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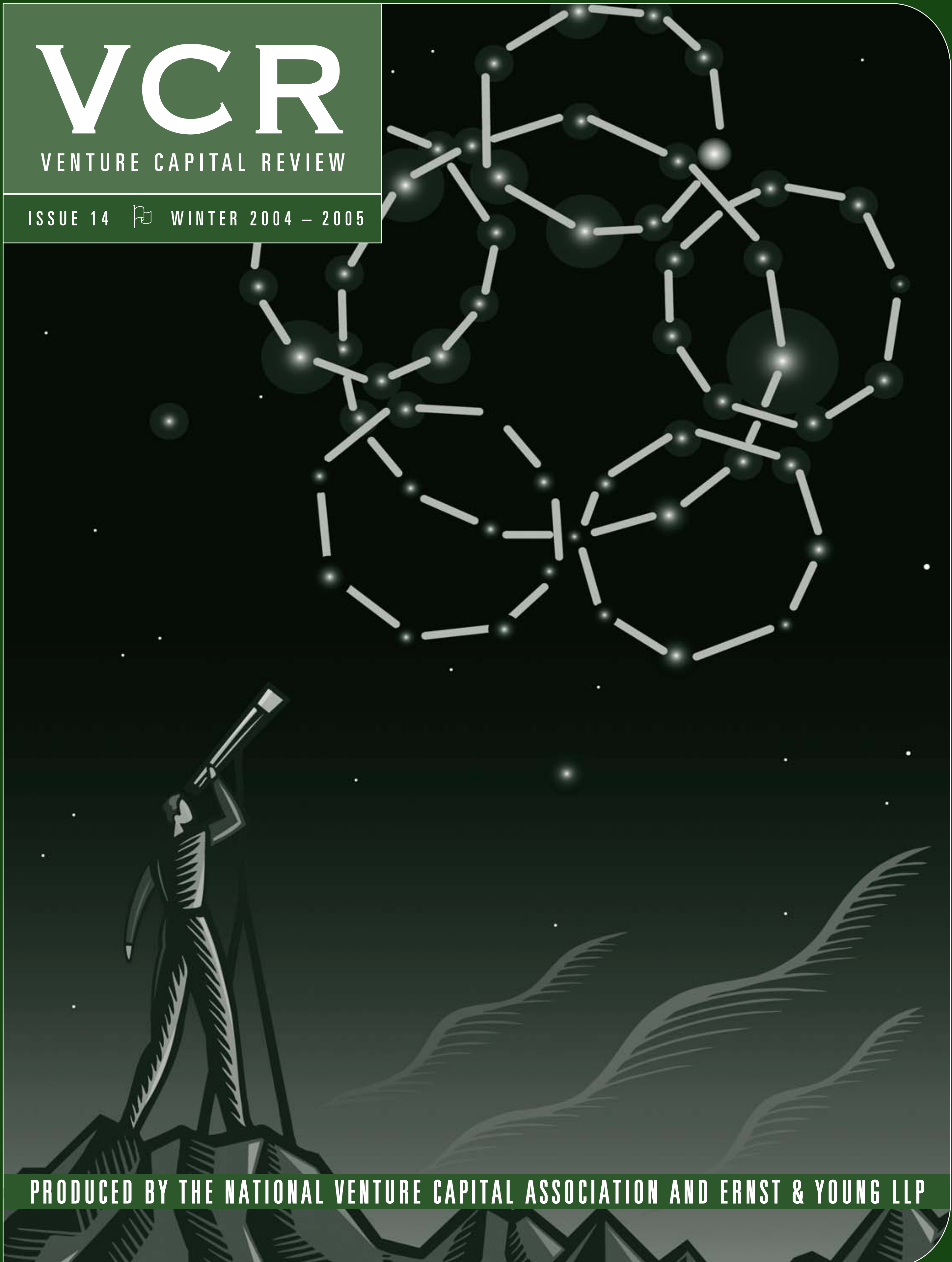

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Liquidity Alternatives

For Venture Capital and Private Equity Investors In Thinly Traded Public Companies

By Mark B. Tresnowski
and
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As the public equity markets show signs of becoming more accommodating to new issues, venture capital and private equity funds ("VCs") are once again preparing portfolio companies for initial public offerings with the hope of gaining the liquidity offered by publicly traded stock. The initial public offering boom of the late 90's, however, demonstrated in an often painful way that taking a portfolio company public does not necessarily create a clear path to liquidity. Although it is considered bad taste to bring up in polite conversation, countless VC professionals can testify to the billions of dollars of paper profits never realized due in part to the difficulty of selling stock of thinly traded public portfolio companies.

