THE ROAD AHEAD

In 2023, for the first time, the Chancery Court explicitly held that officers also have *Caremark* duties. Despite ultimately dismissing the suit on other grounds, in *In re: McDonald's Corp. Stockholder Derivative Litigation*, the Court found plaintiffs adequately pled a red-flag claim against the chief people officer, concluding a litany of HR and EEOC complaints, as well as employee strikes and letters from US Senators, constituted awareness of an allegedly harassment-friendly company culture. The chief people officer was also personally alleged to have committed sexual harassment.

The *McDonald's* opinion noted that an officer's duty of oversight will typically be limited to the officer's areas of responsibility but also noted that "particularly egregious red flag[s]" may trigger an officer's duty to act, even if it is outside the officer's domain.

Following *McDonald's*, *Caremark* claims against officers have been allowed to proceed in at least three cases, including one involving a dispenser of opioids whose management of its controlled substance compliance programs allegedly violated a DEA settlement and the Controlled Substances Act.

To close out a whirlwind year for *Caremark* claims, a December 2023 Chancery Court decision clarified that officer claims are held to the same standard as director claims. In *Segway v. Cai*, the Court considered *Caremark* claims against a corporate officer for alleged failure to escalate substantial financial performance issues to the board. In dismissing the plaintiffs' claims, the Court explained that the standard for *Caremark* claims against officers is the same as for directors, and to think, as the plaintiffs had argued, that *McDonald's* created a lower standard for claims against officers is "a distressing reading of our law."

NO ONE-SIZE-FITS-ALL APPROACH TO OVERSEEING RISK

Discharging the duty of oversight requires directors and officers to demonstrate that they have used good faith efforts to put in place a reasonable system of monitoring and reporting the company's key risks, especially those that relate to mission-critical regulatory, legal compliance and public safety matters.

There is no one-size-fits-all approach. Boards and management have discretion to implement context-dependent and industry-specific approaches to risk oversight tailored to the activities and resources of the businesses they oversee, which may include delegating oversight of specific market or industry risks to board committees. That said, it is not sufficient to solely rely on government regulation of a company's industry or simply hold general discussions with management about operational issues at periodic board and committee meetings.

Other cases in 2023 helped clarify the focus of *Caremark* on legal compliance risks rather than on general business risks, as the Delaware courts have consistently drawn the distinction between these two

types of risks when determining whether a breach of the duty of oversight has occurred. The facts underlying the October 2023 Chancery Court dismissal in *In re: ProAssurance Corp. Stockholder Derivative Litigation* offer a helpful illustration. In that case, an insurance company deviated from its typical practice of underwriting policies for smaller physician groups and agreed to underwrite a policy for a national provider, which created increased risk that loss reserves held by the company would become inadequate. The Court ruled that the board's decision to pursue a higher-risk strategy did not result in *Caremark* liability because "[t]he only so-called red flags were of business risks—not illegality." This distinction was echoed in *Segway*, with the Court stating that *Caremark* was not intended to create officer liability for "everyday business problems" like the financial discrepancies in that case.

At a minimum, directors and officers should ensure that key regulatory, legal compliance and public safety risks are monitored at the company level and included in the agenda for every regular board meeting, and that the board itself includes directors who have sufficient experience in those key risk areas or consults independent external experts who do.

DO YOUR WORK AND DOCUMENT IT

Practically speaking, directors and officers need to be able to demonstrate that they have been proactive in discharging their risk oversight responsibilities. This generally means being able to show that:

- the company has sufficient reporting and compliance systems;
- regulatory and compliance issues are effectively reported up; and
- when issues are reported, actions are taken to investigate and, if appropriate, address such issues.

It is important to contemporaneously document oversight activities, including in board meeting minutes, given that it is now common for plaintiffs' lawyers to use information gathered through books and records requests in an effort to craft a complaint that is more likely to withstand a company's motion to dismiss. ■

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 Exchange Offer \$7,049,783,000 March 2023 Rule 144A Placement of Senior Notes \$750,000,000 September 2023 Counsel to Issuer	 Public Offering of Senior Notes \$300,000,000 September 2022 Exchange Offer \$427,480,000 September 2023 Counsel to Issuer	 Public Offerings of Senior Notes €1,250,000,000 \$1,200,000,000 November 2022 \$5,450,000,000 August and December 2023 Counsel to Issuer	 Rule 144A/Regulation S Private Placements of Senior Notes \$2,100,000,000 €500,000,000 September 2023 Counsel to Issuer	 Public Offerings of Senior Notes \$10,000,000,000 February, May, August, November 2022 and January, May, August, November 2023 Counsel to Issuer	 Public Offerings of Senior Notes €3,500,000,000 September 2022 \$2,000,000,000 March 2023 Counsel to Issuer	 Rule 144A Placement of Senior Notes \$1,265,000,000 August 2023 Counsel to Issuer	 Rule 144A Placement of Senior Notes \$1,000,000,000 May 2023 Counsel to Issuer	 Public Offering of Common Stock \$517,500,000 June 2023 Counsel to Issuer
 Public Offerings of Senior Notes \$500,000,000 Green Bond March 2023 \$750,000,000 February 2024 Counsel to Issuer	 Public Offering of Senior Notes \$500,000,000 April 2023 Counsel to Issuer	 Public Offerings of Common Stock \$264,500,000 November 2022 \$345,000,000 October 2023 Counsel to Issuer	 Public Offering of Common Stock by Selling Stockholders \$193,520,000 June 2023 Counsel to Issuer	 Public Offering of Common Stock and Pre-Funded Warrants \$157,780,000 June 2023 Counsel to Underwriters	 Public Offering of Ordinary Shares and Non-Voting Convertible Preferred Shares \$143,750,000 April 2023 Exchange Offer \$106,268,000 April 2023 Counsel to Underwriters	 Public Offering of Common Stock \$125,000,000 June 2023 Counsel to Issuer	 Public Offering of Common Stock, Common Stock Warrants and Pre-Funded Warrants \$63,998,500 October 2023 Public Offering of Common Stock \$125,010,500 February 2024 Counsel to Issuer	
 Public Offering of Common Stock and Pre-Funded Warrants \$73,061,500 April 2022 Public Offering of Common Stock \$69,000,000 August 2023 Counsel to Issuer	 Public Offering of Common Stock \$40,020,500 May 2023 Counsel to Underwriters	 Public Offerings of Common Stock \$258,750,000 July 2022 \$143,750,000 December 2023 Counsel to Issuer	 Public Offerings of Common Stock \$230,546,000 November 2023 \$460,506,000 March 2024 Counsel to Underwriters	 Public Offering of Common Stock \$115,115,000 December 2023 PIPE Placement of Common Stock and Pre-Funded Warrants \$325,000,000 February 2024 Counsel to Issuer	 Public Offerings of Common Stock by Selling Stockholders \$1,252,250,000 February and November 2023 Counsel to Underwriters	 Public Offering of Common Stock \$402,500,000 March 2022 Public Offering of Common Stock and Pre-Funded Warrants \$402,500,000 February 2023 Counsel to Issuer	 Public Offering of Common Stock and Pre-Funded Warrants \$45,000,000 December 2023 Counsel to Issuer	 Public Offering of Common Stock and Preferred Stock \$310,787,500 August 2022 Public Offering of Common Stock \$150,000,000 January 2024 Counsel to Underwriters
 Public Offering of Common Stock and Pre-Funded Warrants \$99,996,500 January 2024 Counsel to Issuer	 Initial Public Offering of Common Stock \$212,653,000 January 2022 Public Offering of Common Stock and Pre-Funded Warrants \$258,750,000 August 2022 Counsel to Underwriters	 Initial Public Offering of Common Stock \$216,018,000 January 2022 Public Offering of Common Stock \$246,330,000 October 2022 Counsel to Underwriters	 Public Offering of Common Stock \$345,143,750 January 2024 Counsel to Issuer	 Initial Public Offering of Common Stock \$142,312,500 February 2022 Public Offering of Common Stock \$128,800,000 June 2022 Counsel to Underwriters	 PIPE Placement of Common Stock and Pre-Funded Warrants \$350,000,000 November 2023 Counsel to Issuer	 Public Offering of Common Stock and Pre-Funded Warrants \$316,249,000 January 2024 Counsel to Underwriters	 PIPE Placement of Common Stock \$75,000,000 December 2022 PIPE Placement of Common Stock and Pre-Funded Warrants \$108,858,550 January 2024 Counsel to Issuer	

The Reverse Merger Alternative to an IPO

14 Technique Continuing to Gain Traction in Life Sciences Sector Despite SEC Scrutiny

In recent years, a variety of alternative paths to public ownership and trading liquidity have emerged. The reverse merger is one of the newest—and among the oldest—alternatives to a conventional IPO for a private company seeking to become publicly traded, and, due to a confluence of factors, we have seen a marked uptick in reverse merger activity, as well as important legal and business developments impacting this transaction structure.

THE NEW REVERSE MERGER

Despite historical abuses of the technique, reverse mergers remain a potentially attractive transaction structure for private companies with significant cash needs, such as life sciences companies that, for various reasons, may not be able to immediately access the IPO market. But it takes two parties to make a reverse merger, and private companies look for public companies with the following attributes:

- material net cash, replicating the proceeds that would be raised in a traditional IPO;
- limited operations and limited and known (and quantifiable) liabilities;

BASIC STRUCTURE OF A REVERSE MERGER

In a typical reverse merger:

- a privately held company merges with a publicly listed company;
- the pre-merger stockholders of the private company own a majority of the stock of the combined company;
- the management and other employees of the private company become the management and employees of the combined company;
- the composition of the combined company board reflects representation proportional to the post-closing ownership split;
- the business of the private company becomes the business of the public company; and
- the combined company changes its name to that of the private company.

In many cases, the combined company will seek to raise additional capital (either privately, concurrently with the completion of the merger, or publicly, following the merger) to extend its cash runway.

- a reasonably high degree of confidence that it can deliver the requisite stockholder votes to approve the transaction, given its stockholder base; and
- a national securities exchange listing (preferably Nasdaq or the NYSE) that will remain following completion of the transaction.

The trend of declining public company valuations (including a surprising number of companies trading at values below their net cash), coupled with challenging conditions in the traditional IPO market, has led to a significant uptick in reverse mergers with publicly held life sciences companies since the beginning of 2022. These transactions have originated most frequently with pre-commercial life sciences companies that are listed on a major exchange and suffer a scientific setback or other disruption leading to a restructuring (or winding down) of operations—often while holding significant amounts of cash. In these circumstances, the reverse merger transaction results in the public company effectively reinvesting its cash into the business of the private company, giving the public company's legacy stockholders the opportunity to continue to hold stock in a new business while the formerly private company takes advantage of the public company's existing cash and stock exchange listing.

