# *A Guide to Secondary Transactions: Alternative Paths to Liquidity in Private Companies*

*Prepared by Saints Capital with contributions from Wilson Sonsini Goodrich & Rosati.*

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# Overview

The sale of private company shares on the secondary market is becoming increasingly prevalent as the timeline to reach a liquidity event has lengthened over the last decade. In order to proactively manage secondary transactions, the boards, management teams, and investors of these companies need to be aware of the relevant issues, challenges and considerations. Unlike public markets, where information disclosure rules are well established, rights and privileges of existing investors are limited and securities laws are well defined, the world of secondary share sales in private companies is much less understood. While companies and investors are familiar with security transactions involving a primary issuance of shares and are experienced with those dynamics, secondary sales frequently involve a host of different issues. Secondary transactions are often complex in structure, can have securities law implications for companies and participants in the transaction, and regularly involve specific arrangements between buyer and seller.

For secondary transaction participants, relevant considerations include:

- a transaction's implications on the motivations of employees and investors
- enforcement or waiver of the rights and privileges of the company and shareholders (particularly Rights of First Refusal, also referred to as a ROFR)
- implications of the transaction on a company's 409A valuation
- selection of the appropriate buyer and potential new shareholder of the company
- processes allowed by the seller and the company
- legal issues for all parties involved
- information disclosure to a potential secondary buyer.

**What is a secondary sale of shares?**

A secondary sale (also referred to as a direct secondary sale) refers to the buying and selling of an investor's ownership in a privately held, frequently venture-backed or private equity-backed, company. The direct secondary market creates an option for management and investors, especially minority investors, to sell their stock when the entire company is not being sold. Investment stakes can be sold in a single company or across an entire portfolio of companies.

While a robust secondary market for private equity-backed companies has existed for decades, historically, venture capital was too small a segment within the alternative assets class to support a vibrant secondary market. However, over the past decade, there has been significant growth in the amount of money allocated to venture capital investments (from $7.4B in 1995 to $28B in 2008; source: NVCA). This growth in the venture industry has resulted in a striking disparity between venture capital investments and venture-backed company exits: venture capitalists invested in 31,676 deals between 2001 and 2009, but only 3,164, or 10%, of venture backed companies have had exits in that time period (source: NVCA).

**Figure 1: U.S. VC Investments and Liquidity Events 2001-2009**

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| **Number of venture investments** | 4,543 | 3,155 | 2,986 | 3,141 | 3,190 | 3,746 | 4,018 | 4,004 | 2,893 | **31,676** |
| **M&A exits** | 353 | 318 | 291 | 339 | 347 | 363 | 305 | 201 | 244 | **2,761** |
| **IPO exits** | 41 | 22 | 29 | 93 | 56 | 58 | 86 | 6 | 12 | **403** |
| **Total Liquidity Deals** | 394 | 340 | 320 | 432 | 403 | 421 | 391 | 207 | 256 | **3,164** |
| ***as % of total venture investments*** | *8.7%* | *10.8%* | *10.7%* | *13.8%* | *12.6%* | *11.2%* | *9.7%* | *5.2%* | *8.8%* | ***10.0%*** |

Source: NVCA

As a result of this disparity, the direct secondary market has emerged as an alternative liquidity vehicle for investors and founders/employees of venture-backed companies, and it has become an important instrument for investors, companies and employees to address a variety of issues that they face.

While this booklet is specifically targeted towards venture capital-backed companies, many of the issues and dynamics discussed also apply to other private equity investment, such as buyouts and companies without existing professional investors.

## When should someone consider a secondary transaction?

### *Founders and employees*

It should come as no surprise to a founder or employee of a venture-backed company that other shareholders and stakeholders in the company would have concerns regarding the sale of stock by an insider. In public markets, insider buying and selling is closely regulated, tracked and generally seen as an indication of insider concern regarding the company's prospects. It is no different in a private company – and sometimes worse. Since the shares in privately held companies are not actively traded in an open market, the ability for some people to achieve a liquidity event while others (i.e. venture investors) may not be able to do so, can cause some consternation. Furthermore, since management and employees are crucial to the ongoing growth of a company and in achieving a liquidity event, many companies and investors are concerned that allowing employees to sell their shares before an exit event will diminish their motivation. That being said, there are several situations when it is reasonable for employees, management and founders to search for some liquidity through a secondary transaction.

- **Changes in personal financial or family situation** – To the extent that an employee is having a child, has to move to meet the requirements of a growing family, or has financial needs to pay for unexpected health care expenses, parental obligations or tuition, it is entirely reasonable to search for some liquidity from their ownership in a privately held company.

- **Differences of opinion amongst the founders, management and investors on when to sell the company** – The decision to sell a company early versus taking more capital and building the company for long-term success often highlights the risk/return differences between investors and management teams. Allowing some liquidity to founders or early employees can reinvigorate their desire to build the company and aim for a larger exit by relieving some of their financial concerns and providing a capital cushion for their family.

- **Employee departures or changing roles inside a company** – When a founder has been replaced as CEO or an executive's role inside the company has been changed, it is expected that, concurrent with that event, an employee wishes to sell some or all of their stock. In these situations, it is prudent, as part of any termination arrangement, to provide the employee the ability to sell a portion or the entirety of their shares in the company and for the company to cooperate with one or two sophisticated institutional buyers in that process, including waiving any transfer restrictions on the shares (assuming the employee or founder is leaving on good terms).

- **Diversification** – A founder or employee whose net worth is either entirely or significantly held in a single private company and who has worked at the company for several years (i.e., at least four years) has a strong rationale to sell a minority portion of their stock in the company. As long as a meaningful amount of stock is still held by that employee or founder such that their interest are still aligned with the company's goals, providing some liquidity to a long-time employee is entirely appropriate.

- **Tax planning, estate planning or other financial planning needs** – Many early employees who own a substantial number of options may want to exercise those options for tax planning purposes. It is a very sensible request for an employee to ask permission to sell some of their options through a secondary transaction in order to get capital to exercise their remaining options. Similarly, a secondary transaction can help an employee manage the sale of their stock to optimize capital gains tax, AMT laws, or aid in estate planning.

- **Expiring stock options or other stock awards** – Due to the extended liquidity timelines for venture-backed companies, employees frequently find themselves holding stock options or other stock awards that are close to their expiration date. In these situations a company may choose to allow an employee to sell a portion of options on the secondary market to provide capital so that they can exercise their remaining holdings.

### *Venture capital investors*

Just as there are good rationales for founders, employees and management teams to seek liquidity for their stock, there are several compelling reasons for a venture fund to consider a secondary transaction. In general, enabling more capital to be returned to limited partners (LPs) sooner is a good thing for the venture industry as a whole. In particular, it is logical for angel investors and early stage VCs to consider liquidity for some of their older portfolios as those companies mature. Over the past decade, the time to liquidity for venture backed companies has increased dramatically from on average three years in 2000 to over nine years in 2010. Since most venture funds have ten year terms, it is expected that direct secondary transactions will become an increasingly common means of achieving liquidity. Some examples of why a venture investor might consider a secondary transaction include:

- **Return cash to limited partners** – While many venture capitalists view themselves as company builders and take seriously the obligations that they have made to the entrepreneurs and companies in which they invested, venture capital firms have a primary responsibility to their limited partners. In today's challenging economic environment many firms find themselves having not returned capital to their LPs in the seventh or eighth year of a fund. When a firm finds itself in that situation, selling some or all of its holdings to a secondary investor is a sensible way to provide liquidity to their LPs and to ensure continued support for the companies they help start and fund.

- **The firm's expertise is investing in early-stage companies and its value-add is decreasing over time** – Venture capitalists generally acknowledge that some CEOs are better suited for start-ups and other CEOs are more appropriate for mature companies; however, they struggle to accept that some investors are better suited for early stage investments, but inexperienced in managing later stage private companies. While some investors can effectively manage a company over its different stages of development, many others would be better off refocusing their efforts on companies where their skills can provide the greatest value. A secondary transaction can be an effective means for general partners to best match their expertise with the appropriate companies in their portfolio.

- **The fund is over eight years old** – A direct secondary transaction can help facilitate the orderly wind down of a fund that has come to the end of its life. It allows the general partners to provide cash returns to their limited partners, who would otherwise be left holding illiquid assets, and avoids the need for fund extensions or annex funds which frequently come with unattractive terms for the general partners and earlier LPs.

- **Refocus the time and energy of the general partners** – A direct secondary transaction can free up general partners to devote their time and energy to more recent funds and focus on new investments.