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The fundamental challenge in achieving liquidity for the public portfolio company stock is that virtually any liquidity event, short of a complete sale of the company, can be expected to adversely affect the market price of a thinly traded stock. This has implications for the selling funds to be sure as they may be forced to accept a price below the prevailing market price (which many VCs use to value their investment in reports to limited partners), but it is also a critical issue for investors in funds who are not selling, for public stockholders and for management. Managing the liquidation of private equity investments in the public market is not only a complex and risky undertaking from a legal perspective, involving intricate securities law and other legal issues, but also gives rise to difficult relationship issues among a company's key constituents. These issues have become even more challenging with the growing trend of "club deals" where several unrelated VCs jointly sponsor a portfolio company.

In this article, we will examine the liquidity alternatives for VCs holding stock in thinly traded public companies. While we will focus on practical considerations and planning techniques, each situation is unique and deserves comprehensive consideration by legal counsel experienced in these matters. After a brief discussion of registration rights, this article will address the following liquidity alternatives:

- Selling in the Initial Public Offering
- Selling in a Subsequent Underwritten Secondary Offering
- Selling in a Registered Block Trade
- Selling under Rule 144
- Making an In-Kind Distribution to Limited Partners
- Selling in a Private Resale Transaction
- Selling the Company
- Transferring the Risk of the Shares Through Hedging Transactions

Setting the Stage — Registration Rights

The liquidity planning process for any portfolio company starts with the initial investment and the negotiation of registration rights. These standard rights, frequently embodied in a separate agreement, deserve careful consideration because they often form the basis for the liquidity discussions that occur down the road. It is tempting to give registration rights much less attention than other investment terms because, by definition, they may never come into play and, even if they do, practical considerations often supersede the negotiated rights. The reality is that a VC can have extensive registration rights, but if the market is not receptive to an offering or if the company's management is opposed to it, these rights alone will probably not bring about the liquidity event. They do, however, set forth many key terms and conditions that will bear on any registered sale of a VCs equity. While a detailed discussion of registration rights is beyond the scope of this article, the registration issues addressed generally include (a) the rights of investors to "piggyback" on or be included in the portfolio company's registered stock sales, including the initial public offering; (b) the rights of investors to demand their own registered stock sales; (c) the priorities among investors, the company and management in the event of an "underwriters cutback" on the number of shares that can be included in a registered sale; (d) indemnification for potential securities law liabilities; (e) the period during which the company and its investors agree to "holdback" their shares (i.e., not sell them) after any registered offering; and (f) responsibilities for the various costs of a registration.

Selling in the Initial Public Offering

Generally, the initial public offering is simply the first step to achieving liquidity for a portfolio company's shares. The offering will usually consist solely of "primary" shares, or shares sold by the company. The threshold question is whether the offering can include a "secondary" component, in which the VCs can sell some of their shares in the initial public offering. In most cases, the answer will be "no" because the company must use the entire offering to raise capital to fund expansion and/or because the underwriters advise that the perception of equity sponsors bailing out is simply too negative to overcome when trying to introduce a new public issuer. This standard answer, however, should not go unchallenged. Certainly it is easier to sell an offering when the equity sponsors show their confidence in the company by remaining invested, but the potential negative effect of including a secondary component in the offering should be weighed against the negative effect of a large private stock overhang. The equity markets and institutional public equity funds have become increasingly sophisticated and focused on the reality that VC funds will seek liquidity for their investment. Putting that liquidity date off to some date in the future is not really a solution to the problem. Indeed, it may exacerbate the problem. Everyone knows the VC will want to get out of the investment. The question that remains unanswered in an all primary offering is "when?". It is for this reason that the financial press widely publicizes the expiration of "lock up" agreements under which private investors agree with the underwriters to not sell their shares for a specified period. In an efficient market, one presumes that stock prices reflect the private stock overhang of a thinly traded public company and the eventual expiration of the lock up agreements.

