IPO Report

2024

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2024 IPO Report – What's Inside

REVIEW

Pessimism surrounding the Federal Reserve's interest rate hikes, combined with subdued business and consumer confidence as well as geopolitical concerns, weighed heavily on the IPO market in 2023.

With 117 IPOs in 2023 (excluding IPOs by special purpose acquisition companies (SPACs) and direct listings), deal activity increased 48% from the mere 79 IPOs completed in 2022, but still accounted for less than one-third of the 2021 total of 381 IPOs. Total gross proceeds in 2023 were $19.0 billion, up 144% from the $7.8 billion in 2022.

The gross proceeds figure in 2023 was buoyed by the $4.9 billion offering by Arm Holdings—the fourth-largest US IPO in the past 10 years behind the IPOs of Alibaba ($21.8 billion), Rivian ($11.9 billion) and Uber ($8.1 billion)—and the $3.8 billion Kenvue offering, which was the seventh-largest IPO in the past 10 years.

IPOs by emerging growth companies (EGCs) accounted for 91% of the year's IPOs, up from 87% in 2022 and above the 89% average that has prevailed since enactment of the JOBS Act in 2012.

In addition to the overall pace of new offerings being well below the median of 183 over the five-year period from 2017 to 2021, the profile of the average IPO in 2022 and 2023 was also markedly different.

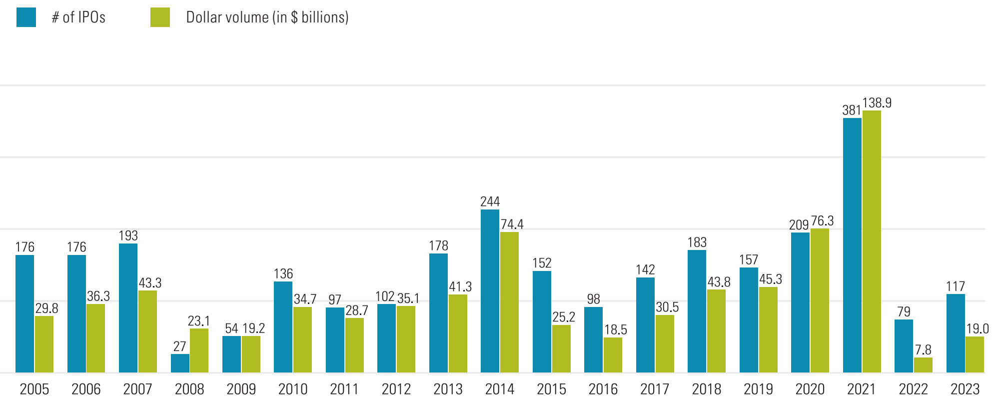
The median offering size for IPOs in 2023 was $10.0 million, 43% lower than the $17.6 million for 2022 and a fraction of the $144.2 million median that prevailed over the five-year period from 2017 to 2021.

The percentage of IPOs raising gross proceeds of less than $25 million increased to 68% in 2023 from 61% in 2022. In comparison, IPOs of that size accounted for only 8% of all IPOs between 2017 and 2021.

The median annual revenue of IPO companies in 2023 was $9.0 million, up from $4.7 million for 2022, but well below the $66.9 million median that prevailed during the five-year period from 2017 to 2021.

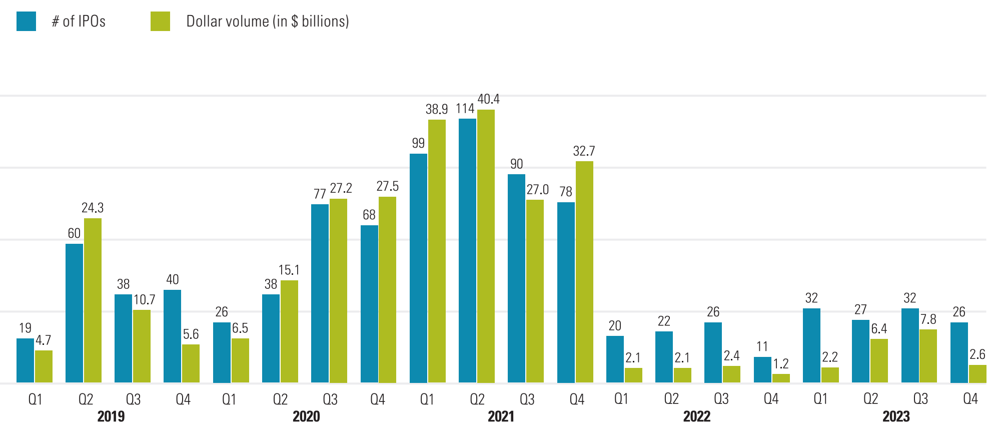
In 2023, only 33% of life sciences IPO companies had revenue—nearly double