- **A portfolio company needs more money and the fund has no more reserves** – In today's environment, venture capital firms frequently find themselves unable to provide necessary follow-on financing to all of their portfolio companies. Particularly in "pay-to-play" situations, a sale to a new investor, with reserves and a willingness to invest in a follow-on round, may maximize the value of the investment for both parties and helps the company raise sufficient capital to accomplish its growth objectives.

- **The partner who made the investment has left and the fund's focus has moved to other industries or sectors** – The venture capital landscape is littered with stranded investments due to changes in fund strategy, industry focus, or partnership dissolutions. A secondary sale of "stranded" investments can often provide attractive returns for those positions that would otherwise wither away unattended.

- **The fund has a different view than the board or management about the direction of the company** – In late-stage companies, when investor syndicates can often be quite large, not everyone will always agree on the future course of the company. In many cases, finding a secondary investor more aligned with the majority view on the direction of the company can be an effective means to resolve those differences while allowing for a graceful exit of an investor that played an important role in the company's early development.

### *Leveraged buyout investors*

While this booklet primarily focuses on topics surrounding secondary transactions in venture capital backed companies, many of the same issues apply to buyout investors. In an economic environment, like today's, where public and strategic exits are more challenging, and investor syndicates have grown quite large, there are several good rationales to have a secondary investor acquire a minority interest in a business. Some examples of why a leveraged-buyout investor might consider a secondary transaction include:

- **A co-investor wants liquidity** – In the early days of leveraged buyouts, deals often involved just one investor who, along with management, owned all of the equity in a company. In the recent past, however, the number of "club" deals has increased considerably. In conjunction with this rise of syndicated deals, the number of co-investors (often limited partners of a fund) in any deal has grown as well. Quite often, investors develop different views about exit timing or company strategy. In addition, the own liquidity needs of co-investors frequently diverge from those of the controlling shareholders. Allowing an exit to a secondary investor in those situations can be an effective way to address these differences of opinion.

- **An equity injection is needed** – In today's challenging economic environment, many leveraged companies find themselves close to or in violation of their debt covenants and in need of an equity cure to help address their credit burden. Frequently, in these circumstances, a co-investor's desire or ability to provide additional equity alongside a sponsor is also challenged. A secondary sale of the co-investment piece to a secondary buyer, who is willing to provide additional follow-on financing, can both protect the position from being wiped out and reduce the funding burden of the sponsor.

- **An investor wants to monetize a portion of its stake without selling the entire company** – While private equity firms commonly sell their portfolio companies to other private equity investors, there are often circumstances where an investor only wants to liquidate a portion of their position. Secondary investors can provide an alternative source of liquidity in these situations. For example, a private equity fund can sell 20% of its ownership stake in one or more companies in their portfolio while maintaining its remaining ownership. A secondary sale not only allows a private equity firm to return capital to its limited partners, but it can often provide a markup on the investment and enable it to reallocate capital to other companies within the portfolio.

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- **After a management change, departing executives seek partial liquidity** – Private equity backed companies regularly change their executive teams – due to performance issues, personal reasons or an executives decision to take another job. In certain situations, it is reasonable to allow a departing executive to sell their shares to a secondary firm. While the sponsor firm may often want to purchase the shares themselves, in some circumstances, such as if the departure is less than friendly or the sponsor fund is already fully invested, allowing a secondary fund to price and purchase the shares for sale makes sense.

- **A private equity firm has outgrown the investment size of their earlier funds** – In recent years, several of the most successful private equity firms have grown substantially in size, and many of these firms have outgrown the size of their earlier equity investments. These older investments, often, still take as much time and attention as the larger deals the firm is currently focused on. In these cases, it makes sense for the fund to sell their smaller, older investments to a secondary firm and allow the investment professionals to focus more time on their larger investments.

### *Company*

Just as employees and investors often have good reasons to consider a secondary transaction, so too do companies. As a company matures, its investor base ages and the company's need for capital and board expertise change. A secondary transaction can help resolve many issues that companies face.

- **Retain and motivate employees** – Recently, there have been several instances of companies that essentially prevented, or strongly discouraged, existing employees from selling any of their shares in a secondary transaction. As a result, in many of those companies, some employees quit in order to sell their shares. The last thing a company wants to do is create an incentive for its best employees to leave so that they can sell their stock. By allowing employees to sell small amounts of vested shares or options in a secondary transaction, a company can empower their employees with the knowledge that they can receive additional compensation beyond their salary and bonus to help relieve the financial pressures they might face. Permitting employees to sell a portion of their shares on the secondary market can become a huge incentive to stay at a more mature firm versus going to a start up.

- **Remove or swap an investor who is not supportive of the current strategy or management** – Dysfunctional board dynamics can inhibit value creation. By replacing an unhappy investor, a secondary transaction can help realign the interests of the investor base and enable the company to execute on it business objectives.

- **Clean up the capitalization table** – In today's venture landscape, there are many misaligned capitalization tables with a long list of tired, early investors. A secondary transaction can help clean up a disorderly capitalization table and provide a refreshed investor base for the company. In addition, a secondary sale can help a company manage its number of shareholders. By acquiring several smaller shareholder positions, a secondary investor can help a company avoid public reporting requirements by keeping their shareholder base bellow the maximum number allowed for a private company.

- **Realign investor interests** – In today's environment of prolonged exit timelines, companies can frequently find themselves in situations where their investors have misaligned interests and investment goals. By providing liquidity to earlier investors, a direct secondary transaction can help a company realign its investor base with an agreed upon exit timing and path.

- **Assist in follow-on financings** – Today, many companies find themselves in the unfortunate situation of having investors who, although supportive of the company, are unable to provide the necessary follow-on financing needed to sustain growth and development. A secondary transaction can not only provide some liquidity to those investors, but it can also provide the company with the necessary funding to reach its next important milestones.

## Types of secondary buyers in the market

There are six major types of active participants in the direct secondary market:

- **Existing investors or the company**
  Existing investors in a company or the company itself can repurchase shares from employees or other investors. For companies with substantial excess cash (ideally due to cash generation from operations), it may make sense for the company itself to acquire shares from employees or investors, similarly to the way public companies conduct share buybacks. However, if the company is burning cash or saving cash for acquisitions, this option may not be appropriate. Sometimes, existing investors may wish to increase their stake in a company. If the company is unlikely to need further capital (therefore reserves at the fund level are not needed) and the inside investor is prepared to pay a reasonable price, they can often be a good buyer of shares. However, since the mandate of the primary investor fund is to provide capital for growth and other corporate purposes, the potential for significant secondary stake liquidation is often limited. Further, an additional investment in secondary shares may limit the investor's appetite in the future for growth capital or acquisition funding.

- **A primary investor**
  Many primary venture capital firms have struggled to provide attractive returns and meaningful liquidity to their investors and as a result have considered or began to explore secondary transactions. In addition, some investors may have tried to participate in a primary round with a company but lost out to another firm, and as an alternative route, they may consider investing through a secondary opportunity. However, since many primary firms do not want to buy common or junior preferred stock, the number of primary firms actively pursuing secondary deals is limited.

- **Fund-less sponsors**
  Fund-less sponsors are participants in the secondary market who aim to identify shareholders seeking liquidity and negotiate a transaction with them. However, instead of financing the deals from an existing fund, the financial backing is arranged on a deal-by-deal basis. These agents or firms usually get compensated with a fee for their intermediary services and/or receive profit sharing after the eventual sale of the stake that was acquired with their help. Sometimes funds will be formed by boutique banks that raise money from a small group of wealthy investors with a mandate to buy shares in one company. It is frequently the case that fund-less sponsors will provide an offer or letter-of-intent and use that agreement to raise money from a third party to consummate a transaction; however, the transactions often fail to close if these groups cannot raise the promised capital.

- **Secondary exchanges**
  Thanks in part to some highly publicized transactions in 2010 (e.g., Facebook, Zynga, LinkedIn, and Twitter), secondary exchanges have become well known as an avenue where private stocks can change hands. Examples of these exchanges are SecondMarket, NYPEXX, and Sharespost. However, these exchanges are limited in their ability to provide information about the underlying companies and frequently charge additional fees associated with the transaction. In addition, secondary exchanges tend to focus only on a few highly publicized, "popular" companies. Transactions in these companies are executed

more on public perception rather than investing fundamentals, leaving a significant number of valuable, privately held companies without access to liquidity on the secondary market. Secondary exchanges are a great platform for smaller transactions when, for example, $100,000 worth of shares need to be sold and the diligence requirements of the buyer are minimal. In situations where larger stakes need to find a buyer or the company is looking for someone who can also participate in follow-on financings, these platforms are not the ideal place to unite buyers and sellers as most buyers on these exchanges are wealthy individuals and small institutions.