In our experience, while 180-day lock-ups are still the norm, underwriters are often willing to consider creative lock-up arrangements where staggered expirations and other creative solutions can be implemented. In the right circumstances, it may be possible to trade off inclusion of some VC shares in the initial public offering or a shorter lock-up for a portion of the VC's shares in exchange for a longer lock-up period covering some or all of the remaining VC shares. For example, the recent Google IPO included a staggered lock-up period. It is also possible to explore creative alternatives to including a secondary component in the offering. One such creative alternative is to do a "synthetic secondary" or "midnight dividend," in which the company declares a dividend immediately prior to the offering, payable from the proceeds of the offering. The benefits of this approach are primarily optical rather than economic. Like including a secondary component in the offering, it results in offering proceeds going to existing investors rather than the company. This approach may also have tax benefits to the VC fund and certain administrative benefits to the offering process.

Once a VC's shares are included in the initial public offering (or, for that matter, any registered public offering), the VC takes on direct responsibility for the company's disclosures in the prospectus as sellers under Section 12 of the Securities Act of 1933 (the "Securities Act"). This is in addition to liability that the VCs may already have as directors under Section 12, and potentially as persons who control the portfolio company under Section 15 of the Securities Act. Section 12 liability can be mitigated if the VC can establish a due diligence defense and Section 15 liability can be as well if the VC can establish that it did not know or have reasonable grounds to believe that there was a material misstatement or omission in the disclosure document. Thus, whether or not they are selling in the offering, VCs should conduct their own due diligence to protect against any potential liability and should take part in the preparation of the disclosure document, both directly and through legal counsel.

For VCs who will continue to have one or more directors serving on the company's board or otherwise will continue to have access to material non-public information, engagement in this process and selling through a registered offering can have its advantages. By definition, sales made in a registered public offering are (or at least should be) made on a "fully-disclosed" basis. A registered offering typically brings together experienced securities lawyers for all parties, accountants versed in securities law requirements, underwriters, senior management and other professionals, all of whom are trying to make sure that the company disclosures are in compliance with the securities laws. Assuming a robust process, the registration statement should contain all disclosure necessary for sale without liability. This can give the selling VC great comfort, particularly in contrast to the VC selling outside of the registered offering context, as in some of the alternatives discussed below. When selling outside of a registered public offering, the VC and its professionals will have to take steps to make sure that all material non-public information is disclosed prior to any sale without the benefit of the "full court press" on disclosure issues typical of an underwritten offering.

Selling in a Subsequent Underwritten Secondary Offering

Like the initial public offering, subsequent underwritten public offerings take a significant amount of time and effort. The process of drafting the registration statement and prospectus is often similar and the liability standards are the same. If the portfolio company has sufficient public market float, has satisfied all of its SEC reporting requirements in a timely manner and has been public for at least 12 months, it should be able to use a Form S-3 registration statement, an abbreviated registration statement that, among other things, allows the company to incorporate its periodic reports (Forms 10-K, 10-Q and 8-K) by reference into the registration statement. While the use of a Form S-3 registration statement is helpful, the real time saving element is that the company has, by definition, already gone through the initial public offering process and established a process for routinely updating its public disclosure. This is not to say that the management time and commitment is not extensive in these offerings. Underwriters will often want to add a keener marketing focus to the disclosure and want management to participate in road shows and investor meetings. This can be time consuming, but should not be considered wasted effort by company management or remaining stockholders, as the marketing process (if successful) will improve the company's profile on Wall Street and provide benefits beyond the confines of the particular offering.

Perhaps the greatest challenge of the subsequent underwritten secondary offering is that it is done entirely in the eye of the public market, in the face of an uncertain impact on the prevailing stock price. Great care is taken to predict the market reaction and the likely selling price, taking into account current market conditions, company performance and the fact that significant additional shares are going to hit the market as the equity sponsors reduce or eliminate their holdings in the company, but this is art more than science. Once the registration statement is filed and the selling shareholders are identified, it is difficult to turn back without at least some damage to the company's reputation in the marketplace. Thus, an offering should not be considered unless there is a clear demand for more public stock. One practical approach to determining the extent of market demand when VCs propose to piggyback on a primary offering (i.e., on offering by the company of its own stock to raise new capital) is to file the registration statement only as a primary offering and then add in the secondary offering element, disclosing the potential sales by the VCs, after the registration statement is on file, giving the company, the underwriters and the VCs an opportunity to at least judge the market's reaction to additional primary shares hitting the market. You generally cannot, however, wait until after the marketing of the offering to add the secondary shares because, depending on the number of shares added, this would most likely give rise to a need to recirculate the preliminary prospectus and delay the pricing of the transaction.