TRANSACTION CONSIDERATIONS

Exchange Ratio

The exchange ratio for a reverse merger transaction is typically based on the relative valuations of the public and private companies. Although the private company's valuation is often tethered to its valuation from its most recent private financing, the final value ascribed to the private company will ultimately be the product of negotiations between the parties, including feedback from any investors providing capital to the combined company. The public company's valuation, by contrast, will typically be based on its anticipated available net cash at closing (after customary deductions and excluding any capital concurrently raised by the combined company) plus a negotiated premium for its public stock listing. As noted below, little to no value is often ascribed to the public company's legacy assets, which fact raises its own set of considerations.

BACKGROUND

In a typical "reverse merger," a private company merges with and into a publicly traded company, with the combined company remaining publicly held. The mechanism is referred to as a "reverse" merger because, while the public company is the legal acquiror, the private company's *stockholders* acquire the public company, as the pre-merger stockholders of the private company own a majority of the stock of the combined company.

SEC Filing and Review

A reverse merger transaction typically requires a merger proxy statement and/or a Form S-4 registration statement to be prepared and filed with the SEC, although as noted below there are certain structures that offer some hope for increased speed. The merger proxy/Form S-4 is at least as complicated as—and is often more complicated and time intensive than—the Form S-1 for a conventional IPO for several reasons:

- The merger proxy/Form S-4 must include separate audited financial statements for each company, plus pro forma combined financial statements reflecting the combination of the two companies.
- The merger proxy/Form S-4 must include detailed descriptions of each company's process leading up to execution of the merger agreement and its board's reasons for recommending approval of the merger. A description of the fairness analysis provided by the public company's financial advisor to the board (including relevant inputs to the fairness analysis, such as financial projections for the private company) must also be included.
- Scrutiny by the Staff of the SEC of merger proxy/Form S-4 filings for reverse mergers has been increasing, particularly in the background, fairness analysis and financial projections sections. The Staff often focuses on the process undertaken by each company, including measures taken by the public company to mitigate potential conflicts of interest, the reasons the public company elected to pursue a reverse merger rather than a liquidation, wind-down or other alternative, and the reasons the private company decided to pursue a reverse merger rather than a traditional IPO.

The Reverse Merger Alternative to an IPO

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— Merger proxy/Form S-4 filings often attract strike lawsuits claiming deficient disclosures and/or an inadequate board process, and activist investors sometimes publicly state that they intend to vote against the transaction unless the terms are modified or that the transaction should be abandoned altogether—in either case introducing delays until a resolution is reached.

These factors can contribute to a longer timeline than that for a conventional IPO, with the period between signing and closing often ranging from three to six months (and sometimes longer).

SIMULTANEOUS SIGNING AND CLOSING

Parties to reverse merger transactions in the life sciences sector often seek to maximize the speed to closing, as the public company's net cash is directly related to both the exchange ratio (and the resulting ownership percentages of each party) and the post-closing public company's cash runway, and every day that goes by means more cash burned prior to the closing of a transaction. As a result, parties often consider whether it is feasible to simultaneously sign and close such a transaction.

Generally, Nasdaq and NYSE rules require pre-closing stockholder approval (i) in respect of the issuance of securities in connection with an acquisition of the stock or assets of another company if the shares of common stock to be issued in the transaction exceed 20% of the issuer's total shares outstanding or represent more than 20% of the voting power of the issuer's total voting securities outstanding prior to the transaction and/or (ii) if the transaction would result in a "change of control" of the issuer. Neither Nasdaq nor the NYSE specifically defines the parameters in which a transaction will constitute a "change of control." For example, in determining whether a "change of control" has occurred, Nasdaq considers "all relevant factors including, but not limited to, changes in the management, board of directors, voting power, ownership, and financial structure of the company."

Under the "sign and close" structure, the need for stockholder approval of the transaction prior to closing is avoided by

first, limiting the amount of common stock issued in the transaction to up to 19.9% of the outstanding common stock and issuing any remaining balance of shares as non-voting convertible preferred stock that does not convert until stockholder approval of the issuance is obtained, and second, ensuring that the transaction does not constitute a change of control for Nasdaq purposes.

The issuer (i.e., the public company) agrees to seek stockholder approval of the conversion of the preferred stock following the closing. Typically, if stockholder approval is not obtained, the issuer would be required to continue to seek stockholder approval and, in certain circumstances (generally beginning six months after closing), various adverse consequences would attach, including that the preferred stock would become redeemable for cash. The shares of preferred stock are issued in a private placement, and so, following closing, a resale registration statement is filed. The "sign and close" structure also assumes that there is no new listing process on Nasdaq required.

Determination of a change of control is a facts and circumstances analysis that considers:

- voting power;
- continuity of management;
- board continuity;
- consistency in corporate headquarters;
- corporate name (no current plan to change the company's name/stock symbol); and
- accounting treatment (that the public company is the "acquirer" of the private company for accounting purposes).

The parties will need to approach the applicable securities exchange prior to the execution of definitive agreements to seek input on whether the proposed transaction structure requires stockholder approval. Frequently, the parties will determine in dialogue with the exchange and each other that the transaction would constitute a change of control and the parties are unwilling to alter the business arrangements to avoid that conclusion; for example, the purpose of these transactions is often to effectively bring the private company public—such that the combined company will reflect the board,

management, operations and even name of the private company—factors that are all indicia of the occurrence of a change of control. Nevertheless, there are times, for example in transactions that constitute more traditional "mergers" or where the private company is more of an asset than a standalone business, that the simultaneous "sign and close" structure can be a viable and speedy alternative.

SHELL COMPANY CONSIDERATIONS

Typically, the parties to a reverse merger have taken the view that the public company is not, as a technical matter, a "shell company," even if it is actively looking for a merger partner and not prioritizing its historical business. A "shell company" is defined as a registrant that has: "(1) no or nominal operations; and (2) either: (i) no or nominal assets; (ii) assets consisting solely of cash and cash equivalents; or (iii) assets consisting of any amount of cash and cash equivalents and nominal other assets." Because the public companies involved in reverse mergers typically have more than "no or nominal" operations or assets, generally still employ a management team and other personnel, and own assets, including intellectual property assets, most recent reverse merger transactions proceeded on the basis that the public company was not a "shell company."

The SEC has begun to challenge those assumptions, however, with significant consequences. In the adopting release for the SEC's final rules related to "Special Purpose Acquisition Companies, Shell Companies and Projections," issued in January 2024, the Staff specifically stated that shell companies will include any "company that has assumed the appearance of having more than 'nominal' assets or operations," and further that the applicable rules will apply "in situations where, in substance, a shell company business combination is used to convert a private company into a public company," including to "any company that sells or otherwise disposes of its historical assets or operations in connection with or as part of a plan to combine with a non-shell private company in order to convert the private company into a public one." This would include the increasingly common "fire sale CVR," in which the public company issues,

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in a pre-closing dividend to its pre-closing stockholders, a contingent value right (CVR) in respect of the right to receive the proceeds of the sale or other monetization of any and all legacy assets of the public company. The Staff has indicated it views this sort of arrangement as essentially ensuring that the public company is a shell company.

If one of the parties in a business combination transaction is deemed to be a “shell company,” other than a “business combination related shell company” (i.e., a SPAC), then there are a number of consequences, including:

- **Form S-3:** The combined company will not be eligible to use a registration statement on Form S-3 until 12 months after the business combination/reverse merger, meaning the combined company must use a registration statement on Form S-1 within the first 12 months.
- **Form S-8:** The combined company will not be eligible to use a registration statement on Form S-8 for any equity plans or awards until at least 60 calendar days after the closing of the transaction.
- **Financial Statements:** The combined company must file the financial statements for the acquired company within four business days of completion of the business combination/reverse merger (with no available extensions).
- **“Ineligible Issuer”:** The combined company will be an “ineligible issuer” for three years following closing of the business combination/reverse merger. During that three-year period, the combined company cannot, among other things, (i) qualify as a well-known seasoned issuer (WKSI), meaning it may not file an automatically effective shelf registration statement on Form S-3 even if the combined company had a public equity float greater than \$700 million; (ii) rely on the safe harbor under Rule 163A, which establishes a broad exemption from quiet period restrictions for certain communications made more than 30 days prior to the public filing of a registration statement; or (iii) use a free writing prospectus.
- **Rules 144/145:** Importantly, affiliates of the private company that receive shares of the public company in the merger are presumptively deemed to be statutory

underwriters with respect to resales of those securities, and as a result those securities may not be included in the Form S-1 resale registration statement and would not be eligible for resale until one year after closing, other than in a fixed price offering in which such investors are named as underwriters in the prospectus.

Care must be taken early in the structuring discussions regarding a potential reverse merger transaction to avoid being deemed a “shell company.” For example, the parties should consider what personnel and operations are at the public company, how the value of the public company is determined in the transaction (including whether any value is ascribed to the company’s legacy assets and operations), and whether the combined company will retain any of the legacy assets or operations following the closing, rather than including a CVR that contemplates all legacy assets being liquidated with the proceeds distributed to pre-closing stockholders.

MERGER AGREEMENT

In a typical reverse merger transaction, the merger agreement is structured as a “public style” agreement, in which there are no post-closing remedies for either party and the representations and warranties and covenants are, to a large degree, reciprocal. However, the following points typically are the subject of particular focus in negotiations:

- **Minimum Net Cash Closing Condition:** Most merger agreements for reverse mergers require the public company to

have at closing a specified minimum amount of “net cash” (below which the private company could refuse to close), a mechanism to adjust the exchange ratio if net cash is below a specified threshold, or both.

- **Net Cash Definition:** Given the minimum net cash closing condition and the importance of the amount of net cash to the premise and economics of a reverse merger transaction, the parties typically spend significant time understanding and negotiating the specific liabilities and obligations—including contingent or potential liabilities—that will be deducted from available cash to determine the amount of “net” cash at closing.
- **CVRs/Dividends:** Because the valuation of the public company in a reverse merger transaction often ascribes no value to its legacy assets, it is not uncommon for the public company to issue to its pre-closing stockholders CVRs representing the right to receive proceeds, if any, from the post-closing monetization of its legacy assets. Depending on the amount of its available cash, the public company may also negotiate the right to pay a cash dividend to its stockholders prior to closing, subject to the minimum net cash closing condition.
- **Termination Fees; Reimbursement of Expenses:** The circumstances in which one party to a reverse merger must pay a termination fee and/or reimburse the other party’s expenses are broader than in the typical public M&A context. ■

REVERSE MERGERS ON MAJOR US EXCHANGES BY INDUSTRY SECTOR AND YEAR

INDUSTRY	2019	2020	2021	2022	2023	TOTAL
Healthcare and Life Sciences	14	12	13	6	14	59
Technology	2	4	4	1	3	14
Consumer Goods and Services	2	3	4	1	—	10
Energy	1	2	4	2	1	10
Financials	1	1	2	2	2	8
Other	5	2	5	3	3	18
Total	25	24	32	15	23	119

Source: S&P Global Market Intelligence

Do I Really Need to Disclose That?

