ALTERNATIVE TO A TENDER OFFER

A PERSPECTIVE FROM SHARESPOST

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Introduction

One of the key advantages SharesPost provides to private companies is controlled liquidity for their existing shareholders. By creating a private online destination, a "Private Investor Portal," companies enable shareholders to interact directly with company-selected investors in an efficient, confidential manner. Any resulting transactions serve to consolidate the company's shares in the hands of selected holders, while providing shareholders with a much-needed interim exit.

An alternative tool that some issuers have used to accomplish the same goal is the combination of a traditional financing by the company followed by a tender offer to its shareholders. In the first step of a two-step process, the company closes a traditional financing by selling shares to new or existing investors. In the second step, the company uses the financing's proceeds to fund a tender offer to shareholders—usually the tender offer's price per share is the same as the financing's price per share. The result is that money is taken in from investors, passed through the company, and ultimately directed to the company's shareholders seeking to cash out.

The perceived advantage to this approach is that it allows the company to use a traditional financing—a transaction that is familiar to board members and management teams—as a means to generate secondary liquidity in a company-controlled manner. The company is in a position both to determine the price per share of the financing and the tender offer and to restrict participants to the company's invitees. As we shall see, though, the tender offer step generally presents multiple, significant legal and execution problems for the company. Further, SharesPost contends that the same objectives can be achieved more quickly, less expensively, with less distraction to management, and with materially less risk to the company through the use of a SharesPost Private Investor Portal.

The summary below briefly discusses the financing/tender offer strategy and highlights the benefits of using the SharesPost platform as an alternative.

The First Step: Primary Capital Raise

Under the financing/tender offer approach, the company first closes a new round of financing—generally by selling preferred stock to some combination of new and existing investors. Though this process is familiar to management teams, it is also extremely time-consuming and, in and of itself, can be a daunting project. Tasks include providing responses to due diligence request lists, numerous management-investor meetings, negotiation of terms, securing board approvals for a new series of preferred stock and liquidation preferences, drafting of a complete set of transactional documents, creating updated disclosure schedules, and closing mechanics.

Frequently, companies with significant demand for liquidity are also experiencing rapid growth and the related demands on management time and attention. Raising new capital to funnel to employees and early investors may not be something the senior team sees as part of the company's core mission. Investors in such financings also frequently expect significant rights in the company, from liquidation preferences and voting rights on key corporate actions, up to and including seats on the boards of directors; for a mature, growth company, managing such rights and investors may not be appealing to the management team. Lastly, the financing documents require the company to make representations and warranties to the new investors. This and the securities laws generally create incremental legal liability for the company.

The Second Step: the Tender Offer

Though primary capital raises by means of private placements of preferred stock are generally well understood by management teams of venture-backed companies, few such teams have experience with tender offers. Tender offers are most frequently discussed in the context of public company mergers and acquisitions, where one company, in a bid to gain control of an acquisition target, offers to purchase the equity of the target's shareholders at a fixed price (usually above the current market value), on fixed terms. The offer almost always is open for a limited period of time. In the private company context, issuers also have used tender offers as a way to conduct a share buyback or repurchase program for the purpose of providing current shareholders with some liquidity for an otherwise illiquid stock. This is especially true for companies with broad shareholder bases or significant numbers of employees holding equity, where individually negotiated share repurchases would be impractical or overly time-consuming, and/or would run the risk of unfairly (or illegally) excluding smaller shareholders.[1] The issuers might choose to either retire the repurchased equity into treasury stock or act as a "middleman," selling the repurchased shares to new investors.

Although an issuer tender offer allows the issuer to make a single "standard offer" to its shareholders, the tender offer process involves its own set of challenges, especially for emerging private growth companies. Three of the biggest such challenges are establishing the offer price, ensuring compliance with the regulations potentially applicable to the process, and managing the related workflows required of a tender offer.

Valuation

Private companies face a unique hurdle with tender offers when it comes establishing the offer price, as market valuations of private company shares are rare outside of events such as a capital raises or acquisitions. Although true of any share repurchase, the fact that tender offer prices are set unilaterally by the company, and are nonnegotiable, puts greater pressure on the issuer to provide a fair and attractive price to its shareholders. While this problem may be partially addressed by conducting a tender offer in conjunction with a financing, if preferred stock was sold in the financing and the company is purchasing common stock via the tender offer, the financing price will only, at best, indirectly suggest an appropriate tender price; therefore, it will be even less useful if there is any delay between the financing and the tender offer. Seeking an independent third-party valuation may be helpful but can be an expensive and time-consuming process. And the company's objectives in a valuation process in this context might be at odds with its objectives in an ordinary course valuation for option pricing purposes.