Selling in Registered Block Trades

Another approach is to sell blocks of the VC's stock in a registered offering targeted to a relatively few institutional purchasers. To deliver these buyers freely tradable shares, the company would file a registration statement for a secondary sale of shares that, unlike the typical shelf registration statement with its broad plan of distribution section, would disclose that the offering will be directed solely to institutional investors who want to purchase shares from the sellers in one or more block transactions. The reason for limiting the plan of distribution in this manner would be to give the market comfort that it would not be flooded with an ongoing stream of resale shares. The sale would not be underwritten, there would be no traditional road show and the selling effort would be directed to a few targeted institutional investors. The registration statement itself, presumably on Form S-3, would also be much less of a selling document given the narrow scope of the sales efforts and the sophistication of the targeted buyers. The disclosure obligations are just as rigorous as in any registered offering, however, and the liability potential for VCs selling under the registration statement is the same as those discussed above for other registered offerings. There is also some risk that the SEC would view this approach as a "registered private placement" and refuse the registration. To minimize this risk, no potential purchasers should be contacted prior to filing the registration statement.

The primary advantage of this approach is that it can permit relatively quick sales of stock and yet avoid the limitations of Rule 144 discussed below. For example, in a registered block trade there are no volume limitations and no prohibition on soliciting buyers. But like all registered offerings, the sale would be announced in advance through the filing of a registration statement. As such, the sale price will take into account the market impact of more shares being added to the public float and of the equity sponsors' reducing their holdings.

Selling under Rule 144

Generally. Rule 144 provides an exemption to the registration requirements of the Securities Act for certain sales of securities. To understand the basic framework of Rule 144, you must divide the universe of company stockholders into "affiliates" and "non-affiliates" and the universe of company shares into "restricted securities" and "unrestricted securities." To further understand Rule 144, you must realize that the Securities Act requires the registration of "transactions," not "securities." Thus, it is each sale, when it is made and by whom, that must be analyzed, not simply whether the security is "registered"; indeed, while there are "restricted" securities under the Securities Act, there is no such thing as a "registered" security.

The first inquiry under Rule 144 is whether the transaction at issue is the sale of a "restricted security." Securities acquired directly from the issuer or from an "affiliate" of the issuer in a transaction that has not been registered with the SEC are considered to be "restricted securities." All other securities are considered to be unrestricted securities. Securities acquired from a portfolio company as part of the initial unregistered investment transaction are invariably restricted securities.

The second inquiry under Rule 144 is whether the proposed seller is an "affiliate" of the issuer. The determination of whether a stockholder is an affiliate can be quite complex but the general rule of thumb is that a director, officer or 10% owner or an owner that has board representation will be an affiliate. Technically, an affiliate is defined as a person that "controls" the issuer. This is a misleading term. Better to think of it as a person that has "influence" over the issuer. This is most obvious when considering a 10% holder, who would clearly not control the issuer, but would likely have significant influence, especially if there is no other concentrated ownership.

Restricted securities, whether held by an affiliate or a non-affiliate, can only be sold or transferred in a registered offering or in conformity with Rule 144. The same rule applies to unrestricted securities held by an affiliate. A non-affiliate can freely resell unrestricted securities. There are other exemptions from the registration requirements of the Securities Act, but they are far less commonly used and, therefore, not discussed in this article.

Under Rule 144, all sales of restricted securities must meet the following conditions:

(i) **Volume Restriction.** The amount of the restricted securities sold, together with all other sales made in the same 90-day period, may not exceed the greater of (x) 1% of the company's outstanding stock and (y) the average weekly trading volume during the four preceding weeks;

(ii) **Manner of Sale.** The sale must generally be a normal unsolicited sale made through a broker;

(iii) **Notice.** A properly completed Form 144 must be delivered to the SEC concurrently with the placing of a sell order for the stock;

(iv) **Adequate Public Information.** The company must generally have filed all of its required reports with the SEC during the 12 months preceding the sale; and

(v) **Holding Period.** The holder must have held the securities for at least one year prior to the proposed sale to sell subject to the volume limits, and, for non-affiliates, two years to sell without any limit.