- **Megabuyers**
  A small group of players across the globe have been making the headlines with large direct or secondary investments in promising internet companies. These include Digital Sky Technologies from Russia who has spent $800 million buying Facebook shares from employees; Elevation Partners, a US private equity firm; and Tiger Global Management, a US-based hedge fund. Similarly to the secondary exchanges, these funds tend to focus only on a few relatively mature companies, and are not interested in purchasing shares in the vast majority of venture-backed companies. For a select group of companies, typically those that can transact at valuations well in excess of $1 billion, these buyers can have attractive attributes – the ability to write large checks, to provide some primary capital, and often to pay premium prices.

- **Secondary funds**
  Broadly speaking, there are two types of secondary funds: direct secondary funds and indirect secondary funds. Direct secondary funds are investment firms with dedicated capital whose sole mandate is to provide liquidity to sellers of private company shares. These firms engage not only with individual shareholders of a given company, but they will also acquire complete portfolios from venture firms, corporations or family offices. Direct secondary funds assume ownership of the companies themselves and often times become active managers of these assets (in some cases in partnership with the existing fund GPs). Indirect secondary funds, on the other hand, buy limited partnership (LP) interests in other investment funds and basically replace current investors in a *fund*. They hold these stakes until the private equity fund sells their portfolio companies and distributes the capital. Indirect secondary investors typically do not have any direct involvement in the management or oversight of the underlying companies. A small number of indirect secondary funds will do select direct secondary transactions, but it is not a core part of their business.

## What to look for in a secondary partner

Like in any private company transaction, working with the right partner in a secondary transaction can not only improve the likelihood of a satisfactory transaction for the seller, but also bring added benefits to the company itself. Working with investors that have experience in secondary transactions, are knowledgeable about venture capital investing, and understand the company and its industry are paramount. When deciding on a partner for a secondary transaction, there are several factors that a potential seller should consider:

- **Reputation within the investor community**
  Working with an investor that already has strong relationships within the venture capital community, and particularly with the existing investors and management team, can significantly improve the chances for a successful transaction. Most venture investors feel more comfortable working with experienced institutional investors with whom they have worked before or who have a track record of successful investing and management. Working with a "known" investor will facilitate the due diligence process and will increase the seller's chances of receiving attractive pricing.

- **Sector expertise**
  Just as when selecting a primary investor, it is often best to have shareholders who understand your industry – they tend to be better investors, more constructive and more appreciative of the challenges that a company may face. Furthermore, working with secondary investors that are knowledgeable about a company's particular industry allows for a more efficient due diligence process, greater appreciation for the company's operations, and, potentially, a better chance of receiving the highest price.

- **Transaction experience**
  Direct secondary transactions can be, and often are, far more complex than primary investments. They involve three parties at a minimum (and sometimes more) - the seller, the company and the buyer - whereas most primary transactions are just between two parties. Most direct secondary transactions necessitate the waiving of rights or privileges by the company and existing investors, the executing of a stock transfer agreement with the company, and the adoption and adherence to existing operative documents by the new investor. In addition, many secondary transactions include complex structures, such as tiered payouts, that enable the seller to get the best pricing for their assets. It is important to work with secondary investors that understand all of the different structuring options, including their liability and tax ramifications. Lastly, there may be issues regarding security laws. In short, experience matters – both experience of the buyer and the attorneys involved.

- **Dedicated capital and ability to close the transaction**
  Surprisingly, many sellers rarely investigate in detail whether or not a buyer actually has the capital necessary to execute a transaction. Groups that have no dedicated capital may appear to be institutional investors when in fact they are not, and some institutional investors will need to raise funds in order to consummate the contemplated transaction. Working with investors that already have funds on hand increases the likelihood of the transaction closing and reduces the risk of future pricing renegotiation.

- **Potential to execute sizeable transactions**
  When contemplating a larger transaction, it is important to work with investors who have the experience and the ability to execute on sizable deals. Working with secondary funds that have dedicated capital and close relationships with other large secondary investors, with whom they can partner on a deal, will increase the likelihood of a satisfactory transaction for the seller.

- **Ability to support the company going forward**
  While providing liquidity to investors and employees is the primary goal of a direct secondary transaction, some sellers – and all companies – also want to ensure that the buyer will continue to support the investment and has additional capital reserves to invest more money if warranted. Special purpose funds, small investors and some secondary funds may not have reserves in place to support follow-on investments. A seller and the company should always ask the prospective acquirer of secondary shares about their willingness to do follow-on investments and their reserves for the transaction.

- **Long-term relationships**
  While historically secondary transactions have been one-time events, the prolonged drought in private company exits and the maturation of the secondary direct industry have initiated a shift in thinking amongst companies and investors about how they view secondary transactions. Increasingly, venture-backed companies and their investors have come to view secondary sales as less of a "point-in-time" event, and instead they want the flexibility to do more secondary transactions at a later date depending upon how the exit environment evolves. Deciding that you want the flexibility to have an investor with the ability and desire to do more than one transaction may change your choice of buyer.

- **Ability to manage confidential information**
  Private companies and their investors are rightfully concerned about information being shared with external parties. The company may inadvertently share information with competitors if proprietary information is shared via exchanges or by brokers with little discretion as to information dissemination. Yet, without sharing information, valuations will be depressed. The ideal is to share a significant amount of information, but only with a select group of investors highly likely to make a full and fair offer. These investors ought to have extensive experience in managing confidential information with the utmost care under non-disclosure agreements so the seller and company can trust that no information will get into unwanted hands.

- **Lack of fees**
  Some potential purchasers (especially secondary exchanges and fund-less agents) charge additional transaction fees to the seller; whereas most institutional investors do not. Understanding the fee implications is important in the overall pricing consideration. Furthermore, many companies have begun charging transfer fees to cover the legal cost associated with these transactions. Sellers should be familiar with the agreement that designate who bears transfer costs.

**Table 1: Summary comparison of the six types of secondary buyers**

| | Experience in secondary transactions and flexibility to achieve best price | Dedicated capital for secondary transactions and ability to close | Capital for additional secondary sales in the same company and for follow-on investments |
|---|---|---|---|
| **Existing investors & company** | • Limited experience with complex secondaries<br>• Flexibility and customization with secondary sellers is not a top priority | • Limited capital for secondaries as it is not their core mandate<br>• Strong ability to close due to familiarity with company and shareholders | • Primary source of follow-on capital but sometimes limited by the age of their fund<br>• Additional secondary sales are not a priority |
| **Exchanges** | • Deep transactions experience<br>• Not a conducive platform for customization | • No dedicated capital but a meeting place of buyers and sellers<br>• Ability to close is dependent on supply/demand | • Potential for finding additional buyers but follow-on capability is questionable |
| **Megabuyers** | • Strong experience with a limited set of companies<br>• Ability to pay high price for a select group of targets | • Large pool of dedicated capital<br>• High probability of closing within target group | • Large capital pool allows for continued buying<br>• Follow-on investments are possible |
| **Direct secondary funds** | • Extensive experience in secondary transactions as it is the core competency<br>• Considerable flexibility in structuring for best price | • Dedicated capital pools, experience with structured deals, and extensive industry expertise allow for high closing rates | • Active participants in follow-on investments<br>• Desire to purchase additional secondary shares in target companies |
| **Fund-less agents** | • Good experience in secondaries but the real buyer's capabilities (the source of capital) are unknown | • No dedicated capital, funding raised on deal by deal basis<br>• Ability to close is lowest within buyer universe | • Unclear until the actual source of capital is identified and secured |
| **Primary investors** | • Limited experience with complexities of secondary sales<br>• Flexibility and customization with secondary sellers is not a top priority | • Limited capital for secondaries as it is not their core mandate<br>• Average ability to close<br>• Less familiarity with challenges of complex secondary transactions | • Primary source of follow-on capital but additional secondary are not be a priority in most cases |

## Process alternatives for a secondary transaction

There are several processes alternatives a company or investor might consider in connection with the sale secondary interests. Each of those processes has pros and cons and some are better suited to certain types of companies. In addition, the pricing dynamics are different in each scenario.

- **Sell shares on a secondary exchange like Sharespost, Second Markets or NYPPE**
  Selling shares on a secondary exchange can result in a high price if the shares are from a large, well known company like Facebook, Twitter, Zynga, LinkedIn, etc. Secondary transactions of these companies represent a huge majority of all trades on these exchanges. These types of transactions are great for employees who own a very small numbers of shares and prices tend to be high. However, outside of those types of transactions, very few other companies' shares trade on the secondary exchanges, and when they do, it is typically not at attractive valuations. In addition, these sales are often not controlled by the company which existing investors and boards tend to dislike since they are unable to have any discretion over the choice of the new investor.