17 Recent SEC Enforcement Actions Highlight Importance of D&O Questionnaires

The Form S-1 for an IPO must include specified information about a company's directors, officers and 5% stockholders. The required information is elicited from these parties through a questionnaire (commonly called the D&O Questionnaire). D&O Questionnaires typically are timed so that they will be completed and returned shortly before the initial Form S-1 filing or submission to avoid the need for immediate updates.

A number of recent SEC enforcement actions alleging failure of companies to disclose perquisites and related party transactions highlight the importance of D&O Questionnaires, including the care taken by directors and officers in completing, and by companies in reviewing, D&O Questionnaires.

SEPTEMBER 2023

- The SEC settled charges against a rideshare company for allegedly failing to disclose a director's role in a stockholder's private sale of approximately \$424 million of shares prior to the company's IPO in March 2019. According to the SEC's order, a director of the rideshare company arranged for a stockholder to sell its shares to a special purpose vehicle (SPV) set up by an investment adviser affiliated with the director; then the director contacted an investor interested in purchasing the shares through the SPV. The company allegedly approved the sale and secured a number of terms in the contract. The director (who left the board at the time of the transaction) received millions of dollars in compensation from the investment adviser for his role in structuring and negotiating the deal. The SEC order stated that the director did not disclose his compensation or his material interest in the transaction to the company. As a result, the company failed to disclose information regarding the sale in its Form 10-K for 2019. Without admitting or denying the SEC's allegations, the company agreed to pay a \$10 million fine.
- The SEC settled charges against a government contractor for allegedly failing to make required disclosures related to its employment of an executive officer's siblings. According to the SEC's order, the company appointed

a longtime employee as an executive officer in 2019. The officer's two siblings were also longtime employees of the company who each received annual compensation in excess of \$120,000 (the threshold amount for disclosure of related party transactions). The company filed annual reports and proxy statements for 2019 through 2021 that did not disclose this information. Without admitting or denying the SEC's allegations, the company agreed to pay a \$500,000 fine.

JUNE 2023

- The SEC settled charges against Stanley Black & Decker Inc. for allegedly failing to disclose perquisites provided to executives, as well as charges against a former Stanley Black & Decker executive for his role in the company's alleged failure to disclose perquisites and personal benefits provided to him. In charging the former executive, the SEC focused on the company's D&O Questionnaire and claimed that the former executive failed to disclose certain of his perquisites and benefits in response to questions relating to compensation. These undisclosed perquisites and benefits were comprised of chauffeur services, other travel items, meals, apparel, car repair services, approved use of the corporate aircraft, personal services provided to the former executive by company employees, and certain gifts and products. The SEC also noted the former executive's receipt of various drafts of the company's proxy statement to highlight that he had the opportunity to correct any misstatements made in his D&O Questionnaire but failed to do so. Neither the company nor the former executive admitted or denied the SEC's allegations. The company's remedial measures, which included an internal investigation, cooperation with the SEC's investigation and disclosure in its Form 10-K, were sufficient to prevent monetary penalties against the company. However, the former executive was ordered to pay a \$75,000 fine.

MARCH 2023

- The SEC settled charges against The Greenbrier Companies, Inc., for allegedly failing to disclose perquisites given to its named executive officers (NEOs)

and certain information regarding related party transactions, and against its founder and former CEO for his role in the company's alleged failure to disclose such information. In the SEC's orders against both the company and the former CEO, the SEC focused on the D&O Questionnaires that the former CEO completed from 2017 to 2021 and, in each such questionnaire, the former CEO's alleged failure to disclose (a) some of his perquisites, including travel expenses for his spouse and personal security expenses, and (b) the dollar amount of his related party transactions. In accepting the settlement offer, the SEC considered the company's training of NEOs and employees on the D&O Questionnaires as a remedial measure. However, despite remedial measures, the company was ordered to pay a \$1 million fine, and the former CEO was ordered to pay a \$100,000 fine, in each case, without admitting or denying the SEC's allegations.

These actions demonstrate the need for careful review of the questions included in D&O Questionnaires, to ensure that they prompt fulsome responses, and careful review of the answers to completed D&O Questionnaires, to ensure that all required information is properly disclosed in the Form S-1. ■

THE REQUIRED INFORMATION

The D&O Questionnaire gathers information that is required to be included in the Form S-1, including biographical and background information for each director and executive officer; compensation information for the company's NEOs and directors; beneficial stock ownership of each director, NEO and 5% stockholder; and information regarding related party transactions.

Other important information is collected through separate questionnaires including (a), a FINRA Questionnaire provided to directors, officers, 10% stockholders and the company in order to support the required representations and disclosures made by the managing underwriters to FINRA and (b), a Selling Stockholder Questionnaire provided to all selling stockholders in order to elicit beneficial stock ownership information, the nature of any material relationship that the selling stockholder has with the company and other required disclosures.

The Pros and Cons of an ESPP

OVERVIEW

An employee stock purchase plan (ESPP) that satisfies the requirements of Section 423 of the Internal Revenue Code (Section 423) permits employees (but not non-employee directors, consultants or advisors) of a public company to purchase shares of common stock at a discount from the market price with favorable tax treatment.

Among other requirements, Section 423:

- requires that substantially all employees (excluding 5% stockholders) be allowed to participate in the ESPP;
- requires that all employees granted options under the ESPP have the same rights and privileges;
- imposes an annual limit of \$25,000 per employee on the value of the stock purchased under the ESPP;
- requires the company's stockholders to approve the ESPP; and
- sets the minimum purchase price at 85% of the lesser of the fair market value of the stock at the beginning of the offering period and the fair market value of the stock on the purchase date.

Accounting rules (ASC Topic 718) require companies to recognize compensation expense over the requisite service period for rights to purchase stock granted under an ESPP, unless the discount is 5% or less and there is no "lookback" feature allowing the discount to be taken from the market price at the beginning of the offering period (rather than the purchase date).

Notwithstanding the compensation charges, the incidence of ESPPs among IPO companies has grown significantly over the past 15 years, with ESPPs generally including a 15% discount and a lookback feature. For example, the percentage of all IPO companies adopting an ESPP increased from 33% in the years from 2010 to 2013 to 60% in the years from 2020 to 2023. All but two of the ESPPs adopted by companies going public since the start of 2020 had a 15% discount, and all but eight had a lookback feature.

Some of the key pros and cons of an ESPP are summarized as follows:

PROS

- An ESPP can encourage broad-based employee ownership of company stock.
- Through the use of payroll deductions, purchases under an ESPP are convenient and typically avoid brokers' commissions.
- Although not a perfect substitute for a directed share program (DSP), an ESPP structured to commence at the time of the IPO may help reduce employee disappointment if the company decides not to make IPO shares available to employees in a DSP.
- Participants can acquire shares at a discount from the market price. With proper structuring, an ESPP can even be used as a means to permit employees to invest at a discount from the IPO price.
- If the ESPP complies with Section 423, participants receive favorable tax treatment for the shares purchased under the ESPP, including deferral of any tax on the discount until the shares are sold, and the possibility of long-term capital gains treatment for further appreciation if applicable holding periods are met.
- If other employers with which the company regularly competes for employees offer ESPPs and the company does not, it may be at a competitive disadvantage in hiring.

CONS

- In practice, many employees immediately sell the shares received under an ESPP, defeating the goal of encouraging employee stock ownership in the company.
- Unless the ESPP is structured with a discount of 5% or less and there is no lookback feature, the company

will incur stock-based compensation charges, which will reduce its GAAP income (though this is less important to companies that report EBITDA measures from which stock-based compensation charges have been removed).

- If the ESPP is structured to avoid compensation charges, the attractiveness of the plan to employees is substantially reduced.
- Legal requirements may force foreign employees to be excluded from the ESPP, potentially alienating a portion of the company's workforce.
- To the extent employees hold the stock acquired under the ESPP and the market price declines below the purchase price, ill will and disappointment among employees may result.
- The ESPP creates administrative obligations for the company, including annual IRS reporting requirements, and administrative foot faults can be costly and time-consuming to remedy.
- Special arrangements are required if the company desires to have the first offering period commence upon effectiveness of the Form S-1 at the IPO price. The company may enroll employees in the ESPP prior to the effectiveness of the Form S-8 (pursuant to which the shares will be registered) only if no money is collected before such effectiveness and if the initial deemed election for all participants is set at the highest permitted level. Ensuring that the arrangement is appropriately structured at a time when the company may not yet have engaged with a third-party plan administrator may create a significant administrative burden on management at an already demanding time. ■

PREVALENCE AND TERMS OF ESPPs IN IPOs

YEAR	COMPANIES WITH ESPP	ESPP DISCOUNT EQUALS 15%	ESPP INCLUDES LOOKBACK FEATURE	INITIAL ESPP OFFERING PERIOD COMMENCES UPON IPO
2014 to 2016	47%	95%	97%	25%
2017 to 2019	57%	97%	97%	20%
2020 to 2023	60%	99%	97%	9%

Source: WilmerHale analysis of SEC filings

An IPO closing heralds the start of Exchange Act reporting obligations, which apply not only to companies but also to their directors, officers and significant stockholders. In October 2023, the SEC amended the rules governing beneficial ownership reporting obligations under Regulation 13D-G. These amendments impact stockholders by accelerating the filing deadlines for initial and amended beneficial ownership reports on Schedules 13D and 13G, among other changes, and stockholders will need to adjust their reporting processes accordingly.

BACKGROUND

Section 13 of the Exchange Act imposes reporting obligations on beneficial owners of more than 5% of any class of equity securities registered under the Exchange Act. For most public companies, their “covered class” is their common stock. Stockholders must make a Schedule 13D or 13G filing with the SEC to publicly report their initial acquisition of the company’s common stock and must amend this filing if material changes occur in the disclosed information. While there is overlap in the disclosure required by the two forms, Schedule 13G is shorter and easier to complete than Schedule 13D. In general, Schedule 13G is available to any stockholder that falls within one of the following three groups:

- **Qualified institutional investors (QIIs)** include investors that fall into one of several enumerated categories (such as banks and broker-dealers), where the acquisition that triggered the filing obligation was made in the ordinary course of business and not to influence the control of the company, and where the investor gave prompt notice if the acquisition was made on behalf of other specified persons.
- **Exempt investors (EIs)** include investors that beneficially owned more than 5% of the company’s common stock prior to the registration of the company’s common stock under the Exchange Act in connection with the IPO (such as founders and pre-IPO investors) and that do not subsequently acquire additional shares representing more than 2% of the company’s common stock in a 12-month period.