The chart below illustrates the general application of Rule 144 to unregistered sales.

Certain of the Rule 144 conditions can be serious impediments to the VC seeking liquidity. We will discuss each of these in more detail below.

The Holding Period Requirement. Rule 144 is not available for restricted stock until after the initial one-year holding period has been satisfied. Thus, a VC desiring liquidity in the first year after its investment will have to find an approach other than Rule 144. After the

	RESTRICTED SECURITIES	UNRESTRICTED SECURITIES
AFFILIATE	Must comply with requirements (i) through (v) above for the life of the investment.	Must comply with requirements (i) through (iv) above (no holding period required).
NON-AFFILIATE	Must comply with requirements (i) through (v) above until the end of the two-year holding period.	Rule 144 does not apply.

expiration of a two-year holding period, non-affiliates can freely sell restricted stock without regard to any of the other Rule 144 conditions. This important exemption is referred to as the "Rule 144(k)" exemption because that is the section of the rule that enables it. If a VC is looking to achieve liquidity as the second anniversary of the investment approaches, consideration should be given to resigning board positions and taking other steps to terminate affiliate status. Affiliate status must be terminated for at least three months before the Rule 144(k) exemption can be used.

The Notice Requirement. Any stockholder relying on Rule 144 (other than Rule 144(k)) must transmit a Form 144 for filing with the SEC before a sale under this rule may be consummated unless the sale, together with other sales during the three preceding months, are for less than 500 shares or $10,000, in which case the form need not be filed. A Form 144 provides notice that the filing person has a bona fide intent to sell the shares within a "reasonable time" after the filing (but filing the form does not obligate the holder to sell during that period or at all). This "reasonable time" period is generally interpreted to mean within the three-month period after the filing. A Form 144 filing is a public filing and can be accomplished either electronically or by a paper filing. The filing can obviously have an immediate impact on the prevailing stock price as the market incorporates the possible additional selling pressure on the stock. To avoid absorbing this impact, many funds will transmit the Form 144 and then immediately execute the Rule 144 sale. They will also avoid giving the company any advance notice of the transaction so that they can avoid placing the company in the position of having to disclose the pending sale as material non-public information. This surprise sale may not be well received by company management, but the VC really has no other choice if it wishes to avoid placing the company in a forced disclosure position where it will have to issue a press release, perhaps file an 8-K and truly give the sale publicity.

The Volume Limitation. Under Rule 144, no person (and certain related persons, including family members, trusts, corporations, partnerships and other organizations in which the seller or related holders own 10% or more of any class of equity securities) can sell in any three-month period more than the greater of (x) 1% of the company's outstanding common stock and (y) the average weekly reported trading volume during the four-week period preceding the filing of the Form 144. For a public company with little public float, the "1% test" will probably yield the higher number. If the weekly trading volume test yields a higher number, consideration should be given to the timing of the Form 144 filing. The four-week period is the four calendar week period preceding the filing of the Form 144. The SEC does not require you to recalculate the volume limit if trading volume decreases after the initial Form 144 filing (although you may recalculate based on increased trading volume other than your own). Thus, when considering the filing date, selecting a date that covers a four-week trading period that includes volume inducing events, such as an earnings release, can produce a higher volume limit for the 144 sales. Of course there are other securities law reasons one might want to sell shares soon after events such as these. We will discuss these reasons below.

When there are several holders, the volume limit applies to each holder individually (i.e., each fund in a "club deal" can sell up to the limit) unless the holders are "acting in concert", in which case all of the holders must share the same limit. Specifically, the rule provides as follows:

> "When two or more affiliates or other persons agree to act in concert for the purpose of selling securities of an issuer, all securities of the same class sold for the account of all such persons during any period of 3 months shall be aggregated for the purpose of determining the limitation on the amount of securities sold."