US IPOs by Year – 2005 to 2023



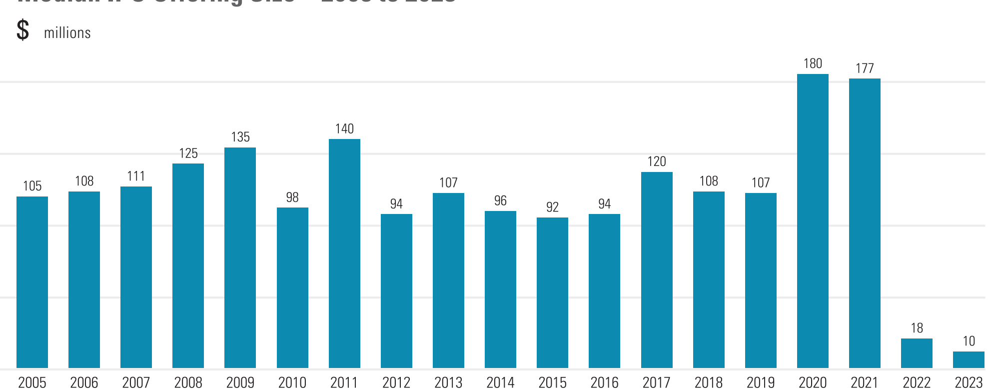
Source: SEC filings

US IPOs by Quarter – 2019 to 2023



Source: SEC filings

Median IPO Offering Size – 2005 to 2023



Source: SEC filings

the 17% figure for 2022, but down from 46% over the five-year period from 2017 to 2021. At $21.9 million, the median annual revenue of non-life sciences IPO companies in 2023 was almost double the $12.0 million in 2022 but well short of the $192.7 million median from 2017 to 2021.

The percentage of profitable IPO companies increased to 42% in 2023 from 34% in 2022 and from 28% of all IPO companies between 2017 and 2021. None of the 21 life sciences IPO companies in 2023 were profitable, compared to 56% of the non-life sciences IPO companies—the highest percentage for non-life sciences IPO companies since the 61% in 2012.

The median IPO company in 2023 ended its first day of trading unchanged from its offering price, compared to a gain of 8% in 2022 and a gain of 16% in 2021. The 2023 median first-day gain figure is the second-lowest annual figure in the past 25 years.

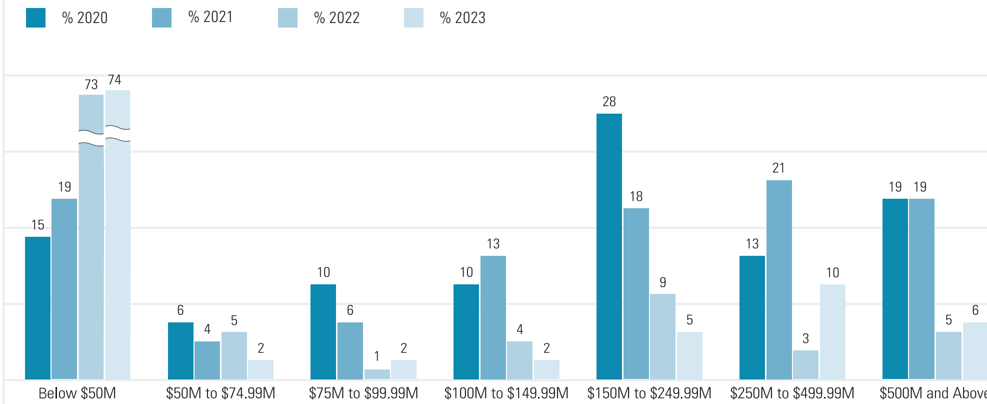
There were six "moonshots" (IPOs in which the stock price doubles on the opening day) in 2023, compared to 20 in 2022 (an anomaly given the small number of 2022 IPOs). Similar to 2022, only one 2023 moonshot ended the year above its offering price. The other five ended the year down a median of 83% from their offering price.

The percentage of "broken" IPOs (in which the stock closes below the offering price on the first trading day) rose to 50% in 2023 from 37% in 2022 and 24% over the five-year period from 2017 to 2021. The 2023 figure represents the highest level of broken IPOs since 2008, when almost two-thirds of the year's IPOs were broken. A slightly lower percentage of 2023 life sciences IPOs (48%) than non-life sciences IPOs (50%) were broken.

2023 IPO companies ended the year trading a median of 56% below their offering price, only slightly down from 2022 IPO companies, which ended that year down 55%. In comparison, 2021 IPO companies were only down 19% in the year of their debut.