SCHEDULE 13D AND 13G FILING REQUIREMENTS UNDER THE AMENDED RULES

Filing Type	Schedule 13D Filing Deadlines	Schedule 13G Filing Deadlines
Initial Filing	Within 5 business days after acquiring beneficial ownership of more than 5% or losing eligibility to file on Schedule 13G	QII & EI: 45 days after calendar quarter-end in which beneficial ownership exceeds 5% QII: 5 business days after month-end in which beneficial ownership exceeds 10% PI: Within 5 business days after acquiring beneficial ownership of more than 5%
Amendment Filing	Within 2 business days after the occurrence of a “material change”* in the facts set forth in the previous Schedule 13D	QII, EI & PI: 45 days after calendar quarter-end in which a material change in the facts set forth in the previous Schedule 13G occurred QII: 5 business days after month-end in which beneficial ownership exceeds 10% or a 5% increase or decrease in beneficial ownership PI: 2 business days after exceeding 10% beneficial ownership or a 5% increase or decrease in beneficial ownership

* A lthough Regulation 13D-G does not define “material,” the SEC has indicated that a material change includes any acquisition or disposition of 1% or more of the company’s common stock.

- **Passive investors (PIs)** include investors that beneficially own between 5% and 20% of the company’s common stock and that do not seek to acquire influence or control over the company.

FILING MECHANICS

Section 13 filings are made electronically via the SEC’s EDGAR system. The recent amendments extend the cutoff time for Schedule 13D and 13G filings to 10 p.m. ET, which aligns with the cutoff time for Section 16(a) ownership reports (i.e., Forms 3, 4 and 5), and require use of a new Schedule 13D- or 13G-specific extensible markup language (XML).

SELECTED OTHER CHANGES

Other key rule changes in the SEC’s October 2023 adopting release include:

- **Item 6:** The amendments revise Rule 13d-101 to expressly state that under Item 6 of Schedule 13D, stockholders must disclose any contracts, arrangements, understandings and relationships with respect to any company securities, including derivative securities that use a covered class as their reference security (such as call options, put options or security-based swaps).
- **Rule 13d-5:** The amendments revise Rule 13d-5 to clarify that a “group”—which is formed when two or more persons

agree to act together for the purpose of acquiring, holding, voting, or disposing of a company’s securities—is deemed to acquire any additional equity securities acquired by a group member after the group’s formation, although the rule includes a carve-out for certain intragroup securities transfers.

- **Technical Amendments:** The SEC also adopted a number of technical amendments to reflect the impact of the substantive rule changes (e.g., updating titles and designations and incorporating conforming changes, as well as utilizing gender-neutral phrasing).

The SEC also provided guidance regarding its views on certain nuanced aspects of beneficial ownership reporting, including group formation and the application of existing rules to cash-settled derivative securities. ■

IMPLEMENTATION TIMELINE

- The amendments became effective on February 5, 2024, with compliance generally required as of that date, subject to the following exceptions:
- Compliance with the XML requirement is mandatory beginning on December 18, 2024.
 - Compliance with the revised Schedule 13G filing deadlines, for both initial and amended filings, is required beginning September 30, 2024.

Accounting Developments in the Spotlight

OVERVIEW

2023 marked a busy year for public company accounting and auditing standard setting, and audit committees and IPO companies should take note. Importantly, the Financial Accounting Standards Board (FASB) published two Accounting Standards Updates that are expected to meaningfully affect public company disclosures regarding segment reporting and income taxes. The Public Company Accounting Oversight Board (PCAOB) also issued a proposal on auditor responsibilities with respect to noncompliance with laws and regulations (NOCLAR) that, if adopted, will likely have sweeping effects on existing audit systems and processes. Plus, SEC Chief Accountant Paul Munter made remarks expressing concern around internal control over financial reporting (ICFR), particularly about strengthening companies' and auditors' risk assessments.

FASB ACCOUNTING STANDARDS UPDATES

Segments. Described by FASB Chair Richard Jones as "FASB's most significant change to segment reporting since 1997," the amended segment reporting standard will require that companies:

- Disclose significant segment expenses that are both regularly provided to the chief operating decision maker (CODM) and included in reported segment profit or loss, along with certain other significant expense items.
- Disclose the title and position of the CODM and explain how the CODM uses reported measure(s) of segment profit or loss in assessing segment performance and allocating resources. Multiple measures may be reported if actually used by the CODM as long as the measure most consistent with US GAAP is disclosed.
- Provide all annual disclosures about a reportable segment's profit or loss and assets in interim periods.
- Make all required segment disclosures even if there is only one reportable segment.

Amended Segment Standard (ASU 2023-07)

Effective for annual periods beginning after December 15, 2023 and for interim periods within fiscal years beginning after December 15, 2024

Amended Income Taxes Standard (ASU 2023-09)

Effective for annual periods beginning after December 15, 2024 for public companies

Taxes. The FASB has responded to investor requests for additional transparency concerning income tax information. Under the amended income tax disclosure requirement, companies will be required to provide more granular detail in the financial statement footnotes, explaining the difference between their effective tax rate and statutory tax rate while highlighting tax risks, opportunities and management in a global context. This disclosure will include a new tax rate reconciliation table with a number of reconciling items, including state, local and foreign taxes by jurisdiction, tax credits, changes in valuation allowances, and nontaxable/nondeductible items, among others.

AUDITING DEVELOPMENTS

2023 was one of the PCAOB's busiest years in recent memory. Of note, its NOCLAR proposal has attracted significant public attention and aims to expand auditors' responsibilities for considering a company's noncompliance with laws and regulations, including fraud. The current audit guidance, AS 2405 *Illegal Acts by Clients*, works in conjunction with Section 10A of the Exchange Act, which establishes investigation procedures and required communications for when an auditor "detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements of the issuer) has or may have occurred."

The NOCLAR proposal would significantly expand auditors' obligations to plan and perform specific procedures for identifying laws and regulations with which noncompliance could reasonably have a material effect on the financial statements,

whether directly or indirectly, which goes beyond the current auditing requirements and Section 10A. The proposal may result in increased auditor fees, changes to the way audits are conducted, and increased pressure on maintaining a client's attorney-client privilege and other legal protections. The PCAOB is reviewing comments on the proposal and is targeting adoption of a NOCLAR auditing standard in 2024.

ICFR RISK ASSESSMENTS

SEC Chief Accountant Paul Munter noted in a public statement released in August 2023 that members of the Office of the Chief Accountant "are troubled by instances in which management and auditors appear too narrowly focused on information and risks that directly impact financial reporting, while disregarding broader, entity-level issues that may also impact financial reporting and internal controls." The statement signals an expectation for a broader consideration of, and even greater disclosure around, risks to a company's ICFR.

Speaking to risk assessments specifically, the statement emphasized the need for management to monitor for new or changing business risks, including loss of financing, customer concentrations, declining conditions affecting the company's industry, and changes in technology. Consideration of these risks could be viewed as potentially expanding the matters to be considered by management in assessing the effectiveness of a company's ICFR.

The statement implored that when ICFR control deficiencies are identified, management and auditors take a comprehensive approach to consider not only the actual misstatement but also the magnitude of potential misstatement which can extend to a wider population of potential misstatements beyond the identified misstatement. ■

EGC RELIEF

The ability of EGCs to elect not to be subject to new or revised accounting standards until those standards are required to be applied to nonpublic companies, and to provide only two years of audited financial statements (instead of three years), is discussed on page 9.

Beyond the “Just Say No” Defense

Updated Data on Common Takeover Defenses Available to a Public Company

Established public companies typically maintain at least some takeover defenses, although the prevalence of several defenses previously considered to be standard has declined over the past decade in response to pressure from institutional investors.

Despite the decline in takeover defenses among established public companies, most IPO companies continue to implement anti-takeover provisions (understanding that such measures may in the future need to be dismantled). In 2022 and 2023, however, adoption rates by IPO companies for many takeover defenses declined markedly from historical norms, likely due at least in part to the unusual characteristics of the IPO market during this period—deal flow was significantly depressed, offering sizes were much smaller and IPO companies had far less annual revenue.

Common takeover defenses include:

CLASSIFIED BOARDS

Supporters of classified boards—in which directors serve staggered three-year terms—believe that this structure enhances the knowledge, experience and expertise of boards by helping ensure that, at any given time, a majority of the directors will have experience and familiarity with the company’s business. These supporters believe classified boards promote continuity and stability, which in turn allow companies to focus on long-term strategic planning, ultimately leading to a better competitive position and maximizing stockholder value. Opponents of classified boards argue that annual elections for all directors increase director accountability to stockholders, which in turn improves director performance, and that classified boards entrench directors, foster insularity and impede efforts to expand board diversity.