- **Complete a primary round of financing through a preferred stock issuance and use some or all of the proceeds to purchase common shares**
  This form of secondary transaction can also provide a very high price to a seller because the buyer can provide better pricing as they are purchasing a preferred security. Since the new securities have liquidation preferences and often come with a variety of rights and privileges superior to those of a common stock holder, the valuation can be maximized. However, these types of transactions also have negative ramifications for existing investors and the common shareholders as additional liquidation preference is added to the capital structure, thereby reducing the value of the existing preferred securities and common shares. In addition, company stock repurchases may raise additional issues in relation to corporate and contract laws.

- **Have the existing investors make an offer**
  There are many benefits to having an existing investor provide liquidity. They know the company so there is often no required diligence and issues regarding rights of first refusal are frequently less relevant. However, existing investors can be quite conservative in their valuation particularly if they perceive little or no outside competition. Existing investors also think that their ROFR rights provide a significant deterrent to outside investors, so they often have little incentive to pay a full price. Lastly, many of them may need to hold their capital for reserves against future financing rounds, limiting their willingness to invest meaningful amounts of money.

- **Sell to a primary investor who missed out or was the "cover bidder" on the last round of financing**
  Clearly an investor who provided a term sheet but was not selected or who got a smaller allocation than it wanted in the last round often can be quite aggressive in valuing securities being sold on a secondary basis. While many venture firms may not be interested in common shares, some will consider it and if they have already done a great deal of diligence they can be a good choice for a purchaser of securities.

- **Hire a banker or broker to run a "mini-auction" for the secondary shares**
  While this approach to a secondary sale can result in attractive valuations in certain circumstances, it can also result in a significant burden being placed on company. In most cases the company will need to cooperate to maximize value as the buyers will want to review financials, projections and spend time with management. Since there is often little benefit for the company, the willingness of management to spend time with multiple buyers is limited and, in our experience, these efforts frequently fail. Many secondary firms refuse to participate in these processes unless they are limited, thereby reducing the benefits of a broad auction. In addition, engaging a broker, even if they are acting on behalf of the seller, can result in unexpected legal issues for the company (see *Important Legal Considerations* section). Further, a broker will often include unfunded sponsors in the auction process who will eventually have to convince a funding sponsor to provide the capital. Because fund-less sponsors have to raise capital after agreeing on the terms of the deal, the close rate of deals with these types of investors is often low. Lastly, since fund-less sponsors need to share information with potential funding sources to complete these deals, there is a significant potential to jeopardize the confidential information of the company.

- **Approach a couple of the established secondary firms and determine their interest level**
  Secondary firms tend to be conservative by nature so valuations tend to be lower than that offered by "retail" investors, but they have some advantages as well. They provide a high degree of confidence of closing, they have extensive experience in doing these types of transactions, they are likely to be flexible on structure and economic sharing arrangements, and they are often well-known and accepted by the existing investors.

## The pricing of a secondary transaction

In addition to the financial performance of the company and macro industry trends, pricing is highly dependent on the type of securities being sold, the information that is shared with the potential buyer and the process in general.

**Type of Security:** The better the terms associated with the security for sale, the higher the price it will receive in a secondary transaction. A senior security in a company's capitalization structure will always price higher than a junior security. Common securities, on the other hand, with few rights and privileges are likely to sell for a lesser amount. When selling junior securities, the value of the preference ahead of the security relative to the value of the company is an important factor that is considered when pricing those shares. For example, if the last round of financing was at a $50 million valuation and there is total preference of $40 million, the value of the common relative to the preferred stock is much lower than if the value of the company was $500 million with $40 million of preference.

**Information Disclosure:** More information disclosure will likely result in a higher price for the seller. In some transactions, no information is shared, and most professional investors will discount the price greatly when key items like financial performance and projections are withheld. Further, if the management team is not willing to meet with the prospective investor, valuation is also likely to be depressed. Yet, most sophisticated secondary investors are also realistic and do not expect that companies will widely disclose extensive amounts of proprietary information. It is entirely appropriate that the company and its board of directors limit what information can be disclosed and to whom. However, we believe that disclosure of information to a limited group of professional investors is a reasonable and fair request, and it is an effective way to ensure that a suitable investor joins the existing syndicate. Key pieces of information that will be needed to properly value the assets for sale include:

- Recent company capitalization table
- Corporate documents (charter, bylaws, and investment agreements)
- Historical and projected financials of the company
- Investor presentation
- Recent board presentations and/or minutes

**Process:** Most sellers incorrectly believe that shopping the deal broadly will increase the number of potentially interested parties and therefore increase the price. Given the large number of potential secondary transactions that are on the market today and that there is a limited group of investors focused on these types of transactions, broad auctions of secondary stakes often end up having very few sophisticated investors participating. Further, since the number of participants and the information disclosed is often inversely correlated, a larger buyer set may be allowed less access to information and to management resulting in larger discounts.

Understanding how the terms associated with the securities being sold, the amount of information that is disclosed and the sales process influence a secondary buyer's behavior are crucial in understanding how a secondary transaction will be priced. Some frequently asked questions regarding pricing include:

***Do I have to be prepared to sell my stock on the cheap?***

No. Secondary buyers take a market value approach, not a simple discount to "carrying" value or the last round price, when valuing a security that is for sale. Senior investment professionals at these firms all have extensive financial, industry and operational experience, which enables them to value securities through sophisticated processes. In addition, deals may involve upside sharing mechanisms, earn-outs and ratchets that work to make valuation more fluid, and eliminate inefficiencies that are sometimes brought about through simple point-pricing.

***Shouldn't the price for my common be the same as the last round?***

The price of any stock depends on many factors. Private, venture-backed companies typically have one or several classes of preferred stock in addition to common stock. Such preferred stock carries with it rights and privileges not typically afforded to common stock. For example, a preferred stock will likely have liquidation preference rights that give it a senior claim to any proceeds distributed to shareholders upon a liquidation or change of control. Common shares, without such preferences, will not receive any proceeds from such liquidation or change of control until the liquidation preference provisions of the preferred stock are met. In some cases, this may ultimately render the common stock worthless. That said, there can be other cases where a common share is worth the same as or more than a preferred share particularly if the last round was done several years earlier and the company has grown meaningfully. Secondary firms advise sellers against simply assuming that the price of a common share today is equal to the last round price. Instead, secondary firms take a market value-based approach to pricing any given equity security taking into account the terms associated with the security, information that they are provided, and dynamics of the sale process.

***Why isn't the price for my common shares the same as the 409A valuation of the company?***

A company's 409A valuation is one data point in the valuation process, but there are many factors that can cause the current valuation to be higher or lower than the last 409A price. In most dynamically changing industries, a material event, either positive or negative, can happen between the last 409A valuation and a secondary sale that dramatically affects the valuation of the company. In addition, secondary buyers have to weigh several other considerations when they value a seller's shares, such as the need for future financings and the potential future dilution, differences in opinion as to the appropriate timing and magnitude of a liquidity event, as well as their own cost of capital and target returns profile. Finally, 409A valuations are typically determined by independent valuation firms based on a host of financial analyses. Secondary buyers may have valuation procedures and sensitivities for deploying their own capital that are very different from the analyses provided by a professional valuation firm.

***What if there are valuation disagreements?***

While price is a major factor in crafting shareholder liquidity deals, it is not always the only one. Creative financing structures have been executed in special situations where a single point-price could not be agreed upon by both parties. For example, a buyer may offer an upside-sharing mechanism whereby the seller gets some cash up-front, but then splits the future proceeds with the buyer, after the buyer has obtained a reasonable return, if the company does well. A secondary buyer's goal is to work with the seller and tailor a transaction that meets their needs under any circumstance.

***What if the company won't cooperate? What are my rights to information and what can I share?***

Understandably, many companies and their board of directors are reluctant to disclose significant amounts of proprietary information during the initial evaluation of a secondary sale. However, there is a substantial amount of information that is publically available that can be helpful in pricing a security that is for sale. The articles/certificate of incorporation is a public document that can always be shared, and it provides a substantial amount of information about a company's capital structure that is helpful in pricing. A seller can also share any legal documents that they have signed as long as the document does not explicitly prohibit them from doing so. Discussing information that is already in the public domain, such as customers listed on a company's website and new product announcements mentioned in press releases is also allowed. In addition, executing proper nondisclosure agreements with a potential seller can allow sharing of certain information that will facilitate a sale. As a final resort, under Delaware law an existing stockholder has a right to inspect the books and records of a company and possibly under the investment documents applicable to a company. While a company may challenge this right, the stockholder does have the right to certain information for a proper purpose under most laws.