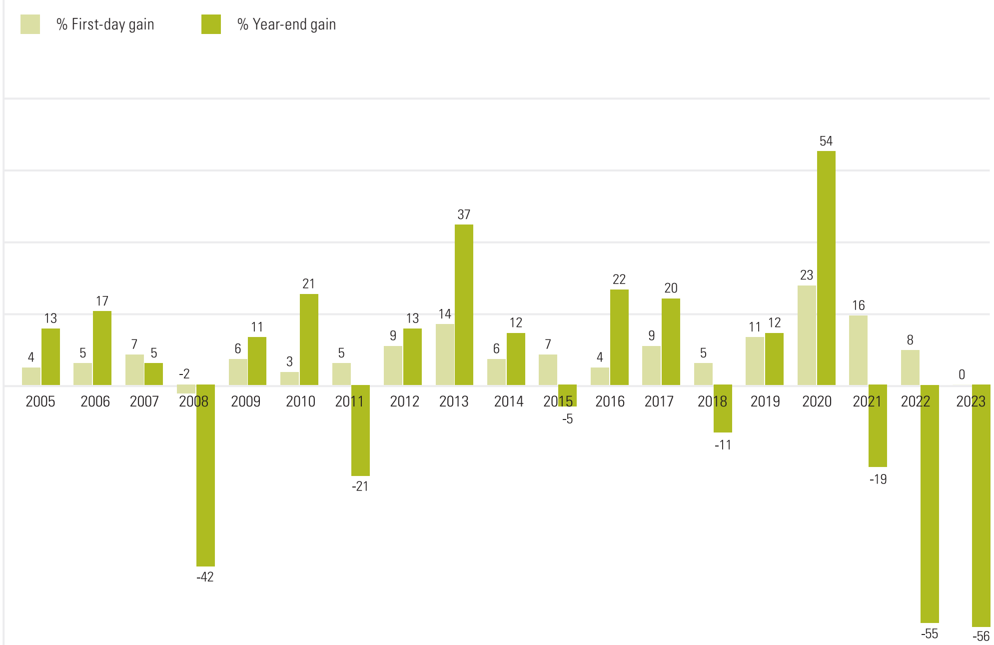
The year's best-performing IPOs were by Jin Medical International (trading an astounding 3,000% above its offering price at year-end), Atlas Lithium (up 421%), RayzeBio (up 245%), Alpha Technology Group (up 218%) and Structure Therapeutics (up 172%).

Distribution of IPO Offering Size – 2020 to 2023

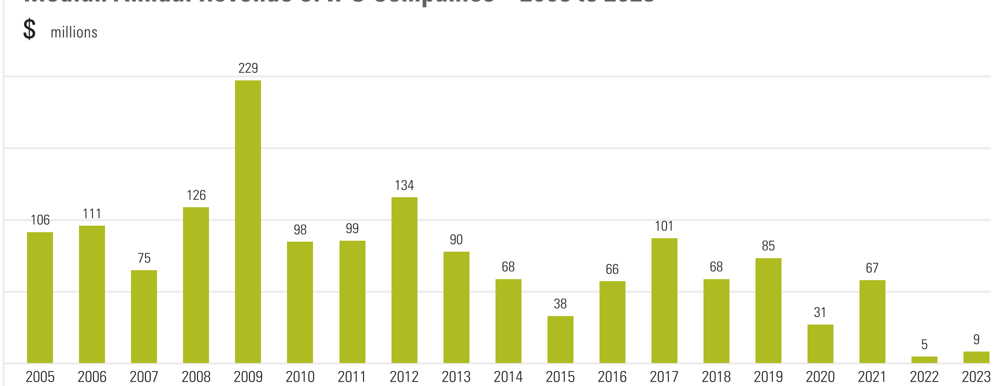


Source: SEC filings

Median IPO First-Day and Year-End Gain by Year – 2005 to 2023



Median Annual Revenue of IPO Companies – 2005 to 2023



Source: SEC filings and IPO Vital Signs

At the end of 2023, 73% of the year's IPO companies were trading below their offering price. While this figure represents an improvement from the 80% of 2022 IPO companies that ended the year below their offering price, 2023 was the second-worst year for this metric since 2008, when 81% of IPO companies ended the year trading below their offering price. Life sciences companies fared better than their non–life sciences counterparts, with 57% trading below their offering price at year-end, compared to 76% of other companies.

While the overall performance of the IPO market was lackluster, IPOs with gross proceeds of at least $100 million fared better, producing a median year-end gain of 6%, with 59% of such IPOs ending the year above their offering price.

Individual components of the IPO market fared as follows in 2023:

— ***VC-Backed IPOs:*** The number of IPOs by VC-backed US issuers increased to 25 in 2023 from 20 in 2022, but the figures for both years are well below the median of 75 over the five-year period from 2017 to 2021 and represent the two lowest annual figures since 2009. The market share of this segment increased to 48% in 2023 from 42% in 2022 but lags behind the 58% total market share for the five-year period from 2017 to 2021. The median offering size for US-issuer VC-backed IPOs in 2023 was $15.0 million, compared to $52.3 million in 2022 and $132.3 million over the five-year period from 2017 to 2021. At year-end, US-issuer VC-backed IPO companies were trading down a median of 56% from their offering price.

— ***PE-Backed IPOs:*** After almost tripling from 30 in 2020 to 86 in 2021, the number of private equity–backed IPOs shrank to just two in 2022 and four in 2023. PE-backed issuers accounted for only 4% of all US-issuer IPOs in 2022 and 8% in 2023, compared to 23% over the five-year period from 2017 to 2021. The median offering size for PE-backed IPOs in 2023 was $240.5 million, compared to $336.0 million in 2021 and $335.9 million over the five-year period from 2017 to 2021. PE-backed IPO companies ended the year a median of 3% above their offering price.