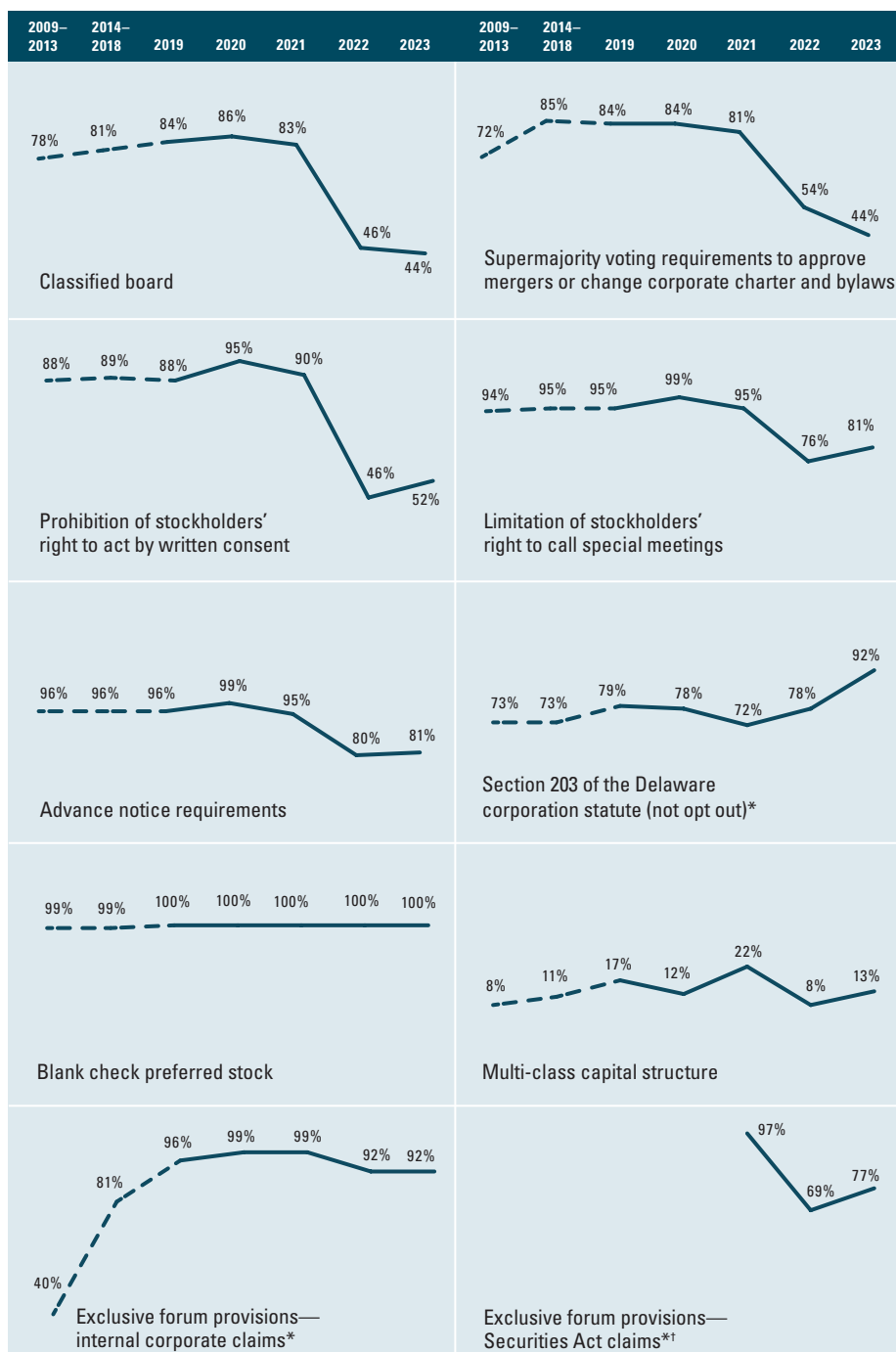
SUPERMAJORITY VOTING REQUIREMENTS

Advocates for supermajority vote requirements to approve mergers or amend the corporate charter or bylaws claim that these provisions help preserve and maximize the value of the company by ensuring that important corporate actions

are taken only when it is the clear will of the stockholders. By contrast, proponents of a majority-vote standard believe it makes the company more accountable to stockholders and that improved accountability leads to better company performance. Supermajority requirements are also viewed by their detractors as

entrenchment devices used to block initiatives that are supported by holders of a majority of the company’s stock but opposed by management and the board. In practice, supermajority requirements can be almost impossible to satisfy, especially for a company with a meaningful number of noninstitutional stockholders.

TRENDS IN TAKEOVER DEFENSES AMONG IPO COMPANIES



*Delaware corporations only
†2021–2023 only

Source: WilmerHale analysis of SEC filings from 2009 to 2023 for US issuers

Beyond the “Just Say No” Defense

6 Updated Data on Common Takeover Defenses Available to a Public Company

PROHIBITION OF STOCKHOLDERS' RIGHT TO ACT BY WRITTEN CONSENT

Written consents of stockholders can be an efficient means to obtain stockholder approvals but can result in a single stockholder or a small number of stockholders being able to take action without prior notice or any opportunity for other stockholders to be heard. If stockholders are not permitted to act by written consent, all stockholder action must be taken at a duly called stockholders' meeting for which stockholders have been provided information about the matters to be voted on and given an opportunity to ask questions.

LIMITATION OF STOCKHOLDERS' RIGHT TO CALL SPECIAL MEETINGS

If stockholders have the right to call special meetings of stockholders—rather than waiting until the next annual meeting to propose matters for stockholder action—one or a few stockholders may be able to call a special meeting, which can result in abrupt changes in board composition, interfere with the board's ability to maximize stockholder value, or result in significant expense and disruption. A requirement that only the board or specified officers or directors are authorized to call special meetings of stockholders could, however, have the effect of delaying until the next annual meeting actions that are favored by the holders of a majority of the company's stock.

REASONS TO ADOPT TAKEOVER DEFENSES

Companies adopt takeover defenses to help:

- ensure stability and continuity in decision-making and leadership that will enable the company to focus on long-term value creation;
- provide the board with adequate time to evaluate and react in an informed manner to unsolicited acquisition proposals;
- provide negotiating leverage for the board; and
- maximize overall stockholder value by providing economic disincentives against inadequate, unfair or coercive bids.

PREVALENCE OF TAKEOVER DEFENSES

	IPO COMPANIES, 2019–2023	ESTABLISHED PUBLIC COMPANIES, YEAR-END 2023	
		S&P 500	RUSSELL 3000
Classified board	78%	11%	43%
Supermajority voting requirements to approve mergers or change corporate charter and bylaws	77%	17% to 33%, depending on type of action	15% to 53%, depending on type of action
Prohibition of stockholders' right to act by written consent	84%	68%	73%
Limitation of stockholders' right to call special meetings	93%	30%	51%
Advance notice requirements	94%	99%	96%
Section 203 of the Delaware corporation statute (not opt out)*	76%	89%	N/A
Blank check preferred stock	100%	95%	96%
Multi-class capital structure	17%	7%	11%
Exclusive forum provisions— internal corporate claims	98%*	56%**	64%**
Exclusive forum provisions— Securities Act claims†	92%*	N/A	N/A

*Delaware corporations only

**Not limited to Delaware corporations

†2021–2023 only

Source: IPO company data is based on WilmerHale analysis of SEC filings from 2019 to 2023 for US issuers. Established public company data is from FactSet's SharkRepellent database at year-end 2023.

ADVANCE NOTICE REQUIREMENTS

Advance notice requirements provide that at a stockholders' meeting stockholders may only consider and act upon director nominations or other proposals that have been specified in the meeting notice and brought before the meeting by or at the direction of the board, or by a stockholder who has delivered timely written notice to the company. Advance notice requirements afford the board ample time to consider the desirability of stockholder proposals, ensure that they are consistent with the company's objectives and, in the case of director nominations, provide important information about the experience and suitability of board candidates. These provisions could also have the effect of delaying until the next stockholder meeting actions that are favored by the holders of a majority of the company's stock. Investors generally do not object to advance notice requirements as long as the advance notice period is not unduly long.

SECTION 203 OF THE DELAWARE CORPORATION STATUTE

Unless it opts out of Section 203, a public company incorporated in Delaware is limited in its ability to engage in a “business combination” with any “interested stockholder” for three years following the time that the person became an interested stockholder without board approval. In general, an interested stockholder is any stockholder that, together with its affiliates, beneficially owns 15% or more of the company's stock. A public company incorporated in Delaware is automatically subject to Section 203 unless it opts out in its original corporate charter or pursuant to a subsequent charter or bylaw amendment approved by stockholders. Remaining subject to Section 203 helps eliminate the ability of an insurgent to accumulate and/or exercise control without paying a control premium but could prevent stockholders from accepting an attractive acquisition offer that is opposed by an entrenched board.

Beyond the “Just Say No” Defense

7 Updated Data on Common Takeover Defenses Available to a Public Company

DIFFERENCES IN ANTI-TAKEOVER PRACTICES AMONG TYPES OF IPO COMPANIES

	ALL IPO COMPANIES	VC-BACKED COMPANIES	PE-BACKED COMPANIES	OTHER IPO COMPANIES
Classified board	78%	88%	88%	39%
Supermajority voting requirements to approve mergers or change corporate charter and bylaws	77%	88%	84%	37%
Prohibition of stockholders’ right to act by written consent	84%	92%	96%	48%
Limitation of stockholders’ right to call special meetings	93%	98%	99%	76%
Advance notice requirements	94%	97%	99%	79%
Section 203 of the Delaware corporation statute (not opt out)*	76%	94%	32%	71%
Blank check preferred stock	100%	100%	100%	99%
Multi-class capital structure	17%	16%	20%	16%
Exclusive forum provisions—internal corporate claims*	98%	99%	100%	90%
Exclusive forum provisions—Securities Act claims*†	92%	95%	100%	68%

*Delaware corporations only

†2021–2023 only

Source: WilmerHale analysis of SEC filings from 2019 to 2023 for US issuers

BLANK CHECK PREFERRED STOCK

When blank check preferred stock is authorized, the board has the right to issue preferred stock in one or more series without stockholder approval under state corporate law (but subject to stock exchange rules) and has the discretion to determine the voting, dividend, conversion and redemption rights and liquidation preferences of each such series. The availability of blank check preferred stock can eliminate delays associated with a stockholder vote on specific issuances, thereby facilitating financings and strategic alliances. The board’s ability, without further stockholder action, to issue preferred stock or rights to purchase preferred stock can also be used as an anti-takeover device.

MULTI-CLASS CAPITAL STRUCTURES

While the majority of companies go public with a single class of common stock that provides the same voting and economic rights to every stockholder, some companies employ a multi-class capital structure under which the company’s

founders or other pre-IPO stockholders hold shares of common stock that are entitled to multiple votes per share, while the public is issued a separate class of common stock that is entitled to only one vote per share or no voting rights at all. Use of a multi-class capital structure can enable the holders of the high-vote stock to retain voting control of the company and to pursue strategies to maximize long-term stockholder value. Critics believe that a multi-class structure entrenches the holders of the high-vote stock, insulating them from takeover attempts and the will of public stockholders, and that the mismatch between voting power and economic interest may increase the possibility that the holders of the high-vote stock will pursue a riskier business strategy.

EXCLUSIVE FORUM PROVISIONS FOR INTERNAL CORPORATE CLAIMS

Exclusive forum provisions stipulate that the Court of Chancery of the State of Delaware is the exclusive forum in which internal corporate claims arising under Delaware state law may be brought

by stockholders against the company. Proponents of these provisions are motivated by a desire to adjudicate such claims in a single jurisdiction that has a well-developed and predictable body of corporate case law and an experienced judiciary. Opponents argue that these provisions—which have been expressly authorized by the Delaware corporation statute since 2015—deny aggrieved stockholders the ability to bring litigation in a court or jurisdiction of their choosing.