The SEC has given only general guidance as to what might constitute "acting in concert." Key factors include the following:

- Any agreement (oral or written) to act together with respect to sales (including any agreements among security holders who agree to sell during a detailed timetable, through a designated broker and with prior notice of sale to the other parties)

- Meetings or conference calls for the purpose of arranging an orderly method for sale of the securities
- Use of same investment advisors or same broker

In short, to preserve the ability to have each VC fund use its own volume limit, it would be best to have them each retain a separate broker and not reach any agreement with the other funds as to how much would be sold and when the sale would occur. It is helpful if each VC fund executes its trades on separate days as well because if all trades in fact occur on the same day, it may be difficult to overcome the perception that the trades were coordinated. But coordination of trades to ensure that they occur on separate days could itself be evidence of acting in concert. If stockholders have acted in concert at any time during a three-month period, all of their trades during that period must be aggregated, even if a particular trade was clearly done on an independent basis.

The Manner of Sale Requirement. Any sale under Rule 144 must be an unsolicited sale by or through a broker. The broker cannot contact potential buyers prior to the sale transaction, thus restricting the availability of Rule 144 for negotiated block trades.

The final issue to consider in a Rule 144 sale is the potential securities law liability implications that arise when a VC is in possession of material non-public information about the portfolio company. While the Section 12 and Section 15 liability provisions discussed above for registered offerings do not apply in the context of a sale under Rule 144, Section 10 of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 thereunder do apply. In a nutshell, these provisions require that the selling VC disclose or have the company disclose to the public all material non-public information prior to the sale transaction. Liability under Rule 10b-5 is somewhat harder to impose than under Sections 12 and 15 because the plaintiff must establish, among other things, that the seller acted with "scienter" in failing to disclose the material non-public information. Scienter requires a showing of knowledge of the misstatement or omission or a reckless disregard for the inadequacy of disclosure. As a practical matter, the selling VC will want to make sure that the sale occurs when the company has recently updated all of its disclosures, such as after a quarterly earnings release. If the company has a permitted period for insider sales, often referred to as a "window period," this can provide the best guideline for when a VC's sales under Rule 144 are likely to present the lowest risk of securities law liability. Caution is advised, however, as the opening of a "window period" is only evidence of, but is not dispositive of, the existence or non-existence of material non-public information. VCs often have information about the company, like the pendency of a material acquisition, of which the rank and file have not been made aware.

Making an In-Kind Distribution to Limited Partners

Another approach to liquidity is for the VC to make an in-kind distribution of the portfolio company stock to its partners and let them seek liquidity on an individual basis as their own investment objectives and strategies may dictate. In a thinly traded stock situation, an in-kind distribution can raise a number of sensitive issues as between the VC and management and between the VC general partner and its limited partners. The problem is that it is very difficult to predict the market impact of a distribution. Some VCs refer to a general rule of thumb that says one third of the limited partners will immediately seek to liquidate their shares, one third will seek to liquidate their shares over a three month period and one third will hold their shares for a longer term, but there is certainly no guarantee that a particular distribution will follow this pattern. Moreover, the market will often assume the worst – immediate efforts to sell all distributed shares. For this reason, management of portfolio companies often resist in-kind distributions and push for more orderly and controllable liquidity alternatives.

From a limited partner's perspective, an in-kind distribution of a thinly traded public portfolio company stock can represent a mixed bag of benefits and burdens. On the one hand, the limited partner, post-distribution, will be free to sell the shares without the limitations of Rule 144 if the two-year holding period has been met (assuming the SEC will allow the limited partner to "tack" or get credit for the fund's holding period in the stock, which is generally the case) and if the limited partner is not itself an affiliate of the portfolio company. If the two-year holding period has not been satisfied, the limited partners can sell under the Rule 144 conditions and requirements but they must all share one volume limitation. This is almost always impracticable to manage so most funds will either not do an in-kind distribution until the two-year period has been satisfied or will only distribute an aggregate amount that is less than 1% of the company's outstanding capital stock, thereby ensuring that the volume limitation will not be exceeded.

There are also tax advantages to the in-kind distribution because the distribution itself is not a taxable event. Limited partners are then free to manage the taxable sale timing in accordance with their own tax strategies. General partners, must also consider the tax implications of a distribution but may have a different perspective than the limited partners because many limited partners are tax exempt and most general partners are not. For general partners, therefore, it is often better to take an in-kind distribution, allowing them to manage the sale and tax timing, but do a post-sale cash distribution to the limited partners so that they can avoid many of the problems of in-kind distributions of thinly traded stocks we are discussing. The fund agreement will dictate whether this is possible.

