Using Rule 144A Equity Offerings to Supplement or Replace IPOs During Volatile Markets

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Over the course of 2010, the IPO market heated up compared to 2008 and 2009. More IPOs closed in the first half of 2010 than during all of 2009. However, the increased IPO activity has not met the historic activity levels witnessed from 2004 through 2007, and the IPO market is still challenging. Investment bankers advising on IPOs often warn their clients that the windows of opportunity for their offerings are constantly opening and closing. Moreover, according to a report issued by Renaissance Capital, Greenwich, CT, on September 13, 2010, the IPO backlog in the United States consisted of 170 companies seeking to raise nearly $60 billion in proceeds. The market has not witnessed a similar IPO backlog since 2007, and it presents a challenge to investment bankers that need to sell these IPOs in a volatile market. For private issuers unable to complete an IPO, an equity 144A offering may be an interim solution.

The IPO process can be a significant drain on a company's finances and its managerial resources. A protracted IPO process will generally compound the financial and other expenses incurred by the company. Companies considering an IPO, or that have started the IPO process, are well-advised to consider alternative financing opportunities. Having a back-up plan, even while pursuing an IPO, ensures that the company will not be adversely affected by delays or by an inhospitable IPO market, and may ensure that the resources spent on the process are not wasted.

Although relatively common in the United States, equity 144A offerings warrant renewed attention given the current state of the market. Advanced, privately-held companies may find an equity 144A offering to be an attractive option in lieu of an IPO. A private company pursuing an IPO may rely on Rule 144A to complete a private placement to institutional investors. Completing an equity 144A offering may also expose the company to a category of investor that otherwise may be unwilling to invest in the company through other private financings. The proceeds raised in an equity 144A offering may allow the company to withstand a protracted IPO process. Being in the driver's seat—ready to complete either an equity 144A offering, or an IPO (if the market cooperates)—will give the company more flexibility.

Rule 144A

Section 5 of the Securities Act of 1933 (Securities Act) sets forth the registration and prospectus delivery requirements for public offerings of securities. Rule 144A under the Securities Act provides a non-exclusive safe harbor from the registration and prospectus delivery requirements of Section 5 for certain offers and sales of qualifying securities by certain persons other than the issuer of the securities. Rule 144A has two operational provisions. First, so long as the reseller of securities in a Rule 144A transaction is not the issuer or a dealer, it will be deemed not to be engaged in a "distribution" of those securities and, therefore, not an "underwriter" of those securities within the meaning of Sections 2(a)(11) and 4(1) of the Securities Act. Second, with respect to sales made pursuant to Rule 144A by a reseller that is a dealer, the dealer is deemed not to be a participant in a "distribution" of those securities within the meaning of Section 4(3)(C) of the Securities Act and not to be an "underwriter" of those securities within the meaning of Section 2(a)(11) of the Securities Act, and those securities are deemed not to have been "offered to the public" within the meaning of Section 4(3)(A) of the Securities Act.

A Rule 144A offering is usually structured so that the issuer first sells newly issued restricted securities to an "initial purchaser," typically a broker-dealer, in a private placement exempt from registration under the Securities Act. The initial purchaser can then take advantage of Rule 144A to immediately reoffer and resell the restricted securities to Qualified Institutional Buyers (QIBs), the largest and most sophisticated category of investors. The ability to immediately resell securities in reliance on Rule 144A enables broker-dealers to structure offerings that more closely resemble traditional firm commitment public offerings. Once the securities are in the hands of QIBs, a market for the securities may develop among QIBs. These markets do not provide the same liquidity as national stock exchanges but they provide some liquidity nonetheless. The issuer can increase liquidity by including its securities in the PORTAL trading market for restricted securities. In many equity 144A offerings, the issuer agrees to complete an IPO or to register the offered securities within a fixed period of time.