EXCLUSIVE FORUM PROVISIONS FOR SECURITIES ACT CLAIMS

Prior to 2020, in response to the growing trend of plaintiffs bringing federal securities law class-action lawsuits in state courts, a handful of IPO companies incorporated in Delaware adopted “federal forum” provisions requiring stockholders to sue in federal court, rather than state court, over alleged violations of the Securities Act of 1933. Adoption of federal forum provisions has soared on the heels of a 2020 Delaware Supreme Court decision confirming the validity of the technique. Federal forum provisions are intended to help a company avoid duplicative litigation filings and steer cases to federal courts more accustomed to hearing federal securities claims, while opponents argue that the provisions prevent stockholders from seeking recourse in state courts they may view as more receptive to their claims. ■

STOCKHOLDER RIGHTS PLANS

A traditional stockholder rights plan (sometimes referred to as a “poison pill”) is a defensive measure designed to deter any acquisition of shares exceeding a specified ownership threshold without board approval. The rights plan gives all stockholders (other than a stockholder acquiring shares of common stock in excess of the specified threshold) a contractual right to purchase additional securities of the company at a substantial discount, thereby significantly diluting the acquiring stockholder’s economic and voting power. When combined with a classified board, a rights plan makes an unfriendly takeover particularly difficult. Poison pills are almost unheard of among US IPO companies and are quite uncommon among established public companies.

Key Developments in a Rapidly Evolving US Antitrust Enforcement Environment

10 Important Considerations for Getting Your Deal Done

Under the Biden Administration, M&A has faced increased antitrust scrutiny. The Federal Trade Commission (FTC) and the Department of Justice Antitrust Division (DOJ) have been vocal about their desire to ramp up antitrust enforcement and eager to challenge M&A transactions in court. Statistically, only a small number of deals face antitrust headwinds: less than 2% of reported transactions are the subject of a “second request,” and the balance receive little to no antitrust scrutiny. Nevertheless, parties to M&A transactions are well-advised to take seriously the antitrust agencies’ aggressive stance. The agencies continue to enforce aggressively when they believe a transaction raises anticompetitive concerns, including based on novel theories and despite mixed results in court.

Three recent developments merit particular attention because they change decades-old policies and create new challenges for M&A: (1) the proposed new HSR notification form, which will significantly expand the burden of preparing HSR filings; (2) the new Merger Guidelines, which reflect the aggressive approach the agencies have been taking to merger analysis; and (3) the emergence of the “fix-it-first” strategy in light of the agencies’ reluctance to resolve competitive concerns through negotiated consent decrees that provide for divestitures or other remedies.

PROPOSED HSR NOTIFICATION FORM CHANGES

In June 2023, for the first time in 45 years, FTC and DOJ proposed a fundamental overhaul of the HSR pre-merger notification form. The HSR form historically has been straightforward, calling for relatively little information but requiring an often-substantial document submission.

The proposed new form would simultaneously (1) move HSR notifications closer towards other jurisdictions’ notification regimes (such as those of the European Union or China) by requiring for the first time detailed narratives regarding key aspects of the substantive antitrust assessment—including horizontal overlaps, vertical relationships and strategic deal

rationale—and (2) substantially expand the existing document submission requirements. Currently, parties need only provide final versions of “Item 4(c) and 4(d)” documents—i.e., documents prepared by or for an officer or director that analyze the transaction with respect to competition, markets or synergies. The proposed changes would sweep in documents that parties ordinarily would not provide absent a specific agency request for those documents, including certain draft 4(c) documents or documents prepared by or for “supervisory deal team lead(s)” with 4(c) content. Certain ordinary-course strategic documents (e.g., business plans) also would be required. The proposal would also require significantly expanded disclosures of other information, such as prior acquisitions and minority stakes.

If the proposed revisions are adopted—and we expect the proposal will remain largely intact—HSR notifications will be much more burdensome and require substantially more preparation time and consideration. That will materially expand the time to closing and transaction costs for many transactions. Additionally, the parties will need to take at the time of notification critically important positions regarding overlaps and non-horizontal relationships, which will frame any subsequent investigation or litigation and potentially have implications for reviews of future transactions. The expanded document submissions will require that businesses be even more vigilant to avoid creating vague, incomplete or otherwise misleading documents that could trigger an extended investigation. It will be even more crucial for companies to have robust training and monitoring programs for both deal-related and high-level ordinary-course document creation.

The proposed HSR form likely will not become effective until the second quarter of 2024, but companies must assume that transactions under current consideration will be notified under the new HSR form.

NEW MERGER GUIDELINES

In December 2023, FTC and DOJ jointly released their final Merger Guidelines, which summarize the procedures and

enforcement practices the agencies use to investigate mergers. The agencies issued the Guidelines after a nearly two-year process, and they make significant changes from the prior guidelines. Key changes include:

- **Market Concentration:** The Guidelines adopt significantly lower market concentration thresholds at which mergers are presumed to harm competition. For example, a market consisting of five companies each with a 20% market share is “highly concentrated,” where previously it would be only “moderately concentrated.” The Guidelines also introduce a new presumption of competitive harm if the merged firm would have more than a 30% market share and the merger increases the Herfindahl-Hirschman Index (HHI) by more than 100.
- **Vertical Mergers:** The Guidelines for the first time address in the same document both “horizontal” transactions (M&A among competitors) and “vertical” transactions (where one party makes an input that can be used in the other party’s product). The Guidelines reflect the agencies’ aggressive approach to vertical deals. They articulate potential harms from a merger that combines firms in a vertical relationship. Those include, among other things, the merged firm: (1) withholding critical inputs from or disfavoring downstream competitors; (2) foreclosing sales opportunities from upstream competitors; and (3) gaining increased visibility into competitors’ sensitive information.
- **Potential Competition:** The Guidelines express a preference for “making” versus “buying,” claiming that “[i]n general, expansion into a concentrated market via internal growth rather than via acquisition benefits competition.” Accordingly, the Guidelines devote substantial attention to the elimination of potential competition, including both “actual potential competition” (where one of the merging parties has set plans to enter a market) and “perceived potential competition” (where current competitors are disciplined by a perception that one or more merging parties might enter). Potential competition will likely continue to receive substantial attention in merger reviews, given

Key Developments in a Rapidly Evolving US Antitrust Enforcement Environment

11 Important Considerations for Getting Your Deal Done

how frequently acquirers with internal R&D capabilities contemplate “make or buy” decisions in the M&A context.

- **Dominant Firms.** The Guidelines emphasize that “mergers can violate the law when they entrench or extend a dominant position” but do not explain what “dominant position” means in the merger review context. Additionally, the Guidelines discuss a potential “conglomerate” concern that a merger could enable the merged firm to extend a dominant position from one market

A MIXED RECORD IN COURT

FTC and DOJ already have been pushing the envelope and pursuing merger challenges based on less traditional theories than are reflected in the final Merger Guidelines priorities. But the agencies’ record in court has been mixed.

- **Potential Competition.** The perceived potential competition theory was at the heart of the FTC’s unsuccessful challenge of Meta’s acquisition of the virtual reality company Within. The FTC recently relied on the actual potential competition theory to challenge Sanofi’s proposed exclusive license to Maze Therapeutics Inc.’s therapy for treatment of Pompe disease, which the FTC alleged would have eliminated a nascent competitor. The parties abandoned the transaction a few days after the FTC sued.
- **Vertical.** The agencies have lost two recent vertical cases in court: Microsoft’s acquisition of Activision and UnitedHealth’s acquisition of Change Healthcare. But they have successfully blocked, or caused the termination of, other recent vertical deals, notably Lockheed’s proposed acquisition of Aerojet, Nvidia’s proposed acquisition of Arm and Illumina’s acquisition of Grail.
- **Conglomerate concerns.** In an especially aggressive move, the FTC in May 2023 sought to block Amgen’s acquisition of Horizon Therapeutics based on a “conglomerate” concern that Amgen could use its large drug portfolio to offer bundled discounts or rebates contingent on the customer buying one or both of Horizon’s drugs, which were alleged to hold monopoly positions, thereby excluding competition from incipient competitors to Horizon’s drugs. This was the first time in over 40 years that a US antitrust agency challenged a transaction based on a conglomerate theory of competitive harm. The parties ultimately settled through a consent decree, with Amgen agreeing not to offer certain types of bundled discounts involving legacy Horizon drugs.

into a related market by, for example, tying or bundling sales of two products.

- **Serial Acquisitions.** The Guidelines state that a firm may violate antitrust law through a series of acquisitions of smaller firms in the same or related sectors. It is unclear whether this means that the agencies might challenge a series of acquisitions as cumulatively unlawful even if no individual acquisition on its own would be anticompetitive.
- **Partial Ownership and Minority Investments.** The Guidelines articulate ways in which acquisitions of partial ownership and minority investments could harm competition.

The new Merger Guidelines largely reflect the agencies’ current approaches to merger reviews. It is less clear, however, whether courts will follow this guidance. Agency guidelines are not legally binding, and courts have generally followed them only insofar as they find them persuasive. Unlike previous merger guidelines, the new Guidelines do not reflect bipartisan consensus. There are also questions about whether the Guidelines would survive a change to a Republican administration, which could result in very different approaches to merger enforcement.

EMERGENCE OF THE “FIX-IT-FIRST” STRATEGY

Until recently, the US antitrust agencies commonly resolved competitive concerns regarding proposed mergers by entering a consent decree with the merging parties that included remedies. The merging parties might sell off overlapping assets to address agency concerns, but the transaction would be allowed to proceed. DOJ and FTC, however, have made clear that they will sharply limit resolutions through consent decrees with remedies, preferring to challenge transactions outright. Since 2022, DOJ has agreed to resolve a merger case through a consent decree only once. The FTC has approved consent decrees with remedies to resolve merger cases since 2022, but it also is articulating a more restrictive approach.

The agencies’ disfavoring of remedies has dramatically changed the merger

review landscape for transactions that may raise antitrust concerns, leading parties increasingly to contemplate “fix-it-first” strategies. With fix-it-first, the parties modify the transaction to address antitrust concerns, typically by entering an agreement with a third party to sell divested assets, without entering a consent decree with the agency. The agency can then either clear the transaction based on the proffered remedy or litigate over the remedy’s adequacy and sometimes over whether the transaction may lessen competition in the first place.

Where there is a remedy that is workable as a business matter and consistent with deal objectives, a well-considered fix-it-first remedy can bring several potential benefits, including (1) decreasing the likelihood of prolonged antitrust litigation; (2) providing upfront certainty regarding the scope of the divestiture; (3) avoiding the compliance burdens of an agency consent decree; and (4) in some cases, avoiding a fire sale at depressed prices at the end of the merger review process.

A fix-it-first strategy can be difficult to execute, however. Among other things, parties should carefully assess how a potential remedy may affect deal objectives and practical challenges for a potential divestiture or other remedy. Those challenges will often include (1) finding a way to extract selected assets from the rest of a merging party’s business and (2) identifying potential buyers capable of competing effectively with the divested assets.

