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IPOS

## Legal Considerations in Pre-IPO Crossover Financings



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An increasingly common financing strategy for companies expecting to conduct an initial public offering (IPO), particularly in the life sciences space, is to conduct a “crossover” financing shortly prior to the IPO. Crossover financings are capital raises by private companies that include investors that traditionally invest

primarily in public companies, rather than with just venture capital funds and other more traditional private company investors. Crossover financings provide unique benefits to both the company and the participating crossover investors beyond just providing an infusion of cash and a private company investment opportunity.

Crossover financings benefit companies looking to become public in the near future by expanding their shareholder base prior to the IPO to include institutional public company shareholders. These shareholders are often buyers in the subsequent IPO, and having them already in the company shareholder base allows the company to significantly increase the likelihood that these investors will purchase a meaningful portion of the IPO, providing a strong base to the deal and momentum for the roadshow. Additionally, having recognizable public company investors, who have conducted substantial diligence and decided to invest in the private company, is often viewed by other potential investors as a form of validation of the company and its science, further increasing the chances for a successful IPO. By investing in a company prior to its IPO, crossover investors obtain a stake in the company at what is expected to be a lower valuation than the IPO price (benefiting from a private company liquidity discount), place themselves in a better position to receive their desired allocations in the IPO and have an opportunity to conduct diligence, understand the company’s science and get to know management at an in-depth level that is not possible in the IPO roadshow process.

While late-stage crossover financings come with significant potential benefits to both the company and the investors, given the complexity of the legal issues involved, they must be structured and implemented carefully to avoid potential securities law violations, as well as to ensure that the company and investors are able to reap those anticipated benefits.

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### Timing Considerations

Section 5 of the Securities Act of 1933, as amended (the Securities Act), provides that every offer or sale of

securities must either be registered or made pursuant to an exemption from registration. Crossover rounds need to be made pursuant to an exemption from the registration requirements of the Securities Act. When crossover rounds occur close in time to the IPO, careful consideration needs to be given to ensure that activities related to the IPO do not invalidate the exemption for the crossover round.

One thing that can invalidate an exemption, with certain exceptions, is the use of “general solicitation,” and the filing of a Form S-1 registration statement can itself be viewed as a general solicitation. Following passage of the Jumpstart Our Business Startups (JOBS) Act of 2012, most companies are allowed to confidentially submit an IPO registration statement and delay publicly announcing plans for an IPO until much later in the process. By doing so, companies may conduct a crossover round much closer to the time of the IPO without the risk that the S-1 itself will constitute an improper general solicitation.

Even after publicly filing the S-1, companies may still conduct a private financing under a valid exemption. However, the company must be careful to avoid having the registration statement deemed an impermissible general solicitation for purposes of the private financing. If the company is looking to conduct a crossover round after publicly filing a registration statement for an IPO, a company should carefully consider which investors it can sell to in a private financing, with a critical eye on any investor with whom the company did not have a meaningful relationship prior to the filing of the registration statement.

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Another timing consideration for companies as the private financing transaction and the IPO get closer together, is the risk that the two offerings could be “integrated” for securities law purposes, whereby the private offering is potentially deemed to be part of the public offering, and could result in a potential violation of Section 5 of the Securities Act. When two offerings occur within six months of each other, they must fall within a regulatory safe harbor or otherwise comply with Securities and Exchange Commission interpretative guidance to avoid integration. In a crossover financing, with the same investors expected to participate in the private financing and the IPO, the integration risk is heightened, and a company will want to discuss with legal counsel in advance to avoid potential integration pitfalls. Further, under the JOBS Act, many companies are also permitted to conduct “testing-the-waters” (TTW) meetings with certain potential IPO investors both prior to and after publicly filing the S-1 and companies often do hold TTW meetings as part of their IPO process. However, especially when these TTW meetings are occurring either concurrently or prior to a

completed crossover financing, the risk of integration between the two offerings is further heightened.

Due to the multiple risks of invalidating an exemption from registration when a crossover financing and IPO occur close in time, a company should keep good records regarding how and when investors were solicited and meetings with investors need to be carefully planned and vetted by legal counsel in advance.

## **IPO Participation Rights**

In traditional private financings, investors are typically granted the contractual right to participate in future private financings, usually on a pro rata basis. In late-stage financing rounds, investors may also request the right to purchase shares in the IPO. This feature can be particularly attractive to crossover investors seeking to increase the likelihood of being allocated their desired portion of shares in the eventual IPO. This is particularly important in a substantially over-subscribed IPO. As a result, investors often negotiate for IPO participation rights in connection with a private crossover round. However, the term “offer” is broadly defined under the Securities Act, and pursuant to SEC guidance, the grant of IPO participation rights may, particularly if granted less than 12 months prior to the IPO, be deemed to be an “offer” of the IPO securities that is made without a registration statement under Section 5 of the Securities Act. This could result in a potential “gun jumping” violation of Section 5 of the Securities Act if the investor purchases shares in the IPO. As crossover financings are often conducted with an expectation that an IPO will occur within 12 months, companies need to carefully structure IPO participation rights to avoid a potential Section 5 violation.