Securities Laws Compliance and Liability

Because of the "take-it-or-leave-it" nature of a tender offer and the limited time duration, tender offers have the potential to be considered coercive and have therefore been subject to extensive legislation and regulation aimed at guaranteeing their fairness. A set of amendments to the Securities Exchange Act of 1934, or the "Exchange Act," was passed in 1968 relating to tender offers; these amendments are commonly referred to as the "Williams Act." The federal regulations promulgated under this legislation by the Securities Exchange Commission, referred to in this brief as the "tender offer rules," create extensive disclosure requirements for, as well as restrictions on, among other things, the time duration of offers and preferential treatment of certain classes of shareholders. In particular, Rule 13e-4 under the Exchange Act governs the procedure to be followed in issuer tender offers.

Many of these rules apply only to public companies, but some of them also apply to private issuers, including:

- **Duration of 20 days:** The tender offer must be open for at least 20 days.

- **Extensions for changes in terms:** If the terms of the tender offer are changed, the offer must be open for at least 10 days after the change.

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[1] Note that this brief does not discuss the precise definition of a tender offer, and is not intended to provide legal advice on whether any particular share repurchase or share buyback program is subject to the rules governing tender offers. Please consult with legal counsel when structuring any share repurchase or buyback program.

- **Preferential treatment of shareholders:** Rule 14e-5 generally prohibits offers to shareholders outside of the tender offer during the period between the announcement and expiry of the offer, outside of certain specified exceptions.

- **Anti-fraud and anti-manipulation:** The anti-fraud and anti-manipulation provisions of the tender offer rules apply to private companies, and expose these issuers to liability for providing inaccurate information, or failing to provide material information, to their shareholders.

In addition, Section 14(e) of the Exchange Act imposes broad antifraud provisions on companies conducting tender offers. These provisions make it unlawful for any person to make an untrue statement of a material fact; omit a material fact, which would render the statements as misleading; or engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer. The obvious absence of any "bright lines" or safe harbors to let the issuer know when they have satisfied their Section 14(e) requirement potentially mandates significant time be spent by lawyers drafting disclosures, but without ever fully eliminating this source of legal exposure.

As a result, it is considered a best practice by certain practitioners to follow *all* tender offer rules, even in the private company context, except for those that specifically relate to filings with the Securities Exchange Commission. This is both because (1) determining which of the various rules apply to private issuers requires a careful, fact-specific legal analysis, and (2) following the rules helps inoculate the company against claims by shareholders that they were either manipulated into accepting an offer or provided inadequate disclosure when making their investment decisions.

This last problem is particularly acute for emerging private growth companies, who have difficulties valuing their stock but expect the value will rise. These factors create a real and significant risk that a shareholder selling in a tender offer will, when the stock later jumps in value, seize on any omission of fact as the basis for a legal claim. Even skilled attorneys may find it challenging to give the company comfort as to the adequacy of disclosure, given the number of unsophisticated, non-institutional sellers with whom the company will be entering into agreements. As a result, a prudent issuer tender offer conducted by a private company can be comparable in time, expense, and disclosure to the same process conducted by a public company. Even when protective steps are taken, the company is exposed because it has stepped directly into contract with every selling shareholder and is liable for all the representations and warranties or omissions in the transactional documents, and several other potential causes of action that arise by statute.

Execution Risk and Cost

The complexity and demands of a tender offer also present the company with substantial execution challenges. For example, the company conducting the tender offer must explain to some material number of unsophisticated shareholders the tender offer process, and the financial analysis and related support for the related price per share. One or more shareholders may argue that the tender price is insufficient and seek to transact on the secondary market. Frequently, larger holders may also want their individual lawyers to review the tender offer documents and propose changes. Company management will need to lead shareholders through each of these discussions over what is generally a multi-month period.

In addition, because the financing and the tender offer generally will not close simultaneously, the company may bear both substantial price and dilution risk. The company may close the financing but then face a situation in which one or more shareholders elect not to sell at the same price and, therefore, don't participate in the tender offer—perhaps due to a change in the market or new developments with respect to the company. In this event, the company has sold shares with the representation to its board and investors that the proceeds will be used to repurchase shares, so it becomes exposed when it is unable to do so. Shares have been issued diluting existing shareholders, but the company is unable to execute on the promised use of proceeds.

The financing/tender approach also presents the company with significant legal costs. Attorneys' fees for the financing can be considerable, and the legal costs for the tender offer are generally even greater. One private company recently using this approach estimated its total legal bills to be in excess of $150,000.

Lastly, because this approach to shareholder liquidity is not a repeatable process, the company must repeat the entire process at each interval in which it desires to provide shareholders with liquidity.