If the parties decide to employ a fix-it-first strategy, timing considerations will be critical. They will almost invariably face difficult decisions regarding the balance between seeking to persuade the agency—or ultimately a court—that the transaction will not harm competition and beginning the divestiture sales process to minimize closing delays or the risk of going past the transaction’s end date. The parties should ensure that the regulatory provisions in the applicable transaction documents faithfully reflect the parties’ understanding of critical topics such as regulatory efforts clauses, remedy commitments, the end date and reverse termination fees. ■

DOJ M&A Safe Harbor Policy

On October 4, 2023, DOJ announced a safe harbor policy that may shield companies from criminal prosecution for misconduct they uncover at companies they are acquiring or have recently acquired. Under the M&A Safe Harbor Policy, DOJ will presumptively decline to prosecute acquiring companies that voluntarily self-report misconduct they discover within six months from the date of closing, cooperate with DOJ and “fully remediate” the misconduct within one year from the date of closing.

The policy, which will be applied across the entire DOJ (particularly in areas implicating cybersecurity, technology and national security), adds timelines and more precise standards to a similar policy that had previously been applied in the Foreign Corrupt Practices Act (FCPA) Unit of DOJ and follows previous policy revisions aimed at encouraging voluntary self-disclosures of criminal misconduct by similarly offering potential declinations of prosecutions. The M&A Safe Harbor Policy is also the latest in a series of policy and guidance updates from DOJ regarding corporate compliance programs that are aimed at incentivizing companies to discourage and disclose corporate malfeasance. The policy is, however, DOJ’s most focused effort regarding M&A transactions across industries and enforcement areas.

BACKGROUND

In January 2023, Kenneth A. Polite Jr. announced revisions to DOJ’s FCPA Corporate Enforcement Policy and expressly extended its application to all corporate criminal matters handled by DOJ’s Criminal Division. Similar to the M&A Safe Harbor Policy, the revised and expanded Corporate Enforcement Policy offers a presumption of a declination to companies that voluntarily self-disclose misconduct to the DOJ, fully cooperate, timely and appropriately undertake remedial measures, and disgorge any profits from unlawful conduct, but the policy does not provide timelines and other specifics.

M&A SAFE HARBOR POLICY

The M&A Safe Harbor Policy builds on the Corporate Enforcement Policy by implementing a department-wide framework that focuses specifically on the M&A process. This is intended to create greater consistency across DOJ. To be eligible for a declination under the M&A Safe Harbor Policy (which applies to antitrust, sanctions and other criminal violations), an acquiring company must:

- self-report misconduct committed by the acquired company within six months from the date of closing, regardless of whether the illegal activity was identified before or after the acquisition; and
- fully remediate the misconduct within a year of the closing date.

These baseline time frames are subject to a reasonableness analysis and may be extended by DOJ depending on the facts and circumstances of a particular transaction.

The policy provides that aggravating factors—which include involvement by executive management in misconduct, significant profits from misconduct, and egregious or pervasive misconduct—at the acquired company will not have any impact on the acquiring company’s ability to obtain a declination. At the same time, aggravating factors may prevent an acquired company from receiving a declination based on a self-disclosure from an acquiring company. Furthermore, misconduct disclosed under the M&A Safe Harbor Policy will not be taken into consideration for any future recidivist analysis for the acquiring company.

The policy applies only in the criminal context and does not affect civil merger enforcement.

Even before the M&A Safe Harbor Policy was announced, recent enforcement actions demonstrate the premium DOJ has placed on voluntary self-disclosure in the M&A context. For example, in December 2022, Safran S.A. received a declination of prosecution with disgorgement after it voluntarily disclosed information about improper pre-acquisition payments to

consultants made by two companies Safran acquired, cooperated with the ensuing investigation and remediated the issues.

KEY CONSIDERATIONS

The M&A Safe Harbor Policy underscores the importance of robust due diligence during the acquisition process to make sure an acquiring company understands potential criminal exposure at the target company. Including compliance issues as a regular part of the diligence process, and not an afterthought as a deal is about to close, is key to identifying and addressing relevant risks.

While incentivizing voluntary self-disclosures through the presumption of declinations, the M&A Safe Harbor Policy does have specific requirements as to the timing of disclosure and remediation. Although DOJ suggested there may be some flexibility in these deadlines, companies should expect the deadlines will be enforced in the absence of discussions and assurances from DOJ and in situations involving ongoing or imminent harm (particularly in the area of national security), companies should not delay self-disclosure if they wish to take full advantage of the policy.

Acquiring companies should act diligently during the M&A process to identify criminal misconduct at acquired companies and consider the benefits and risks of potential disclosure to DOJ. At the same time, companies must remain mindful that DOJ has specified that the policy applies to only “criminal conduct discovered in bona fide, arm’s-length M&A transactions” and “does not apply to misconduct that was otherwise required to be disclosed or already public or known to [DOJ].”

The M&A Safe Harbor Policy provides potentially helpful incentives to disclose malfeasance and avoid prosecution, but companies should proceed cautiously to ensure they are eligible for the policy’s benefits. They should also be mindful that restitution and disgorgement, as well as a public recitation of the facts, will be required even if DOJ declines prosecution. ■

A Comparison of Deal Terms in Public and Private Acquisitions

13 Market Data Highlights Key Differences

Public and private company M&A transactions share many characteristics but also involve different rules and conventions. (Business combinations involving SPACs or other “shell companies” are subject to additional considerations that are not discussed below.)

GENERAL CONSIDERATIONS

Public and private company acquisitions differ in various fundamental respects:

- **Structure:** An acquisition of a private company may be structured as an asset purchase, a stock purchase or a merger. A public company acquisition is generally structured as a merger, often in combination with a tender offer for all-cash acquisitions.
- **Letter of Intent:** If a public company is the target in an acquisition, there is usually no letter of intent. The parties typically go straight to a definitive agreement, due in part to concerns over creating a premature disclosure obligation. Sometimes an unsigned term sheet is also prepared.
- **Timetable:** The timetable before signing the definitive agreement is often more compressed in an acquisition of a public company. However, more time may be required between signing and closing to prepare and circulate a proxy statement for stockholder approval (unless a tender offer structure is used), to comply with notice and timing requirements, and to obtain antitrust clearances that may be unnecessary (or easier to obtain) in smaller, private company acquisitions.
- **Confidentiality:** The potential damage from a leak is much greater in an M&A transaction involving a public company, and rigorous confidentiality precautions are taken accordingly.
- **Litigation Risk:** Litigation against the target, its board of directors and/or the acquirer is much more common in acquisitions of public targets than private targets. The board of a public target almost always (and the board of the acquirer sometimes) obtains a fairness opinion from an investment banking firm.

DUE DILIGENCE

When a public company is acquired, the due diligence process differs from the process followed in a private company acquisition:

- **Availability of SEC Filings:** Due diligence typically starts with the target’s SEC filings, enabling a potential acquirer to investigate in stealth mode until it wishes to engage the target in discussions.
- **Speed:** The due diligence process is often quicker in an acquisition of a public company because of the availability of SEC filings, thereby allowing the parties to focus quickly on the key risks and transaction points.

MERGER AGREEMENT

The merger agreement for an acquisition of a public company reflects a number of differences from its private company counterpart:

- **Representations:** In general, the representations and warranties from a public company are less extensive than those from a private company, are qualified in some respects by the public company’s SEC filings, may have higher materiality thresholds, and do not survive the closing.
- **Exclusivity:** The exclusivity provisions are subject to a “fiduciary exception” permitting the target to negotiate with a third party making an unsolicited offer that may be deemed superior and, in certain circumstances, to change the target board’s recommendation to stockholders.
- **Closing Conditions:** The “no material adverse change” and other closing conditions are generally drafted so as to limit the target’s closing risk and give the acquirer little room to refuse to complete the transaction if regulatory and stockholder approvals are obtained.
- **Post-Closing Obligations:** Post-closing escrow or indemnification arrangements are extremely rare.
- **Earnouts:** Earnouts are unusual, although a form of earnout arrangement

TIPS TO MINIMIZE LITIGATION RISK

Although a public target’s board may not be able to avoid litigation entirely, a sound process will allow the target to anticipate and deflect many common challenges to proposed acquisitions:

- Hire qualified (and unconflicted) advisors to steer the process and lead the negotiations with potential buyers.
 - If potential conflicts exist, establish a committee of disinterested directors and task them with active oversight of the process.
 - Give due consideration to the array of financial and/or strategic parties that should be solicited and share information with bidders on equal terms.
 - Keep bidding competitive, and instruct management not to discuss the terms of their future employment or compensation with potential buyers until authorized by the board (typically after the price and other major terms are in place).
 - Negotiate hard over the price and deal terms, which should be sufficiently flexible to permit the board to comply with its fiduciary duties.
 - Contemporaneously prepare minutes of board and committee meetings in order to help demonstrate the robustness of the process.
 - Make fulsome disclosures in the proxy statement, and involve litigation counsel to review the disclosures in advance.
- called a “contingent value right” is not uncommon in the life sciences sector.
- **Deal Certainty and Protection:** The negotiation battlegrounds are the provisions addressing deal certainty (principally the closing conditions) and deal protection (exclusivity, voting agreement, termination and breakup fees).

SEC INVOLVEMENT

The SEC plays a significant role in acquisitions involving a public company:

- **Form S-4:** In a public acquisition, if the acquirer is issuing stock to the target’s stockholders, the acquirer must register the issuance on a Form S-4 registration statement that is filed with (and possibly reviewed by) the SEC.
- **Proxy Statement:** Absent a tender offer, the target’s stockholders, and sometimes the acquirer’s stockholders, must approve

A Comparison of Deal Terms in Public and Private Acquisitions

14 Market Data Highlights Key Differences

the transaction. Stockholder approval is sought pursuant to a proxy statement that is filed with (and often reviewed by) the SEC. Public targets (subject to certain exceptions) must provide for a separate, nonbinding stockholder vote with respect to all compensation each named executive officer will receive in the transaction.

- **Tender Offer Filings:** In a tender offer for a public target, the acquirer must file a Schedule TO and the target must file a Schedule 14D-9. The SEC staff reviews and often comments on these filings.
- **Other SEC Filings:** Many Form 8-Ks and other SEC filings are often required by public companies engaged in M&A transactions.
- **Public Communications:** Elaborate SEC regulations govern public communications in the period between the first public announcement of the transaction and the closing of the transaction. Most written communications in connection with a business combination transaction must be filed with the SEC.

IMPACT OF R&W INSURANCE

Representation and warranty insurance (R&W insurance) provides coverage for indemnification claims arising from misrepresentations by the seller in the sale of a company. The use of R&W insurance continues to be prevalent, particularly in sales of privately held companies backed by venture capital or private equity investors, although usage declined somewhat in 2022 and early 2023 compared to 2021, according to studies conducted by SRS Acquiom (a provider of post-closing management services).