— ***Life Sciences IPOs:*** There were 21 life sciences company IPOs in 2023, two fewer than the 23 in 2022—the two lowest annual tallies in the past 10 years—down from 138 in 2021. The life sciences company share of the IPO market was 18% in 2023, down from 29% in 2022 and 39% for the five-year period from 2017 to 2021. At $80.0 million, the median offering size for life sciences IPOs in 2023 was more than double the $36.0 million median offering size for life sciences IPOs in 2022 and 7% higher than the $74.8 million median from 2017 to 2021. At year-end, life sciences IPO companies were trading a median of 46% below their offering price, compared to the median loss of 58% for non–life sciences IPO companies.

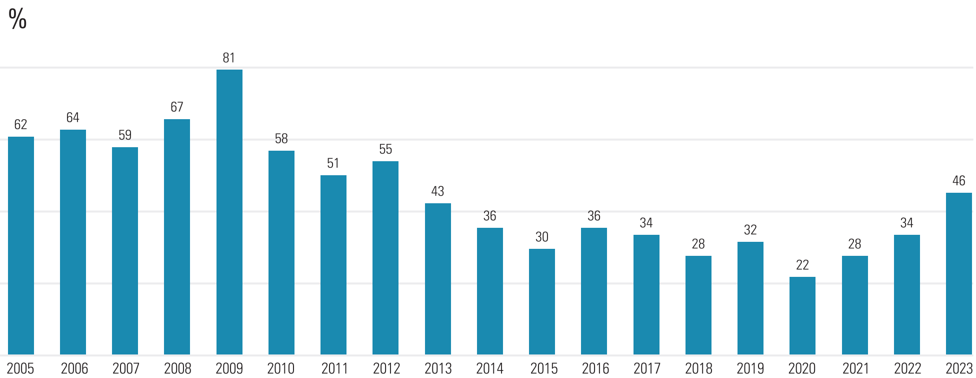
— ***Tech IPOs:*** Deal flow in the technology sector increased to 34 IPOs in 2023 from 25 IPOs in 2022 but remains well below the median of 59 over the five-year period from 2017 to 2021. The tech sector's share of the US IPO market declined to 30% in 2023, from 32% in 2022 and 35% over the five-year period from 2017 to 2021. The median offering size for tech IPOs in 2023 was $8.4 million, compared to $15.0 million in 2022 and $227.3 million over the five-year period from 2017 to 2021. Tech IPO companies ended the year a median of 62% below their offering price.

— ***Foreign-Issuer IPOs:*** The number of US IPOs by foreign issuers more than doubled from 31 in 2022 to 65 in 2023. Foreign-issuer IPOs accounted for 56% of the US market in 2023, up from 39%

DIRECT LISTINGS

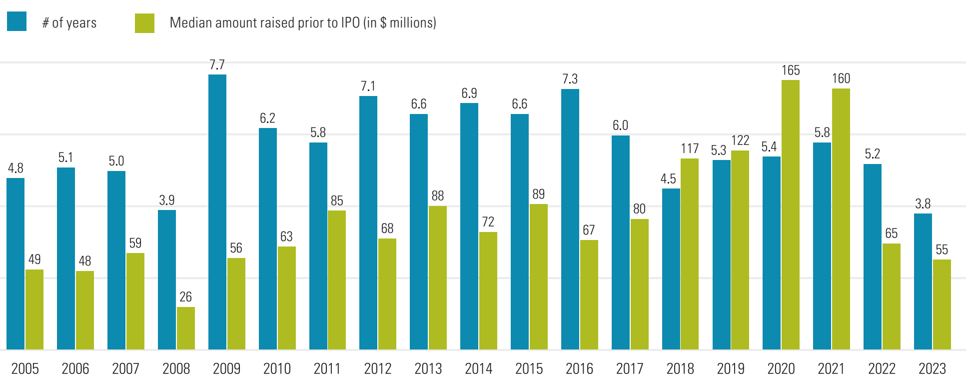
There were four direct listings in 2023, up from one in 2022 and the second-highest annual tally behind the six in 2021, but median proceeds in 2023 were well below the preceding years since 2018—the year of the first direct listing.

Percentage of Profitable IPO Companies – 2005 to 2023



Source: SEC filings and IPO Vital Signs

Median Time to IPO and Median Amount Raised Prior to IPO – 2005 to 2023



Source: PitchBook

in 2022, and 2023 represents the first year on record where foreign-issuer IPOs outpaced those by US issuers. Among foreign issuers, companies from China led the year with 17 IPOs, followed by companies from Hong Kong (with nine IPOs), Singapore (with seven IPOs), Japan (with six IPOs) and Malaysia (with five IPOs). Foreign-issuer IPO companies ended the year down a median of 53% from their offering price.