Conducting a 144A Offering

An equity 144A offering may take up to four months. However, the preparations for an equity 144A offering are substantially similar to those for an IPO. An issuer that has embarked on the IPO process can leverage all of that work, and quickly and efficiently use the IPO documents for the equity 144A offering to pursue both the equity 144A offering and the IPO simultaneously, or, at least, not withdraw or abandon the IPO. The two primary documents in an equity 144A offering are the offering memorandum and the purchase agreement. While there are no regulations regarding the information that must be disclosed in an offering memorandum, in most cases the issuer follows the format of a registration statement on Form S-1 or F-1. An issuer pursuing an IPO can, with little additional effort, convert its registration statement on Form S-1 or F-1 into an offering memorandum, or vice versa. The purchase agreement is substantially similar to an underwriting agreement and, with a few exceptions, the representations and warranties section of the document will be identical. Accordingly, the substantial work that the parties will undertake to negotiate these contentious provisions will be useful for both the equity 144A offering and the IPO.

The underwriters of the proposed IPO may also serve as the initial purchasers in the equity 144A offering. Therefore, switching between these two offering formats will not necessarily involve a change in offering participants. The initial purchasers in an equity 144A offering will want to perform a due diligence review of the issuer that is substantially similar to the review that underwriters will perform in an IPO, thus the diligence also will not require duplicative efforts.

Additional Benefits

In addition to providing a capital-raising alternative, an equity 144A offering offers other benefits to issuers. Although issuers generally produce offering memoranda that include SEC-style disclosure, the content of the offering memoranda is a result of industry practice, not SEC regulation. Issuers are not required to comply with the regulations that prescribe the disclosure requirements for registration statements. This provides issuers with greater flexibility (although the anti-fraud provisions of the federal and state securities laws are still applicable). For example, an issuer may elect to include only annual financial statements, without providing interim quarterly data. Further, there is no SEC review of the offering memorandum, thus eliminating the delaying effect of an SEC review. Until the issuer becomes a reporting company, the issuer is not subject to the corporate governance provisions of the federal securities laws and the national securities exchanges, nor is it exposed to the liabilities related to these provisions, particularly those set forth in the Sarbanes-Oxley Act. However, for issuers that have commenced, but have yet to complete, the IPO process, the most important benefit is that an issuer can complete a Rule 144A offering while waiting for the IPO window to open.

Finally, many Rule 144A offerings are structured as global offerings, with a side-by-side offering targeted at foreign holders in reliance on Regulation S. This dual structure permits an issuer, especially a foreign private issuer, to broaden its potential pool of investors. A foreign private issuer may take advantage of this structure to attract investors from its home country that are already familiar with the issuer.

Limitations

Of course, Rule 144A offerings are more restrictive than public offerings. Rule 144A offerings are limited to QIBs, which means there will not be an immediate, liquid secondary market for the offered securities. The lack of liquidity will lead to a liquidity discount for the offered securities. Additionally, Rule 144A offerings generally are also made available only to issuers in certain industry sectors. Moreover, although a Rule 144A offering may allow a private company to delay becoming subject to SEC reporting requirements, Rule 144A issuers are required to provide purchasers, at their request, reasonably current information, including a very brief statement of the nature of the business of the issuer and the products and services it offers and the issuer's most recent balance sheet and profit and loss and retained earnings statements, and similar financial statements for such part of the two preceding fiscal years as the issuer has been in operation (the financial statements should be audited to the extent reasonably available). With respect to a foreign private issuer (as defined under the federal securities laws), information will be presumed reasonably current if the information meets the timing requirements of the issuer's home country or principal trading markets. A non-reporting issuer that conducts an equity 144A offering also must monitor the number of its equity holders to ensure that there are no more than 500 U.S. holders. Exceeding this number will subject the issuer to SEC reporting requirements. However, the number of holders can be monitored relatively easily by a transfer agent or by the PORTAL exchange.

This article discusses the availability of Rule 144A as an alternative method to access capital in a private equity offering before an issuer completes an IPO. The considerations are different for reporting companies. Rule 144A is not available for a security that, when issued, is part of the same class as a security already listed on a U.S. national securities exchange. This means that if an issuer already has its common stock listed on a U.S. national securities exchange, it cannot conduct a Rule 144A common stock offering. Such an issuer would be required to offer debt or convertible debt or convertible preferred stock that is appropriately structured in order to ensure that the offered security is not "fungible" (or considered the "same security") with the listed security. It is also important to consider that an equity 144A offering does not come with any of the baggage that may be associated with a reverse merger into a public company shell, or with a SPAC approach.

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