The presence of R&W insurance in private company acquisitions influences the negotiated outcomes of various deal terms. Below is a brief summary of the principal effects of buy-side R&W insurance, based on studies conducted by SRS Acquiom.

— Financial Terms:

- Indemnification escrows are significantly smaller (or eliminated entirely).

- Among deals with purchase price adjustments, a separate escrow to secure the purchase price adjustment is much more likely.

— Representations and Warranties:

- The seller is much less likely to provide a “10b-5” representation.
- “Pro-sandbagging” provisions allowing the buyer to seek indemnification for the seller’s misrepresentations even if the buyer knew of the misrepresentations prior to closing are much less likely.
- Deals are much more likely to provide that materiality qualifications in representations and warranties are disregarded for purposes of determining both breaches and damages.

— Liability Provisions:

- “Non-reliance” and “no other representations” provisions, which are

intended to limit or eliminate seller liability based on extra-contractual statements, are more likely.

- Seller representations and warranties are much less likely to survive the closing; when they do survive the closing, they have a median survival period of 12 months.
- Any indemnification obligations of the seller are much more likely to be subject to a “deductible” (in which the seller is liable only for damages in excess of a specified threshold amount) than a “tipping basket” (in which the seller is liable for all damages once the threshold amount has been reached).

COMPARISON OF SELECTED DEAL TERMS

Set forth below is a comparison of selected deal terms in public target and private target acquisitions based on data from the MarketStandard database of SRS Acquiom and the most recent deal points

“10b-5” Representation	
PUBLIC (ABA)	Not reported
PRIVATE (ABA)	7%
PRIVATE (SRS ACQUIOM)	23%
Standard for Accuracy of Target Representations at Closing	
PUBLIC (ABA)	
“MAC/MAE”	97%
Other standard	3%
PRIVATE (ABA)	
“MAC/MAE”	74%
“In all material respects”	23%
“In all respects”	2%
PRIVATE (SRS ACQUIOM)	
“MAC/MAE”	41%
“In all material respects”	55%
“In all respects”	4%
Inclusion of “Prospects” in MAC/MAE Definition	
PUBLIC (ABA)	2%
PRIVATE (ABA)	10%
PRIVATE (SRS ACQUIOM)	16%

Fiduciary Exception to “No-Shop/No-Talk” Covenant	
PUBLIC (ABA)	100%
PRIVATE (ABA)	9%
PRIVATE (SRS ACQUIOM)	—
Opinion (Nontax) of Target’s Counsel as Closing Condition	
PUBLIC (ABA)	Not reported
PRIVATE (ABA)	1%
PRIVATE (SRS ACQUIOM)	4%
Appraisal Rights Closing Condition	
PUBLIC (ABA)	2%
PRIVATE (ABA)	81%
PRIVATE (SRS ACQUIOM)	47%
Acquirer MAC/MAE Closing Condition	
PUBLIC (ABA)	100%
PRIVATE (ABA)	93%
PRIVATE (SRS ACQUIOM)	98%

A Comparison of Deal Terms in Public and Private Acquisitions

15 Market Data Highlights Key Differences

studies available from the Mergers & Acquisitions Committee of the American Bar Association's Business Law Section. The SRS Acquiom data is for acquisitions of private targets by US public companies with purchase prices ranging from \$25–\$750 million in which SRS Acquiom served as shareholder representative and that closed in 2022 or the first half of 2023. The ABA private target study is based on publicly available agreements for acquisitions of private targets by public companies with purchase prices ranging from \$30–\$750 million that were completed (or for which definitive agreements were executed) in 2022 or the first quarter of 2023. The ABA public target study is based on merger agreements for transactions with US public company targets with total deal consideration in excess of \$200 million that were completed in 2021, 2022 and the first half of 2023 (excluding de-SPAC transactions and transactions involving targets majority-owned by the buyer, real estate investment trusts, business development companies and companies formed in US territories).

The chart on page 14 compares the following deal terms in acquisitions of public and private targets:

- **“10b-5” Representation:** A representation to the effect that no representation or warranty by the target contained in the acquisition agreement, and no statement contained in any document, certificate or instrument delivered by the target pursuant to the acquisition agreement, contains any untrue statement of a material fact or fails to state any material fact necessary, in light of the circumstances, to make the statements in the acquisition agreement not misleading.
- **Standard for Accuracy of Target Representations at Closing:** The general standard that will be applied to assess the accuracy of the target's representations and warranties set forth in the acquisition agreement for purposes of the acquirer's closing conditions:
 - A “MAC/MAE” standard provides that each of the representations and warranties of the target must be true and correct in all respects as of the closing, except where the failure of such representations and warranties to be true and correct will not have or result in a *material adverse change/effect* on the target.
 - An “in all material respects” standard provides that the representations and warranties of the target must be true and correct in *all material respects* as of the closing.
 - An “in all respects” standard provides that each of the representations and warranties of the target must be true and correct in *all respects* as of the closing.
- **Inclusion of “Prospects” in MAC/MAE Definition:** Whether the “material adverse change/effect” definition in the acquisition agreement includes “prospects” along with other target metrics, such as the business, assets, properties, financial condition and results of operations of the target.
- **Fiduciary Exception to “No-Shop/No-Talk” Covenant:** Whether the “no-shop/no-talk” covenant prohibiting the target from seeking an alternative acquirer includes an exception permitting the target to consider an unsolicited superior proposal if required to do so by its fiduciary duties.
- **Opinion of Target's Counsel as Closing Condition:** Whether the acquisition agreement contains a closing condition requiring the target to provide an opinion of counsel (excluding opinions regarding the tax consequences of the transaction).
- **Appraisal Rights Closing Condition:** Whether the acquisition agreement contains a closing condition providing that appraisal rights must not have been sought by target stockholders holding more than a specified percentage of the target's outstanding capital stock. (Under Delaware law, appraisal rights generally are not available to stockholders of a public target when the merger consideration consists solely of publicly traded stock.)
- **Acquirer MAC/MAE Closing Condition:** Whether the acquisition agreement contains a closing condition excusing the acquirer from closing if an event or development has occurred that has had, or would reasonably be expected to have, a “material adverse change/effect” on the target, either as a standalone closing condition or through the bring-down at closing of a “no material adverse change/effect” representation. ■

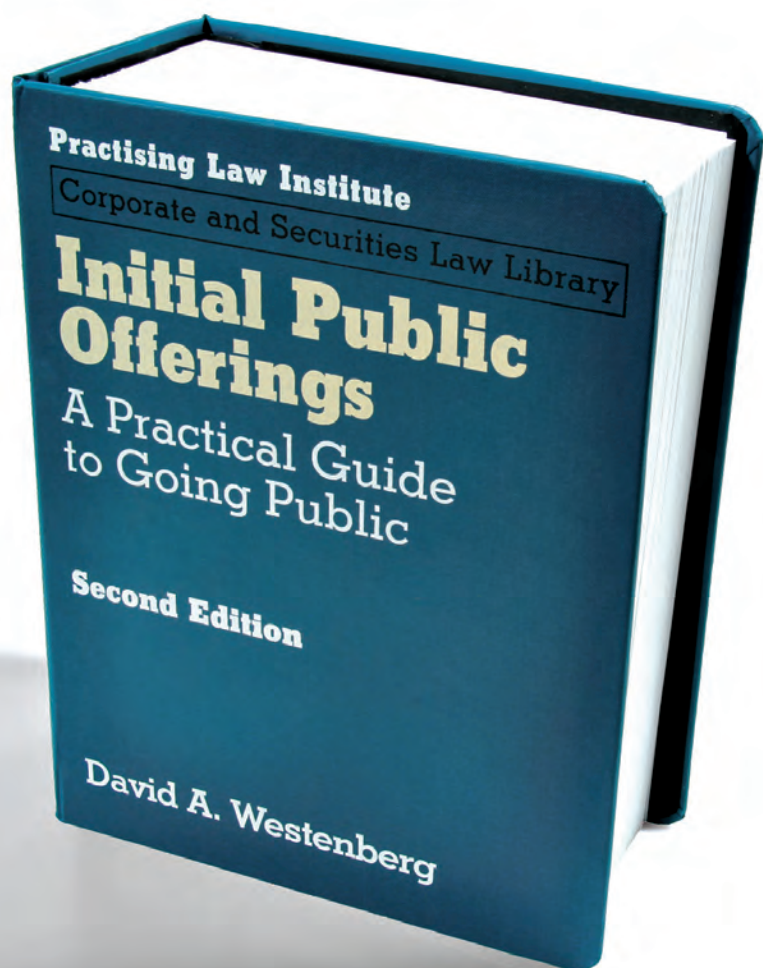
POST-CLOSING INDEMNIFICATION CLAIMS

Based on an SRS Acquiom study analyzing post-closing indemnification claims in more than 700 private target acquisitions with fully released escrows during the period from the fourth quarter of 2020 through the second quarter of 2022:

- **Frequency of Claims:** 30% of all transactions had at least one post-closing indemnification claim (excluding purchase price adjustments) against the escrow. Claim frequency was lowest (16%) in deals valued at more than \$500 million and highest (37%) in deals valued between \$50 million and \$100 million. At 31% to 32%, claim rates were very similar among US public buyers, US private buyers and US private equity buyers.
- **Size of Claims:** Median claim size as a percentage of the escrow ranged from a high of 13% for regulatory compliance claims to less than 1% for transaction fees/costs and capitalization claims. On average, claim size as a percentage of the escrow was highest on deals valued at more than \$500 million (89%) and on deals with US private buyers (68%), and lowest on deals valued between \$100 million and \$200 million (23%) and on deals with US private equity buyers (29%).
- **Subject Matter of Claims:** Overall, the overwhelming majority of claims were for breaches of representations and warranties (71%) and transaction fees/costs (27%).
- **Bases for Misrepresentation Claims:** Most frequently claimed misrepresentations involved tax (45%), employee-related (12%), undisclosed liabilities (11%), capitalization (9%), intellectual property (6%) and financial statements (4%).
- **Resolution of Claims:** Contested claims were resolved in a median of 4.4 months. Fraud claims (median of 20 months) and breach of fiduciary duty claims (median of 18.6 months) took the most time to be resolved, while claims for purchase price adjustments were resolved the quickest (median of 0.7 month).
- **Purchase Price Adjustments:** 92% of all transactions had mechanisms for purchase price adjustments. Of these, 88% had a post-closing adjustment (favorable to the buyer in 48% of transactions and favorable to target stockholders in 40% of transactions).
- **Expense Fund:** 96% of all deals had expense funds. The average size was \$348,000 (0.58% of transaction value) in deals with earnouts and \$203,000 (0.33% of transaction value) in other deals.

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