OUTLOOK

IPO market activity in the coming year will depend on a number of factors, including the following:

— ***Economic Growth:*** The advance estimate indicates US GDP increased by 2.5% in 2023, despite predictions that US GDP growth would slow from the 2.1% in 2022. The labor market continued to post strong overall job growth, with total nonfarm employment exceeding the pre-pandemic high of 152.4 million jobs by over 4.5 million jobs. Despite the strong job growth figures, inflation trended downward over the course of 2023, although it remained above the Fed's target 2% level. The elusive soft landing that looked like a pipe dream at the start of 2023 seems more realistic one year later, although low levels of business investment, weak home sales and depressed US exports all point to structural challenges that remain.

— ***Capital Market Conditions:*** Stable capital market conditions absent volatile swings have historically been a precursor to a buoyant IPO market. The Dow, Nasdaq Composite Index and S&P 500 ended the year up 14%, 43% and 24%, respectively. Continued capital market growth and stability will be building blocks for a healthy IPO market in the coming year, but interest rates may need to come down for momentum to remain.

— ***Venture Capital Pipeline:*** The overall level of venture capital investment declined to $166.8 billion in 2023 from $242.1 billion in 2022 and $348.2 billion in 2021. The number of VC-backed companies raising rounds of at least $100 million fell to 269 in 2023 from 532 in 2022 and 843 in 2021. Despite these declines, the ability of companies to continue raising "IPO-sized" private rounds will give them some flexibility as to when they seek to enter the public market. That said, VCs invest with an expectation of a liquidity event, and their demands for returns are likely to increase when favorable market windows emerge. When private market valuations meet the harsher reality of public markets, some companies may choose to delay their IPO plans.

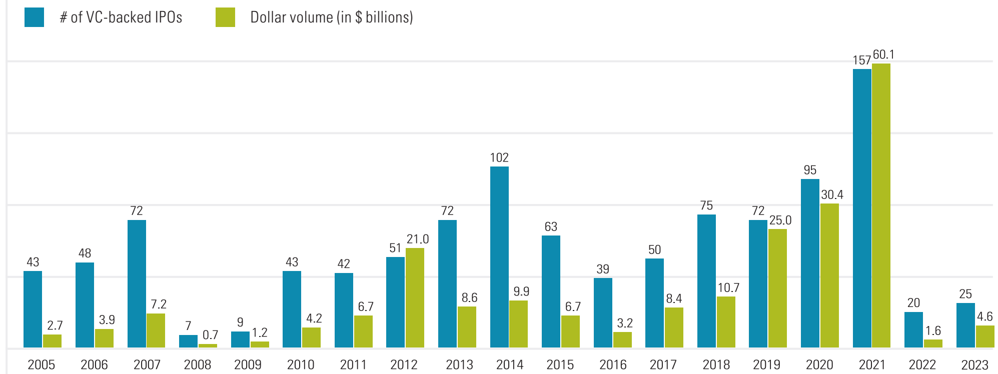
— ***Private Equity Impact:*** While PE-backed companies largely stayed on the sidelines of the IPO market for the second consecutive year and fundraising dipped to $556.1 billion in 2023 from $528.8 billion in 2022, private equity firms continue to sit on enormous amounts of "dry powder." As uncertainty subsides and interest rates decline, one can expect private equity firms to reengage.

Despite economic and geopolitical challenges that remain, the IPO market enters 2024 with expectations for a revival, especially in the latter half of the year if anticipated interest rate cuts by the Fed come to fruition. There are a wide array of qualified companies in the IPO pipeline, but market conditions need to improve sufficiently to see a significant resumption in deal flow. ■

SPAC IPOS

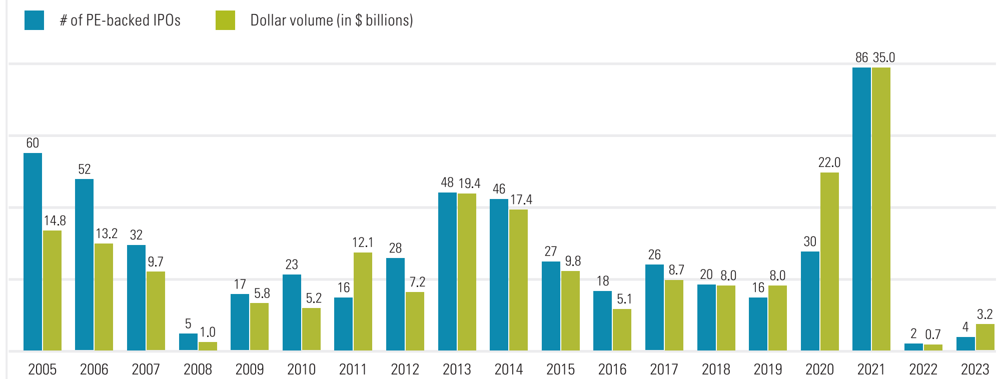
In 2023, there were 31 SPAC IPOs with total proceeds of $3.45 billion, continuing the decline from 86 SPAC IPOs in 2022 and 613 in 2021. The 2023 count represents the lowest annual tally since the 12 in 2016. Despite the decline, at year-end there were 127 SPACs still searching for a business combination and 140 that had entered into a definitive agreement but not yet finalized the merger.