The real challenge for the limited partners in these situations is trying to liquidate their positions without pushing the stock price down. As discussed above, the mere fact that a distribution has occurred may make it impossible to achieve this result (or, in the nature of a self-fulfilling prophecy, the distribution may have already depressed the stock price). When the fund values the distributed stock for purposes of the general partner's carried interest at the pre-distribution stock price, the limited partners will have even greater angst over the predicament in which they find themselves because the general partner will be insulated from the affects of illiquidity and they will not. To mitigate this problem, oftentimes the fund will establish a broker relationship for the benefit of all limited partners who wish to sell. The broker will then try to manage the sales to minimize the market impact. Note, however, the impact this may have on the "acting in concert" consideration for Rule 144 purposes if the volume limitation is still applicable.

VC fund agreements typically contain detailed provisions regarding in-kind distributions generally and valuation of distributed securities in particular. Some, for example, require that value of the distributed securities be calculated for purposes of the general partner's carried interest based on the average of the pre- and post-distribution trading prices over a specified period. Others simply allow the general partner to make a good faith determination of the appropriate illiquidity discount.

The other consideration a VC must take into account in an in-kind distribution scenario is the potential for securities law liability. These circumstances do not present the direct liability of a registered offering. Nor do they present the direct 10b-5 liability of a sale by the VC under Rule 144 or otherwise. There is a risk, however, that either the SEC or private litigants will pursue the VC if it distributes shares in-kind to its limited partners when the VC fund managers have access to material non-public information, on the theory that this distribution is tantamount to a sale by the general partner because it has reason to know that sales by the limited partners will inevitably result. This risk is minimized if the distribution occurs during the company's "window period" or other permissible trading period, occurs without any recommendation by the VC to its investors to sell or hold the distributed shares and can be demonstrated to have been motivated by independent considerations.

Another potential securities law liability concern arises under Section 16 of the Exchange Act, the provision that requires forfeiture of any "short swing profits" by a director, officer or 10% stockholder of a company. These are generally measured as the positive difference between any sale price and any purchase price for trades occurring within six months of each other. If the VC fund is a 10% stockholder or is deemed to have "deputized" a director or officer to act on its behalf, then a sale by it within six months of a purchase can give rise to Section 16 liability. Avoiding Section 16 liability may be another reason to favor an in-kind distribution over an outright sale of stock in the portfolio company or at least an in-kind distribution to the VC general partners who are directors of the company or any limited partner who may be deemed a 10% owner.

Selling in a Private Resale Transaction

Perhaps the easiest liquidity transaction to execute is for the VC to simply sell its position in the public portfolio company to another investor in a private transaction. We will distinguish here between a private resale of the VCs position and a sale of the entire company, which is itself a form of private resale transaction. The problem with the private resale transaction is that the VC will virtually always have to sell the shares at a discount to the prevailing market price because the new investor will be inheriting the illiquidity problem. This problem is made worse if the VC is an affiliate of the company because the purchaser would then have to start an entirely new Rule 144 holding period. These transactions are exempt under the securities laws under the what is referred to as the "4(1½) exemption" (because it falls somewhere between the Securities Act §4(2) "private placement" exemption and the §4(1) "transactions not involving an issuer, underwriter or dealer" exemption), which essentially means that the sale will be exempt if it would have been a valid private placement had the seller been the company itself. Thus, among other things, the selling VC cannot generally solicit buyers or publicize the sale and the buyer must be taking the shares without a view to distribute them further. The securities law liability imposed by Rule 10b-5 will also apply, so the selling VC will want to take steps to manage this risk through disclosure and appropriate timing as well as through representations and warranties from the purchaser. The Exchange Act expressly provides that this 10b-5 liability cannot be waived, and VCs should generally not take great comfort in so called "big boy" letters to the extent they purport to have the buyer waive any securities law claims against the seller.

The other essential element of a private resale transaction is ensuring that the purchaser can step into the shoes of the seller with regard to its rights against the company, especially the registration rights. Well drafted investment documents typically permit this but should be reviewed for any limitations on assignability.

Selling the Company

The other obvious liquidity transaction is a sale of the entire company. While such a transaction is beyond the scope of this article, it is worth noting that such a sale is often made at a price that is at a premium, rather than a discount, to the prevailing market price, and that it virtually never contains any escrow of indemnification provisions post-sale. As such, it is an extremely attractive alternative for the VC looking to achieve liquidity on all (but not part) of its investment. The principal issue in such a transaction is certainty of closing, as the market value of a company that has been the subject of a failed sales attempt is invariably damaged.