***How do tax considerations enter into the decision on pricing and transaction structure?***

Sellers are concerned with (1) gains qualifying as ordinary income which is taxed at the marginal rate or capital gains which is currently taxed at 15% and (2) the timing of tax payments they have to make (i.e. now or later). In order to qualify for long-term capital gains tax, a seller needs to have held the stock they are selling for at least one year. In case of option exercise, it is the holding period of the stock after the option has been exercised that counts and not how long ago the option was granted. Secondary buyers provide considerable flexibility in structuring transactions in order to optimize the seller's tax obligations and achieve the best economic outcome. Solutions include profit sharing arrangements where proceeds to seller get paid over time; "loan for share" structures if the seller is exercising options and has not held shares for a year; or collared loans which do not qualify as a constructive sale.

## Possible transaction structures

While structuring a deal can be seen as an unnecessarily complex addition to a transaction, it can effectively allow the bridging of valuation gaps that may arise from information asymmetries or diverging economic outlooks on a business' potential. Below is an overview of different ways to structure secondary transactions, including some creative solutions that make it possible to find a common ground between sellers and buyers.

- **Via primary senior preferred stock issuance by company**
  The company raises primary capital (i.e., the cash goes to the company coffers instead of directly to the sellers) from new or existing investors in exchange for senior preferred shares. Then some (or all) of the money raised this way is used to outright purchase the shares from the seller. Effectively the company reduces the number of outstanding common shares but increases the amount of preferred shares.

- **Via junior preferred stock issuance by company**
  A secondary transaction can also be executed through a junior preferred investment into the company. Similarly to a secondary investment via a senior preferred investment, the company raises capital from new or existing investors and this is used to repurchase the shares from the seller; however, by investing through a junior security the existing investors can maintain their senior liquidation preferences and other important protective provisions.

- **Outright purchase**
  In this very clean scenario, a secondary buyer pays the entire purchase price upfront in cash to the seller in exchange for the particular class of stock being sold. Only the name of the shareholders change, similar to when shares are bought on a public stock exchange, with no economic involvement of the company.

- **Upside sharing / escrowed shares**
  In an upside sharing structure, the buyer acquires the seller's shares for a set price and agrees to split the investment proceeds from those shares with the seller above certain, pre-determined valuation targets. The concept of escrowed shares is similar. In an escrow agreement, the seller places some of the shares that they did not sell in a separate account as a form of collateral in case a minimum return threshold for the purchased securities is not met. For example, the seller sells 100 shares to buyer and places 100 shares in escrow (i.e. they cannot sell these shares until the company is liquidated), with maximum release subject to meeting an agreed upon threshold. The seller promises to give anywhere between 0 and 100 shares to the buyer as a form of an earn-out, depending on the exit of the company, to provide buyer with a minimum return.

- **Loan for shares**
  Under certain transfer restrictions, one potential solution is that the secondary buyer provides a loan in the amount of the price of the shares, and in return the seller pledges those shares to the buyer as collateral. Upon a liquidation event of the company, the seller receives the cash and uses it as repayment of the loan with a certain return embedded. This structure can be used when the company or the existing investors have a right of first refusal or co-sale rights; receiving a loan will not qualify as a sale of the shares, therefore the transfer restrictions will not get triggered. A loan can also be done so as to avoid taxes on

sale or to have a staged sale over time. In loan structures, there are requirements for some downside risk and/or upside economics to insure there has not been a constructive sale, but they can be done in order to defer taxes to the future.

- **Loan for options exercise**
  Before owning shares, sellers may need cash to pay the exercise price of their options and this, too, can be facilitated by a secondary buyer. In return for the cash provided, seller delivers the negotiated amount of shares after the exercise of the options.

**Table 2: Overview of possible secondary transactions structures**

| | Pros | Cons |
|---|---|---|
| **Primary senior preferred stock issuance by company** | • Typically provides the highest price<br>• Allows the company to control selection of new investor<br>• Allows for rights and privileges to be easily conveyed to the buyer<br>• Makes deal possible where new investor cannot get comfortable with owning common shares | • Lengthier process with company involvement<br>• Additional liquidation preference not favorable to junior and common holders<br>• Requires the company to make reps and warranties<br>• Requires complete disclosure |
| **Junior preferred stock issuance by company** | • Allows existing investors to retain senior preferences and protective provisions<br>• Allows the company to have some control over the new investor<br>• Allows for rights and privileges to be easily conveyed to the buyer<br>• Makes deal possible where new investor cannot get comfortable with owning common shares | • Can be a lengthier process with company involvement<br>• Additional liquidation preference not favorable to other common holders<br>• Requires company cooperation and requires the company to make representations and warranties<br>• Requires complete disclosure |
| **Outright purchase** | • Simple, clean structure<br>• Does not change existing capital structure<br>• Usually quick to complete<br>• Can be completed with less information disclosure | • ROFR and co-sale rights might be exercised and hamper transaction<br>• Usually provides the lowest price |
| **Upside sharing / escrowed shares** | • Flexible, allows for bridging valuation gaps and information asymmetries<br>• Can minimize taxes<br>• Allows for higher pricing than outright common purchase<br>• Can be structured to provide win-win economics | • In some structures, seller retains some downside risk<br>• Escrowed shares reduce liquidity options for seller before exit<br>• Added complexity<br>• Upside share must be tracked and reported |
| **Loan for shares** | • Potentially avoids ROFR process<br>• Does not affect capitalization table<br>• Can defer income taxes<br>• Highest reward (although highest risk) | • May not be viewed favorably by existing investors<br>• Additional complexity<br>• Must be structured to avoid constructive sale<br>• May be prohibited by documents<br>• Will likely require additional personal guarantees or additional collateral |
| **Collared loans** | • Can defer income taxes<br>• Potentially avoids ROFR process<br>• Does not affect capitalization table<br>• Limited downside risk with some upside potential | • Complexity<br>• May not be viewed favorably by existing investors<br>• May be prohibited by the documents<br>• Must be structured carefully to avoid constructive sale |



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## Important considerations for the company and its board of directors

### *Legal considerations*

There are several important legal considerations that a seller and company need to be aware of when considering a secondary transaction. Some of the most common issues include:

***How do stock transfer restrictions affect a secondary sale?***
Private company stock is typically subject to transfer restrictions which are designed to allow the company and its investors a measure of control over its stockholder base. The two most common transfer restrictions are the right of first refusal (ROFR) and right of co-sale (Co-Sale). The ROFR provision gives the company, and sometimes its major investors, the right to match or counter any offer for the shares of the company from an outside investor, and it is designed to keep the ownership of the company from straying afield from its original investor base. The Co-Sale condition gives major investors the right to sell their shares in the same proportions and for the same terms as other shareholders should they receive an offer. The ROFR and Co-sale provisions are typically contained in the investment documents or bylaws of a company, and sometimes in the charter/certificate of incorporation.

In order to comply with these contractual transfer restrictions, the seller is typically obligated to provide a notice to the company and the major stockholders informing them of the price and terms on which the secondary purchase is proposed to occur. After such notice, there will be some time period, typically 10-30 days, in which first the company and then the major investors have a right to buy the shares from the proposed seller. If the right of first refusal is not exercised by the company and the major investors and there is a Co-Sale provision, the major investors will have an additional period of time to exercise a co-sale right in which they will sell to the secondary buyer their shares of stock on the same terms as the seller was proposing to sell such stock.

Both the right of first refusal and the co-sale right can act to frustrate the intent of a secondary transaction. The ROFR provision can prevent the buyer from acquiring the entire number of shares it wants, and the Co-Sale right can thwart a seller from selling all of the shares that they would like. However, there are several ways for the seller and buyer to work together to limit the potential impact of these transaction restriction on a secondary sale. The simplest way to manage transfer restriction is to ask for an upfront waiver of those rights from the company and major investors. In our experience, many companies and investors are willing to waive those rights, particularly if the secondary transaction brings additional benefits to them such as providing additional follow-on capital to the company or if the transaction resolves issues amongst the investor base. A structured transaction, such as an upside share agreement where the seller does not receive all of their potential proceeds at the closing of a transaction, can act as a deterrent to the exercise of transfer restriction. In addition, secondary buyers have employed loan structures to avoid triggering the ROFR and Co-Sale provisions. Lastly, working with secondary investors that have experience in managing the ROFR and Co-Sale processes and who are well known by the existing investors can also lessen their impact.