The SharesPost Process

Using SharesPost as the platform enabling controlled shareholder liquidity provides several advantages over the financing/tender offer approach. Through the SharesPost Private Investor Portal, company-selected buyers are matched directly with selling shareholders. The company uploads summary historical financial information, which is shared only with company-approved buyers and sellers under nondisclosure agreements. Any resulting transactions are priced by buyer and seller negotiating directly and without company involvement. The company can set restrictions on who can buy, who can sell, what percentage of their holdings can be sold, and when. For example, the company can offer liquidity either by permitting transactions that meet the company's parameters to occur on a rolling basis, or by permitting SharesPost to match aggregated buy-and-sell-side interest at a single market clearing price on a quarterly basis. The company is in control at all times, but the work of creating liquidity is done by the SharesPost platform and its transaction specialists.

The process is designed to be securities law compliant, and to reduce the legal risk to the company. SharesPost's prequalification of buyers as accredited investors allows transactions to rely on several exemptions from registration under federal securities laws (assuming that the other requirements are met). SharesPost also restricts access to the SharesPost trading boards to sophisticated, accredited investors who are members of SharesPost and have previously expressed an interest in reviewing materials related to the companies in certain specific sectors. In addition, SharesPost only allows its members to review posts that have been generated after they have filled out the requisite questionnaire and been vetted by a SharesPost broker. These safeguards ensure that a substantial, preexisting relationship exists between SharesPost and prospective buyers and sellers. This relationship and other website restrictions meet the requirements to avoid a "general solicitation" in connection with the SharesPost platform.

As compared to the financing/tender offer approach, the SharesPost process allows companies to be much less central to the transaction activity. Specific advantages over the tender offer rules include:

- The individually negotiated transactions on the SharesPost platform do not trigger the tender offer rules, exempting the company from the extensive regulatory and disclosure burdens associated with executing a tender offer. Because all SharesPost members are sophisticated, accredited investors under Regulation D or Qualified Institutional Buyers (QIBs), companies are generally able to set their own levels of disclosure rather than having one dictated to them by the tender offer rules.

- The transactions can be completed at any time, giving investors and shareholders much greater flexibility.

- Because prices are set through negotiation between buyer and seller and without direct involvement of the issuer, the risks associated with the issuer generating a value for its own stock are avoided. The SharesPost platform in fact creates an independent source of pricing information regarding the company's equity that can help set a market price for future transactions.

- Because SharesPost transaction specialists leverage the platform to facilitate the transactions, most of the work, distractions, and headaches for a company's management is eliminated.

- The SharesPost approach reduces the company's legal liability because the transactions are between sellers and buyers—the issuer never enters into contract with either party.

The SharesPost platform also allows the company to define and control its shareholder base. The company can limit participation to some or all of its existing investors. It may also choose to access additional buy-side interest from the SharesPost investor community. A company can set the selection criteria for which SharesPost members are introduced to the company; in many cases, these members may be less valuation-sensitive than its current investors, will buy common stock, and will actively embrace secondary platforms. Accordingly, they may be a better fit for a long-term liquidity program.

The following chart highlights some of the key points of comparison between the financing/tender offer approach and the use of a SharesPost Private Investor Portal:

	Financing/Tender Offer	**SharesPost Private Investor Portal**
Achieves shareholder liquidity	Yes	Yes
Maintains company privacy and investor selection	Yes	Yes
Burden on management	Substantial; extensive management time required for both financing and tender offer	Minimal; SharesPost Transaction Specialist manages all aspects of liquidity program
Issuance of preferred stock	Yes; frequently a new layer of liquidation preferences and other preferred stock controls imposed	None: no issuance of new company stock, as all transactions are secondary (resales of already-issued shares)
Legal liability	Substantial; company bears liability under tender offer rules as well as under financing and repurchase contracts. Securities laws (e.g., 10b-5) impose another layer of liability on the company .	Significantly reduced; company is not a party to any transaction, and no tender offer occurs, avoiding claims based on tender offer rules, contracts and securities laws generally
Price exposure	Substantial; shareholders not compelled to participate in tender offer	None; company not a party to transactions. Prices set by arm's-length negotiation between buyer and seller
Shareholder experience	Questionable; shareholders forced to take or leave a single, company-determined price	Better; shareholders given comfort of market-determined price
Cost	Substantial; legal fees for financing and tender offer are considerable	None; no charge to company for SharesPost services
Repeatable process	No; company must repeat the entire process at each instance it wishes to provide shareholders	Yes: investor portal remains in place to provide liquidity with whatever frequency is approved

	liquidity	by the company

Conclusion

Issuer tender offers in the private company context, although not as challenging as those conducted by public companies, are still complex transactions with limited flexibility that require significant time and effort. SharesPost provides a flexible, direct, and effective alternative source of liquidity to shareholders.