Venture Capital–Backed IPOs – 2005 to 2023



Source: SEC filings
Based on US IPOs by VC-backed US issuers

Private Equity–Backed IPOs – 2005 to 2023



Source: Refinitiv and SEC filings
Based on US IPOs by PE-backed US issuers

CALIFORNIA

IPO activity by California-based companies in 2023 remained well below its historic level. The state produced 18 IPOs, up from 11 in 2022 but considerably less than the median of 48 that prevailed over the five-year period from 2017 to 2021.

Gross proceeds increased to $2.9 billion in 2023 from a paltry $209.7 million in 2022, but the total for 2023 represents the fourth-lowest annual amount since 2010. The largest California IPOs in 2023 came from Instacart ($660 million), Nextracker ($638 million) and ACELYRIN ($540 million).

Technology and life sciences companies accounted for 61% of the state's IPO total in 2023—down from their 73% share in 2022 and lower than their 84% share in the five-year period between 2017 and 2021.

The number of VC-backed California IPOs increased from six in 2022 to 10 in 2023. The 2023 tally represents 40% of all US-issuer VC-backed IPOs, up from the state's 30% share in 2022 but trailing the 44% share that prevailed during the five-year period from 2017 to 2021.

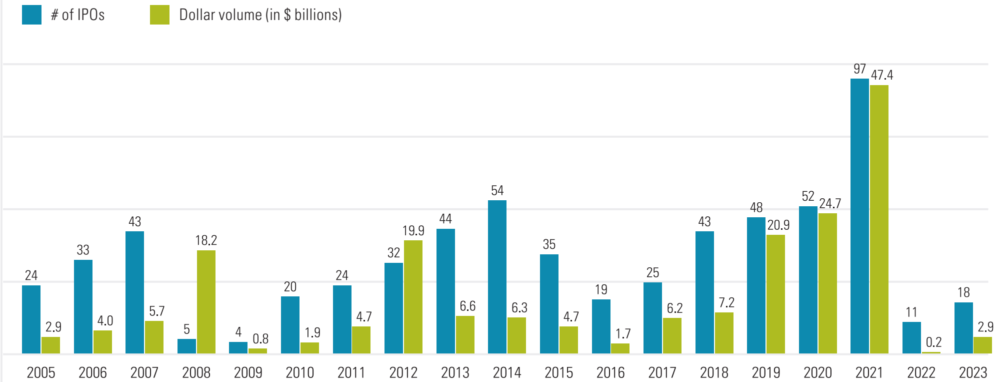
California IPO companies produced a median first-day gain of 5% in 2023. Sacks Parente Golf was the state's top performer, with a first-day gain of 624%, followed by specialty Asian grocer Maison Solutions (up 124%) and a trio of biotech companies—Structure Therapeutics (up 73%), RayzeBio (up 33%) and ACELYRIN (up 31%).

At year-end, California IPO companies were trading down a median of 45% from their offering price, with only one-third of California IPO companies trading above their offering price.

The best-performing California IPOs of the year were RayzeBio (up 245% at year-end), Structure Therapeutics (up 172%) and Genelux (up 134%).

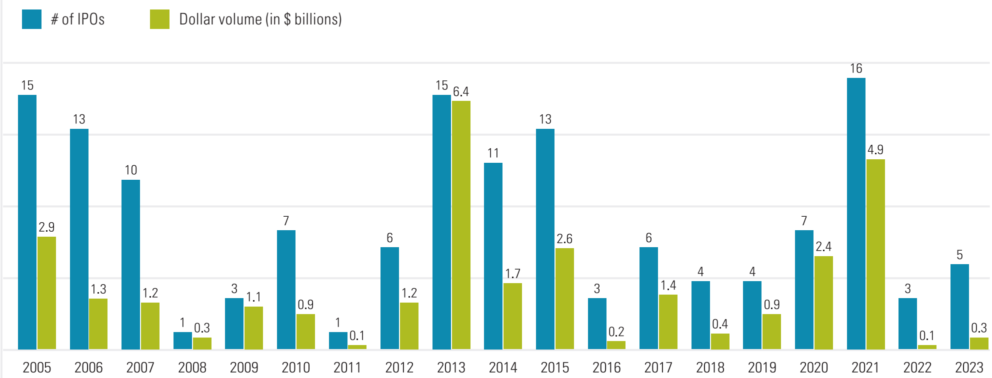
With the largest pool of VC-backed companies in the United States and a wealth of entrepreneurial talent, California should remain a major source of strong IPO candidates in the coming year, with deal flow dependent on market conditions.