A common approach to solve for these gun-jumping concerns is to provide investors the right to participate in the IPO only “if permissible under the securities laws” or, if not, to participate through a concurrent private placement on terms substantially similar to the IPO. When using this type of approach, it is still important to consider potential issues at the time of the IPO. From the standpoint of the crossover investor, purchasing shares through a concurrent private placement may be less attractive because the shares received will be unregistered and subject to minimum holding periods before they can be sold pursuant to Rule 144 of the Securities Act, as compared to shares purchased in the IPO, which would be immediately transferrable registered shares. Further, the company and underwriters may have marketing concerns with a concurrent private placement. Since the shares issued in the private placement are not immediately resellable in the public market, the expected market float post-IPO will be lower, and potentially too low for a successful IPO. In addition, any potential marketing benefits of naming this investor in the IPO roadshow process may be decreased by stating it will be participating in a concurrent private placement.

If a company has granted IPO participation rights and is conducting an IPO, especially if within 12 months, the company will need to work closely with its legal counsel, underwriters and the participating investors to structure any IPO participation in a way that is not deemed to result from an unregistered offer.

## Investor Diligence Prior to IPO

One of the key benefits to investing in a private round, as compared to a public offering, is an investor's ability to conduct extensive diligence. This is especially true in the life sciences setting where the technology can be difficult to understand, intellectual property positions can be complicated, clinical trials are risky and management teams are critically important. In a private round, investors can conduct their own detailed diligence into the underlying science and conduct first-hand review of regulatory correspondence and clinical trial information, as well as spend meaningful time getting to know management. In a public offering, while the underwriters will conduct in-depth diligence, the company generally can provide investors only with information that is described or contained in the prospectus relating to the offering.

However, as a crossover round gets closer to the IPO timeframe, and in particular if there is a possibility that the crossover round will not occur and the company will proceed directly into the IPO, the company must be careful with exactly how much information, and when it provides such information, to crossover investors. If the company provides access to written diligence materials to an investor, but no crossover round materializes and the company instead moves directly into the IPO process, there will be a risk that those written materials constitute a written offering of the IPO securities prior to the public filing of the registration statement, which could potentially result in a Section 5 violation. Therefore, companies should keep the diligence process for the private financing separate from the diligence process for the public offering, take steps to make clear that any written diligence materials are solely used for the crossover financing and ensure that access to written diligence materials is cut off once the crossover round ends or it determines not to proceed with the private financing. Further, if the company is in the process of drafting its IPO prospectus at the same time it is presenting to potential crossover investors, the company should ensure that any offering materials or presentations to the crossover investors are generally consistent with what the IPO prospectus will ultimately say and are limited to materials that will ultimately appear in the IPO prospectus.

## Disclosure of IPO to Crossover Investors

One of the risks crossover investors take on in participating in crossover rounds is that they will not have immediate liquidity for their shares like they do when investing in already public companies, and so they have a strong interest in making sure the IPO occurs on a relatively short timeline. Therefore, these investors may press for rights that keep them informed about the status of the company's financing decisions and expectations, whether through board representation, board observer rights or other contractual rights. Further, as part of the IPO process, the company will likely need to obtain shareholder consents and lockups and receive certain information from its large pre-IPO shareholders prior to any public announcement of the IPO. However, a company preparing for an IPO is also subject to "Quiet Period" restrictions that are intended to prevent it from soliciting offers for its IPO prior to publicly filing a registration statement. Since these crossover in-

vestors are likely to be purchasers in the IPO, there is a risk that a company's communications with these investors regarding the IPO may be deemed to be "offers" and so the company will need to carefully balance its disclosure obligations to these shareholders with its Quiet Period requirements, and vet these communications with counsel. In addition, the company should ensure that investors are required, and informed of their obligation, to maintain the confidentiality of the information they receive in connection with their status as a private company investor.

## Disclosure of Crossover Investors in IPO

One of the primary benefits for a company in conducting a crossover round is the validation investments from such investors can convey to the market in the IPO process. Therefore, a company will often want to prominently disclose these investors in its TTW meetings, IPO prospectus and roadshow. While there are certain disclosure obligations in the IPO prospectus for 5 percent shareholders, a company will need to make certain it has received consent from its investors prior to otherwise disclosing them in the IPO prospectus or roadshow. When seeking consent for any IPO disclosure, the company will need to be careful in how and what it communicates, so as to not violate its Quiet Period requirements and ensure the information about the IPO remains confidential. Ideally a company will obtain this affirmative consent up front as part of the crossover financing process.

## Crossover financings are an increasingly common and important step for many companies preparing for an IPO.

One of the other company benefits from a crossover round is being able to show that a significant portion of the IPO is subscribed for prior to TTW meetings or the roadshow, which can establish momentum for the IPO sale process. This is usually done by obtaining indications of interest from existing shareholders prior to the roadshow, and disclosing these indications of interest in the IPO prospectus. While these indications of interest cannot be binding obligations to purchase, the market generally understands these indications of interest to represent a "pre-sold" portion of the total IPO book. Disclosure of these indications of interest will appear in several spots in the IPO prospectus, most notably on the cover page. Given their prominent disclosure and the market practice, the company needs to have substantial discussions with the shareholders to be included in the indications of interest disclosure, and will need to be careful in discussing with the shareholders their potential investments to be certain that the company does not cross the line into an impermissible offer or sale.

## Conclusion

Crossover financings are an increasingly common and important step for many companies preparing for an IPO. When planned for and executed correctly, a

crossover financing can be a significant boon to a company, both from a valuation and fundraising perspective; however, there are multiple potential legal traps for the unprepared company or investor, particularly as transaction timing and process change. Any company

considering a crossover financing in advance of an IPO should carefully discuss with its counsel the entire process to ensure that both transactions are structured to achieve the company's desired goals and avoid legal pitfalls along the way.