Transferring the Risk of the Shares Through Hedging Transactions

Wall Street has developed a vast array of financial products to allow holders of restricted or otherwise illiquid shares to lock in value, essentially offloading the downside risk in exchange for the upside potential. These strategies, sponsored by most large investment banks, range from a simple private resale at a discount along the lines discussed above, where the investment bank purchases the restricted stock and then engages in its own hedging transactions, to prepaid forward sales and costless collars. VCs should consult with investment bankers to explore these transactions in the right circumstances. Beware, though, that their usefulness is somewhat limited in the context of a thinly traded stock. Each of these hedging strategies depends on someone taking various future positions in the stock and if the stock is thinly traded, and consequently somewhat volatile, hedging strategies are often prohibitively expensive or simply not feasible at all.

Conclusion

Taking a portfolio company public is almost always a tremendous achievement for a VC and often a testament to the VC's skill in working with a good management team to bring a company to maturity. It can start you down the path to liquidity, but as all VCs know, in the eyes of their investors the only numbers that go on the scoreboard are those that represent actual investment returns. When the portfolio company's stock remains thinly traded, VCs often can get liquidity at attractive valuations if they proactively manage the process with their fellow investors, company executives and financial and legal advisors. Everyone may not get what they want in the end, but a thorough understanding of the issues and competing interests should enable all parties to come close to achieving their desired results. ◎

LIQUIDITY ALTERNATIVES CHART

	POTENTIAL AFFECT ON VC STOCK SALE PRICE	POTENTIAL AFFECT ON FUTURE STOCK PRICE	TIMING	EXPENSE	VOLUME LIMITATIONS	POTENTIAL SECURITIES LAW LIABILITY
SELLING IN THE INITIAL PUBLIC OFFERING	Probable negative market reaction	Should reduce future overhang discount	Long process of at least two to three months	High transaction expense and underwriting fees	No limitations other than market demand	Yes, under Sections 12 and possibly 15 of the Securities Act
SELLING IN A SUBSEQUENT UNDERWRITTEN OFFERING	Less negative than selling in IPO but still a widely publicized sale by equity sponsors	Should reduce overhang discount going forward	Not as long as the IPO but requires an SEC registration and potential SEC review	High transaction expense and underwriting fees	No limitations other than market demand	Yes, under Sections 12 and possibly 15 of the Securities Act
SELLING IN A REGISTERED BLOCK TRADE	Filing of registration statement can depress stock price as market anticipates increased float	Should reduce overhang discount going forward	Shorter registration and execution process unless SEC review	Lower transaction expenses than underwritten transactions	No limitations other than market demand	Yes, under Sections 12 and possibly 15 of the Securities Act
SELLING UNDER RULE 144	Should be minimal if sale occurs immediately after Form 144 transmitted for filing.	Should reduce overhang discount going forward	Rapid execution but not available until first anniversary of share purchase	Lower transaction expenses than registered transactions	Volume limitations as calculated with possible "acting in concert" impact	Yes, under Rule 10b-5 of the Exchange Act
DISTRIBUTING SHARES TO LIMITED PARTNERS	None unless distribution is announced in advance or an illiquidity discount or other fund agreement provision applies	May have ongoing negative affect as limited partners sell shares over time	Rapid execution but not practicable until first anniversary of share purchase	Minimal transaction expenses	No limitations unless still within two-year holding period. In this holding period, single Rule 144 volume limit applies to all partners	Possible. Steps should be taken to minimize.
PRIVATE RESALES	Discount to market price inherent in transaction	Difficult to determine	Rapid execution at any time subject to market demand	Significant transaction expense in form of discount	No limitations	Yes, under Rule 10b-5 of the Exchange Act
SELLING THE COMPANY	Generally a premium to market	Not applicable	Generally a long process of several months	High transaction expenses	No limitations	If a stock sale, yes, under Rule 10b-5 of the Exchange Act
HEDGING TRANSACTIONS	Discount and/or fees essential to transaction	Difficult to determine	Rapid execution at any time subject to market demand	Significant transaction expense in form of discount and fees	No limitations	Probably not

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