California IPOs – 2005 to 2023



Source: SEC filings

Mid-Atlantic IPOs – 2005 to 2023



Source: SEC filings

MID-ATLANTIC

The Mid-Atlantic region of Virginia, Maryland, North Carolina, Delaware and the District of Columbia produced five IPOs in 2023, up from three in 2022 but below the median of six that prevailed over the five-year period from 2017 to 2021.

North Carolina accounted for two of the region's IPOs in 2023, with the District of Columbia, Maryland and Virginia each adding one.

While gross proceeds in the Mid-Atlantic region more than doubled from $130.8 million in 2022 to $342.1 million in 2023, almost all of the region's proceeds came from CAVA Group's $318 million IPO; the remaining four IPOs each had gross proceeds below $10 million.

There were two VC-backed IPOs in the region in 2023, compared to one in 2022 and a median of three over the five-year period from 2017 to 2021.

Mid-Atlantic IPO companies produced a median first-day gain of 6% in 2023. CAVA just missed out on a moonshot, ending its first day of trading up 99% from its offering price; and Cheetah Net Supply Chain Service had a 73% first-day gain.

At year-end, the median 2023 Mid-Atlantic IPO company was down 68% from its offering price, with CAVA as the only one up from its offering price (shedding part of its first-day gain to end the year up 95%).

The region's traditional strengths in the life sciences, technology, financial services and defense sectors should continue to produce attractive IPO candidates as market conditions improve.

NEW ENGLAND

The New England IPO market produced five IPOs in 2023, down from eight in 2022.

Massachusetts produced three of the region's IPOs in 2023, with Connecticut adding the remaining two.

Gross proceeds in the region declined by 7% from $1.24 billion in 2022 to $1.15 billion in 2023.

The largest New England IPO in 2023 was by Klaviyo ($576 million), the region's only non-life sciences company IPO, followed by Apogee Therapeutics ($300 million) and Neumora Therapeutics ($250 million).

The region's share of all US-issuer life sciences IPOs in the country declined from 42% in 2022 to 24% in 2023 and trails the 29% that prevailed over the five-year period from 2017 to 2021.

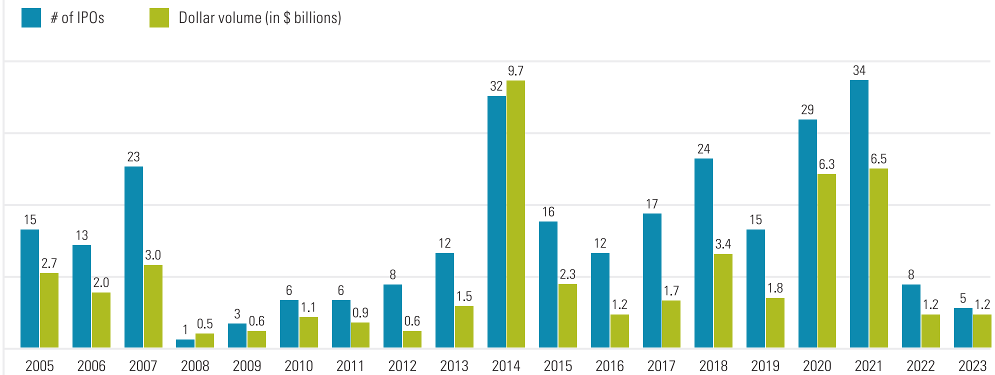
For the second consecutive year, all of New England's IPOs came from VC-backed companies. The region accounted for 20% of all US-issuer VC-backed IPOs in 2023, down from 40% in 2022 but only slightly lower than the 23% over the five-year period from 2017 to 2021.

New England IPO companies produced a median first-day gain of 9% in 2023. The region's top performers in first-day trading were Apogee Therapeutics (up 25% from its offering price), Intensity Therapeutics (up 19%) and Klaviyo (up 9%).

At year-end, New England's 2023 IPO companies were up a median of less than 1% from their offering price, with 60% of the region's IPO companies trading above their offering price. The best-performing New England IPOs at year-end were Intensity Therapeutics (up 71%) and Apogee Therapeutics (up 64%).

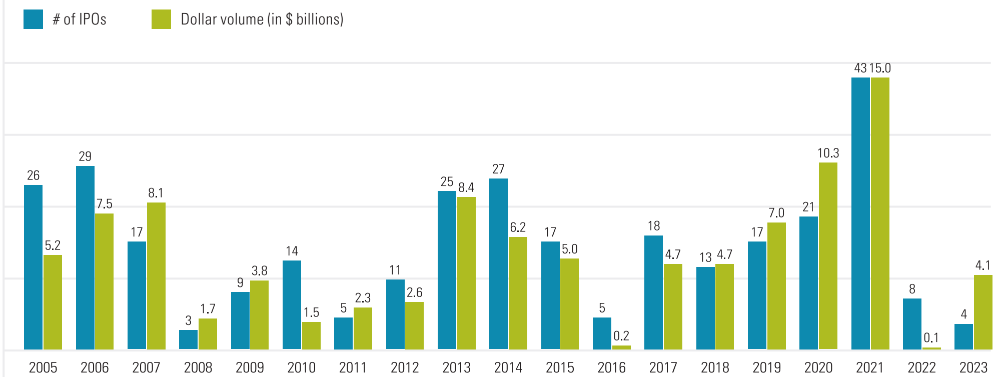
With the region's world-renowned universities and research institutions continuing to spawn tech and life sciences companies, and with strong levels of venture capital investment, New England should continue to generate compelling IPO candidates in the coming year, with the pace of deal flow dependent on market conditions.