***Are other contractual obligations associated with the shares for sale important to a secondary buyer?***

A seller's stock also frequently have other important contractual rights such as registration rights and preemptive rights, which are of interest to many, if not all, secondary buyers. These rights are typically transferable under the investor agreements governing the stock. In addition, a secondary buyer typically will require a separate transfer agreement with the company and the seller, which states that all parties agree that the buyer will gain those rights in the transaction. Occasionally there are certain provisions that the company and preferred investors do not wish to be transferred to a secondary buyer. Oftentimes secondary buyers are willing to forego specific rights, but it can result in different pricing for the seller.

***Are direct secondary sales impacted by the transfer limitations on restricted stock in the Securities Act?***

Because a secondary transaction often involves the transfer of restricted securities, it is important in ensure that a secondary transaction is not viewed as a company-sponsored underwriting and, therefore, does not trigger any registration requirements under federal or state securities laws. There are several legal exemptions to the federal Securities Act that allow for secondary transactions to occur without running afoul of the law.

- **Sale to a sophisticated accredited investor** – Generally, under the Securities Act, a private company may issue new shares to an accredited investor without being subject to the registration requirements under Section 4(2) of the Securities Act. An accredited investor is basically an individual or an institution that has a lot of money and the financial wherewithal to invest in risky, unregistered securities. Similarly, a secondary transaction between a seller and an accredited investor is also not subject to registration requirement, as long as it follows the same procedures that apply in the Section 4(2) (a legal concept which is sometimes referred to as "a Section 4(1 ½) transaction"). In addition, Rule 501 of Regulation D allows for the resale of restricted securities if they are sold to an accredited investor. Most institutional secondary buyers are considered accredited investors and have no issue making representations to the seller and company to that fact.

- **Rule 144** – Rule 144 allows public resale of restricted and control securities if certain conditions are met. The specific conditions that must be met under Rule 144 will depend on whether or not the seller is considered an affiliate of the company (broadly defined as a person that controls or is controlled by, or is under common control with, the company). CEOs, senior executive officers and board members are typically considered "affiliates" of companies for this purpose. In general, for a transaction to qualify for exemption under Rule 144, the following conditions must be met:

    - **Holding period** – Before someone can sell restricted securities in the marketplace, they must hold them for a certain period of time. For non-affiliates the required holding period for restricted share in a venture-backed private company is one year. This one year holding period condition applies only to the shares for sale. If a seller has purchased additional securities in the company at some time period after they purchased the securities they are trying sell, the holding period of those securities does not affect the holding period requirements of the securities for sale. In the case of a stock option, the holding period begins as of the date the option is exercised and not the date it is granted (unless the stock option has a net exercise feature, in which case the holding period begins on the date of grant of the stock option).

- **Adequate current information** – The buyer must receive adequate current information about the issuer of the securities before the sale can be made. This generally means that the issuer has complied with the periodic financial reporting requirements that most venture-backed companies already provide to their investors.

In summary, the simplest way for a seller and the company to avoid violating the legal restrictions of transferring restricted stock in a secondary transaction is to work with established secondary firms who are viewed by the SEC as accredited investors.

### *Does a secondary sale constitute a tender offer?*

A secondary sale is typically not considered a tender offer. Under the federal Exchange Act, a tender offer is defined as a broad solicitation by a company or a third party to purchase a substantial percentage of a company's registered shares, whether the company is publically traded or privately held. Compliance with the tender offer rules for a private company entails additional regulatory requirements and expenses, including a 20 business day offer period for the subject shares, which a company would normally like to avoid. While there are several tests for whether a particular transaction will constitute a tender offer, the two important factors which generally exclude secondary transactions from being considered one are 1) whether there is an active and wide-spread solicitation of a broad base of the company's shareholders and 2) whether the solicitation is for a substantial percentage of the company's outstanding shares. Since most secondary transactions are between a single or limited number of sellers, typically do not involve any form of public solicitation, and are for smaller ownership stake in the company, they are often not considered tender offers. While there are no specific rules defining what is considered a tender offer, a company can avoid a secondary transaction being considered a tender offer by limiting the number of sellers to less than 10-15 people at any one time and by working with a few established secondary investors who are considered accredited investors by the SEC.

### *How much information should the company share with potential secondary buyers?*

Understandably, many companies are reluctant to share their confidential information with outside investors considering a secondary transaction, particularly when there is still considerable uncertainty around whether the transaction will even occur. On the other hand, companies also want to ensure that the buyer can bring the most benefits to them and that the seller can get the best pricing possible for their shares.

A common solution to these concerns is for the company and seller to offer a staged release of information to the potential buyers. Most secondary buyers can indicate an initial level of interest in a transaction with very basic information such as the company's capital structure, the shares for sale and a basic description of the company's business plan and development status – most of which is publically available information. Once a potential buyer has indicated a sufficient level of interest in the transaction, they will be willing to sign a confidentiality agreement with the company, at which point the company can share a more substantial amount of information.

***Is the company liable for information that is shared as part of a secondary transaction?***
A company's level of liability for information that is shared during a secondary transaction, in part, depends on the how the transaction is structured. In the case where an investor purchases new preferred securities in the company and the company uses those proceeds to buy other, existing shares in the company, the company will make the standard representations and warranties associated with the sale of the preferred stock. In the case where the company is not a direct party to the transaction, but only providing helpful information and facilitating the stock transfer on its share registry, secondary buyers are often willing to state in the stock purchase agreement that the company was not directly involved in the transaction and therefore does not carry any liability for any information provided.

It is best practice during the negotiation of a secondary transaction for the company to execute a nondisclosure agreement with the potential purchaser. The company should also be selective as to how many prospective purchasers it shares information with, and it should insure that the potential purchaser is a sophisticated institutional investor. Further, if a transaction is consummated, the company should insist that the new investor sign and acknowledge that the information provided was done as a convenience for a third party, the selling stockholder, and request that the buyer indemnify the company from any claim arising from the accuracy or incompleteness of the information provided. The law is ambiguous as to whether the provision of information creates what is called a Rule 10b-5 liability obligation from the company to the purchaser, but by structuring a transaction to involve only sophisticated investors and following the above recommendations, a company can minimize any such potential risks.

***What are the legal implications of involving a broker in a secondary transaction?***
Under the federal laws and the laws of certain states, like California, if brokers are involved and the brokers are not registered, sales to, or purchases from, an unlicensed broker may lead to rescission rights or damages against the unlicensed broker and, arguably, against the company. In undertaking secondary transactions, a seller must take extra precaution if a broker is involved to ensure that the broker is in fact registered and in compliance with the applicable laws.

### *Considerations for the board of directors*

In addition to the legal considerations, there are several issues that the board of directors must consider when a company is involved in a potential secondary transaction. Some of the most common concerns are the following:

***Will a secondary transaction have an impact on the company's 409A valuation?***
A frequent question associated with a secondary transaction is how the sale will impact the value of the company's securities for 409A purposes and the company's ability to offer low-priced options to its employees. To date, the valuation firms have maintained that secondary sales are just one data point they look at in the 409A appraisal process along with other valuation methods such as public comparables and discounted cash flow (DCF) analysis. The circumstances surrounding a secondary transaction are important factors that valuation firms must consider when deciding how much weight to place on a secondary sale in determining its impact of 409A valuations. There are several aspects of a secondary transaction that are considered when determining its impact on a company's 409A valuation.

- **Seller and buyer motivation**
  There are frequently extenuating circumstances surrounding a secondary transaction that mitigate its impact on a company's 409A valuation. For example, a seller may be facing external financial difficulties that make them willing to take a lower-than-fair market price. On the other hand, a purchaser may be willing to pay a premium to gain access to a privately held stock that they would not otherwise have. Because of these mitigating circumstances, the actuaries frequently conclude that the secondary transaction does not fit the definition of an efficient market transaction and minimize its impact on a company's 409A valuation.

- **Similarity of securities sold**
  Secondary transactions often involve granting the buyer additional rights and preferences which a common shareholder does not typically have. For example, if preferred stock was sold in the transaction, those preferred shares frequently include liquidation preferences, voting rights and information privileges that are not granted to common shareholders. To date, the valuation firms have considered those differences from common shares to be material, and as a result minimize the transaction's effect on the 409A valuation.

- **Type of transaction**
  Certain types of secondary transactions can have a greater or lesser impact on a company's 409A valuation. For example, if a secondary transaction is executed through an initial purchase of preferred shares with the company then repurchasing common shares with the proceeds, the valuation firms are likely to place more weight on the price paid for the common shares in their 409A assessment. On the other hand, if a secondary sale is affected without the direct involvement of the company it is less likely to impact its 409 valuation.

- **Transaction volume**
  Valuation firms also consider the size of a transaction when determining its impact on a company's 409A valuation. Actuaries consider such factors as the number of shares traded, the percentage of fully diluted ownership sold and the dollar amount exchanged. Transactions for a small number of shares, and particularly for small ownership percentages, typically have minimal or no impact on a company's 409A valuation. While there is no fixed

rule for what size a secondary transaction must be before it impacts a company's 409A valuation, most actuaries place less emphasis on a secondary transaction that is for less than 10% of a company's fully diluted shares.

- **Information asymmetry**
  Secondary transactions frequently occur where the buyer has only limited access to company information, and as a result their impact on the company's 409A valuation tends to be minimized.

- **Proximity of timing**
  Actuaries must also consider material events that may have occurred since the execution of a secondary sale. When a secondary transaction occurs a substantial time before such events, its impact on the company's 409A valuation is minimal.

- **Deal structure**
  Valuation firms also take into consideration whether a secondary transaction involved just the exchange of cash for the securities or whether it included additional pricing provisions such as an upside share arrangement or share escrow. Structured transactions tend to have less of an impact on a company's 409A valuation.

***How can I eliminate or reduce the impact of a secondary share sale on 409A valuation?***
First, the best thing to do is to have the buyer and seller enter into a confidentiality agreement. If such an agreement is in place, even if the seller is an executive of the company, the details of the secondary transaction do not need to be (and cannot be) disclosed to the valuation firm. If there are ROFR and Co-Sale provisions that require the transaction be disclosed to the company, we would advise the company agree to waive its right of first refusal in advance of the deal in which case the company would, again, not be required to disclose the valuation.

While there are no set rules on how to minimize a secondary transactions impact on a company's 409A valuation, if price must be disclosed, certain types of deals are less likely to have an effect. A secondary sale is less likely to change a company's 409A valuation if:

- it is for smaller volumes of shares (<10%)
- the company is not directly involved in repurchasing the shares (such as through a preferred investment in the company)
- the seller or buyer can demonstrate extenuating circumstances to the sale (for example, a unique financial situations for the seller or if only one buyer was allowed to enter into negotiations for the purchase)
- the transaction involves structured pricing mechanisms such as an upside share or escrow
- the initial transaction is done through a loan structure instead of an outright purchase.

***Are there situations when a company should discourage secondary transactions?***
Yes. Boards of directors may wish to impose black-out periods on sales of employee stock during certain periods of time – particularly during periods where the company is fundraising or executing or discussing material transactions. Depending upon the maturity of the company, it may also be prudent to black out trading around quarter or year end. These guidelines need not

be as stringent as public companies but are good business practice and prevent incentives from becoming misaligned between the company and its employees.

***Is it possible to do a secondary transaction during the S-1 registration period?***

Recently, several founders and long-time employees of venture-backed companies have sold a portion of their shares on the secondary market immediately before or even after the company has filed their Registration Statements on Form S-1 with the SEC for proposed initial public offerings. While many underwriters have understandable concerns about allowing a secondary transaction to occur during the registration period, there are certain circumstances where they have been permitted. In most cases, the company had been on file for some time, but it was determined to be unlikely to issue in the near future. In those situations, the underwriters allowed a few of the long-time employees to get some partial liquidity on a small portion of their shares. When a secondary transaction occurs during the registration period, underwriters typically require that the buyers agree to certain restriction on their shares which most sophisticated secondary investors are willing to do. Typically, the company will also have to file an amendment to their Form S-1 disclosing relevant information about the secondary transaction, for example, if the secondary sale was made by an executive officer or director.

***How do we minimize the potential distraction on the company that a secondary transaction can cause?***

Companies and their board of directors are commonly concerned that a secondary transaction will incur unwanted demands and distractions on the management team when it is focused on executing the company's business goals. Companies and their boards can best minimize these interruptions by working with a limited number of experienced secondary investors whose transaction experience and valuation expertise can significantly reduce the burden put on the company and its management team. While it may seem appealing, from a process perspective, to have an unsophisticated investor (or groups of investors) execute a secondary transaction with little information disclosure and minimal company interaction, there are often significantly long-term negative consequences. For example, working with less experienced investors can prove particularly challenging if the company underperforms or experiences other setbacks.

***How do we maintain employee motivation and insure retention in conjunction with a secondary sale?***

Companies are frequently apprehensive that their employees' interests will no longer be aligned with those of the company and its investors if they sell their shares on the secondary market, and that they will become a flight risk. This is an appropriate concern. Yet, in today's challenging economic environment, many companies have found that allowing employees to sell part of their shares in a secondary transaction can be an effective retention tool by easing some of their employees' financial burdens and ultimately leading to a more productive work environment. In these situations, the board needs to balance the shareholder's right to sell their stock with the company's long term objectives of high employee motivation and retention. We suggest that the company consider a secondary program for their employees where the company will waive its ROFR rights and agree to share detailed company information with secondary buyers, if:

- employees agree to sell no more than 10-25% of their vested or owned position

- only employees who have been at the company at least four years are allowed to participate in a secondary transaction
- information is shared with only one or two credible financial investors acceptable to the board and who agree to adhere to the board's guidelines
- the company will prevent the disclosure of information and exercise its ROFR privileges, if their guidelines are not followed.

***How can a company prevent secondary transactions from increasing their shareholder base above the point where they are considered a public entity?***

When a company reaches more that 500 shareholders the SEC considers the company a de facto public company. A secondary transaction, particularly the sale of employee and founder common shares on a secondary exchange, frequently raises the concern that the company will surpass the 500 shareholder limit and subject the company to the registration requirements of a publically traded firm. Executing a transaction with a single investor who is willing to buy from a group of small investors so as to minimize the number of investors can be effective means to control the number of shareholders in a privately held company.

***Does the company have any influence over who acquires their shares on the secondary market?***

While it is well accepted that a company and its board should be selective in choosing a new primary investor - often considering price, terms, experience, reputation, and the investor's desire for involvement in the governance of the company - many boards do very little to control or select a secondary investor. While it may not be much of a concern if the stake to be purchased is small, it should be an important consideration if the secondary buyer will have a meaningful voting position amongst the shareholders or if they will play role as a board member or observer. If a company does not properly manage the secondary process, they can find themselves in the unenviable position where there are more secondary investors than primary investors amongst the shareholder base and the interests of the earlier investors and the company's board are not aligned with those of the secondary buyers. A further consideration for the board when it is considering a secondary transaction is the behavior of secondary investors after an IPO. Some secondary investors may have the intension to sell immediately, obviously creating downward pressure on the public stock while others desire a longer holding period and longer-term exit plan.

We suggest boards take a more active role in selecting secondary investors. While they may not have specific rights to control the process, they do have discretion as to how much information and how much management access to provide. Outright denying information and access to potential secondary investors removes any control that the company can exercise over the process and can result in new investors who know very little about the company, its strategy and objectives. On the other hand, a company can exert considerable influence on the selection of a secondary buyer by managing to whom and how information is shared.

***If I am on the board of directors, can I buy from a shareholder given that I may have more information that isn't or shouldn't be disclosed?***

For an insider with a seat on the board, care must be taken when purchasing shares from a third party that is not privy to important, material information about the company. In particular, if a board member is aware of potential material events that are reasonably likely to occur at the company, they place themselves at significant risk of lawsuit or claims by a seller if they purchase the seller's shares and some good news subsequently emerges. Generally, in those situations, it is appropriate for a company to institute a black-out period and prudent for a board member, or any other knowledgeable insider, to not purchase shares from third party outsiders. However, if there is no probability of material events occurring, an insider with a seat on the board may proceed with the secondary transaction and obtain a "big boy" letter from the seller, disclosing that the insider may have material information that he cannot, in the exercise of his fiduciary duties to the company, share with the seller, and that such information may lead to a significant benefit to the purchaser as a result of the transaction. While by no means perfect, this "big boy" letter helps provide disclosure to the seller and an acknowledgement of the dynamics that exist between the sophisticated buyer and seller transacting on an arm's length basis. If the seller is not a sophisticated institutional investor, it would also be prudent to have the seller advised by a professional broker or advisor.

***I am on the board of directors and approached by a potential purchaser of secondary shares in a company that I am on the board of or an investor in – what information can I or should I share?***

While subject to fiduciary duties and contractual confidentiality provisions, investors and board members discuss, in general terms, the performance of their companies all the time with other professional investors whom they trust. Most professional investors understand that violating the trust of other investors is a sure way to insure no one will ever talk to you again. That said, it is appropriate for a board member or investor to ask if a nondisclosure agreement has been put in place between the company and a potential purchaser in connection with a proposed secondary transaction. The director should ask about the nature of the secondary purchase and insure that it is consistent with insuring the ongoing motivation of the employees and in line with the goals and objectives of the company. Further, the type and amount of information shared should depend upon whether the board member would be open and willing to have the potential investor as a fellow stockholder in the company. Asking questions as to the experience of the investor, its committed capital and references is entirely appropriate. Asking about investments in competing companies is in many cases necessary as some companies impose transfer restrictions that will not allow competitors or those connected to competitors to become their stockholders. In short, with a nondisclosure agreement in place, if a board member is comfortable that the potential new investor will adhere to the process guidelines outlined by the company, and they believe that the investor would benefit the company overall, sharing information and discussing the outlook for the company is entirely reasonable. Discussions between existing and potential investors do not create Rule 10b-5-type liability issues any more than would be the case if a company was raising money, and they can provide the prospective new investor with a better sense of the likely direction of the company going forward before making its investment decision.

***What other issues should I be concerned with if I am on the board of directors and I am approached by potential purchaser of secondary shares?***

When a member of the board of directors is approached about a potential secondary purchase, they should be mindful of their fiduciary duties to the company and its stockholders, including the potential seller. The director must follow their duties of care and loyalty to the company, including not engaging in a situation that could be viewed to be beneficial to the director at the cost of the company and its other stockholders. In addition, under the corporate opportunity doctrine, when a director is approached with a potential purchase opportunity, they need to consider if they should offer the opportunity first to the company. When a company has a ROFR provision in place, this concern is less important. In general, given the different facts and circumstances that surround a secondary sale, it is best practice for the director to confer with the company's counsel to ensure that they are well informed of their fiduciary duties in relation to the proposed sale.

## Case studies

**Case 1: Employee liquidity in a well known, mature, privately held company**
**Seller:** Current or former employee
**Company:** Internet company with significant revenues
**Shares for sale (ownership):** Common shares or options (<1%)
**Information disclosure:** None

It is becoming increasingly common that employees in certain well-publicized privately held companies are interested in getting some personal liquidity by selling some or all of their shares on the secondary market. These transactions usually entail a relatively small number of shares, and there is already considerable information about the company in the public domain. In these situations, it is often in the seller's best interest to trade their shares on a secondary exchange which will typically result in better pricing. For a select number of well known companies, there is a substantial buyer base that will purchase the securities without significant information requirements.

The company and/or existing investors are another possible avenue for sellers in these situations; however, they are likely to be more price sensitive than buyers on the secondary exchanges. In addition, existing investors are sometimes limited in how much capital they can invest in one of their portfolio companies, which will hamper their ability to participate in a secondary transaction.

These situations are less suitable for institutional secondary firms for a number of reasons. First, the size of these transactions tends to be small and below minimum investment thresholds for most secondary firms. The lack of information disclosure from the company also makes it difficult for secondary firms to value the securities for sale.

| | Pros | Cons |
|---|---|---|
| **Secondary Exchange** | • Typically will provide the highest price<br>• Limited information disclosure requirements | • Limited to only a small number of well-known private companies<br>• Company has no control over or input in the process<br>• Seller will have to pay deal fees |
| **Company or Existing Investors** | • Already knowledgeable about company<br>• Does not alter the investor base<br>• Does not require release of confidential information to outsiders | • Likely to receive lower pricing<br>• Secondary transactions are not their primary focus<br>• Limited capital available for secondary transactions |
| **Secondary Funds** | • Experienced in secondary transactions | • Likely to receive lower pricing<br>• Can be a lengthier process with company involvement<br>• Deal size may be below their investment threshold |

**Case 2: Employee liquidity in an earlier stage, less mature private company**

**Seller:** Founder
**Company:** Pre-commercial venture-backed medical device company with FDA-approved product
**Shares for sale (ownership):** Common shares or options (3-5%)
**Information disclosure:** Yes

Similar to case 1, employees in many venture-backed companies are interested in achieving some liquidity for their shares. In these circumstances, where the company is less well known by the public and/or less mature, a secondary exchange is not the best solution because there are not enough buyers on the exchanges to facilitate a transaction and the information limitations of the exchanges hinder their ability to generate interest.

The company and its existing investors could be possible buyers of secondary shares in these cases. However, they are often reluctant to do secondary transactions in companies at this stage given their potential future capital needs.

In these situations, it is often in the seller's best interest to approach a select number of institutional secondary buyers about their interest in a transaction. As mentioned above, when selecting which secondary institutions to approach it is important for the seller to consider the buyers knowledge about the industry sector, transaction experience, whether the buyer has capital to purchase their shares and the buyer's ability to close on a transaction in a reasonable timeframe.

| | Pros | Cons |
|---|---|---|
| **Secondary Exchange** | • Possibility to get higher prices<br>• Limited involvement required from the company | • High likelihood of transaction not closing because of limited number of buyers<br>• Company has no control over or input in the process<br>• Seller will have to pay transaction fee |
| **Company or Existing Investors** | • Already knowledgeable about company<br>• Does not alter the investor base<br>• Does not require release of confidential information to outsiders | • Likely to receive lower pricing<br>• Secondary transactions are not their primary focus<br>• Limited capital available for secondary transactions |
| **Secondary Funds** | • Experienced in secondary transactions<br>• Have investment professionals that are knowledgeable about the industry sector<br>• Ability to do structured transaction | • Can be a lengthier process that requires company involvement |

**Case 3: Sale of an institutional investor's position in a portfolio company that has additional follow-on requirements**

**Seller:** Venture capital firm
**Company:** Commercial-stage software company raising a $15 million insider bridge note to fund to profitability
**Shares for sale (ownership):** Preferred shares (10-20%) with board seat
**Information disclosure:** Yes

In today's economic environment, many venture capital firms find themselves unable to support all of their portfolio companies' financial needs. A secondary sale of their position in those companies is often a better alternative to suffering from "pay-to-play" provisions and significant dilution of their holdings. It is in the seller's best interest, in these situations, to approach a select number of institutional secondary buyers about a transaction, especially when the securities for sale have board rights associated with them. In choosing which firms to approach, it is important to consider the experience and capital base of the firms. In addition, it is imperative to work with firms that have previous experience working on boards and with other institutional investors. Working with institutional secondary investors with dedicated capital, knowledge of the specific industry sector and sufficient transaction experience will ensure a better outcome for the seller.

Secondary exchanges are unlikely to be helpful in these situations since most of the investors on those exchanges are unable or unwilling to provide follow-on capital. The company and insider investors are also unlikely to be interested in these types of secondary transactions given the additional capital needs of the company.

| | Pros | Cons |
|---|---|---|
| **Secondary Exchange** | • None | • Unlikely to transact given the stage of the company<br>• Unable to provide follow-on capital |
| **Company or Existing Investors** | • Already knowledgeable about company | • Unlikely to be interested in a secondary transaction given the additional capital needs of the company |
| **Secondary Funds** | • Experienced in secondary transactions<br>• Ability to provide follow-on capital<br>• Investment professionals at the secondary firms can bring additional expertise to the company and its board | • Will be a lengthier process<br>• Will require company involvement and disclosure of confidential information |

**Case 4: Partial employee liquidity in a pre-IPO company**

**Seller:** Founder
**Company:** Commercial-stage software company planning to file their S-1
**Shares for sale (ownership):** Common shares (5-10%)
**Information disclosure:** Yes

A recent trend in the secondary market is for founders and employees who own a significant portion of a pre-IPO company to seek liquidity for a portion of their shares. Understandably, in these cases many underwriters are uncomfortable about the potential implications that a secondary sale could have on a registration. However, there are select situations where they have allowed a secondary transaction.

It is in the seller's best interest, in these situations, to only approach a select number of institutional secondary buyers about a transaction. In choosing which firms to approach, it is important to not only consider the track record and capital base of the firm, but also their experience in working with underwriters in these types of transactions.

Inside investor could be a potential source of liquidity in these cases; however, both the inside investors and the underwriters are typically uncomfortable with how an inside transaction could effect the pricing of the eventual IPO.

A secondary exchange's inability to manage confidential information makes them an unsuitable approach for a secondary sale in these situations.

| | Pros | Cons |
|---|---|---|
| **Secondary Exchange** | • None | • Significant issues with information disclosure<br>• Incapable of addressing underwriter's restrictions |
| **Company or Existing Investors** | • Already knowledgeable about company<br>• No due diligence | • Typically do not have sufficient capital to cover all of the liquidity demands<br>• Potential implications on eventual pricing of the IPO |
| **Secondary Funds** | • Experienced in secondary transactions and in working with underwriters<br>• Have sufficient capital to close a transaction<br>• Capable of managing confidential information | • Will be a lengthier process<br>• Will require company involvement and disclosure of confidential information |

If you have any questions or would like to know more about finding liquidity for private company shares, please feel free to contact Saints Capital:


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