New England IPOs – 2005 to 2023



Source: SEC filings

Tri-State IPOs – 2005 to 2023



Source: SEC filings

TRI-STATE

The number of IPOs in the tri-state region of New York, New Jersey and Pennsylvania fell from eight in 2022 to four in 2023.

New Jersey produced two of the region's 2023 IPOs, while New York and Pennsylvania each accounted for one.

Gross proceeds from tri-state IPOs increased from $145.2 million in 2022 to $4.1 billion in 2023, bolstered by Kenvue's $3.8 billion IPO.

The tri-state region produced a pair of VC-backed IPOs in 2023, the same count as 2022 but well below the median of 11 over the five-year period from 2017 to 2021.

As in 2022, both of the region's VC-backed IPOs were also life sciences companies—Mineralys Therapeutics produced a $192 million IPO, and Lexeo Therapeutics produced a $100 million IPO.

Tri-state IPO companies in 2023 gained a median of 6% in first-day trading. Only two of the region's IPO companies ended their first day of trading above their offering price, led by Kenvue (with a first-day gain of 22%) and Mineralys Therapeutics (up 15%).

At year-end, tri-state IPO companies were down a median of 24% from their offering price. The best-performing tri-state IPO, and the only one to end the year in positive territory, was Lexeo Therapeutics (up 22% from its offering price at year-end).

With its high level of venture capital activity and its sophisticated capital markets ecosystem, the tri-state region can be expected to produce IPOs from emerging life sciences and technology companies as well as larger, private equity–backed companies when market conditions improve. ■

PROFILE OF SUCCESSFUL IPO CANDIDATES

What does it really take to go public? There is no single profile of a successful IPO company, but in general, the most attractive candidates share the following attributes:

- **Outstanding Management:** An investment truism is that investors invest in people, and this is even truer for IPO companies. Every company going public needs experienced and talented management with high integrity, a vision for the future, plenty of energy to withstand the rigors of the IPO process and public company life, and a proven ability to execute. An IPO is not the best time for a fledgling CEO or CFO to cut their teeth.
- **Market Differentiation:** IPO candidates need a superior technology, product or service in a large and growing market. Ideally, they are viewed as market leaders in their industry. Appropriate intellectual property protection is expected of technology companies, and in some sectors, such as life sciences and medical devices, patents are *de rigueur.*
- **Substantial Revenue:** Substantial revenue is generally expected—at least $50 million to $75 million annually—in order to provide a platform for attractive levels of profitability and market capitalization.
- **Revenue Growth:** Consistent and strong revenue growth—25% or more annually—is usually needed, unless the company has other compelling features. The company should have visibility into sustained expansion to avoid the market punishment that can accompany revenue or earnings surprises.
- **Profitability:** Strong IPO candidates generally have track records of earnings and a demonstrated ability to enhance margins over time, although IPO investors often appear to value growth more highly than near-term profitability.
- **Market Capitalization:** The company's potential market capitalization should be at least $200 million to $250 million in order to facilitate development of a liquid trading market. Substantial post-IPO ownership by insiders may mean a larger market cap is required to provide ample float.

Other factors can vary based on a company's industry and size. For example, many life sciences companies will have much less revenue and not be profitable. More mature companies are likely to have greater revenue and market caps but slower growth rates. High-growth companies are likely to be smaller and usually have a shorter history of profitability.

Beyond these objective measures, IPO candidates need to be ready for public ownership in a range of other areas, including accounting preparation, corporate governance, financial and disclosure controls and procedures, external communications, legal and regulatory compliance, and a variety of corporate housekeeping tasks. ■

HOW DO YOU COMPARE?

The characteristics of the IPO market in 2022 and 2023 were vastly different than in the preceding three years. Deal flow fell by more than one-half, offering sizes were much smaller and IPO companies had far less annual revenue. US-incorporated issuers completing US IPOs in 2022 and 2023 were significantly less likely to include selling stockholders, utilize a directed share program or engage a "Big 4" accounting firm, and their IPOs generally received more SEC comments and took longer to complete.

METRIC	2019–2021	2022–2023
Annual number of IPOs	249	98
IPO companies qualifying as EGCs under the JOBS Act	92%	89%
Median offering size	$163.9 million (18% < $50 million and 17% > $500 million)	$15.0 million (73% < $50 million and 6% > $500 million)
Median annual revenue of IPO companies	$59.0 million (48% < $50 million and 15% > $500 million)	$6.2 million (72% < $50 million and 10% > $500 million)
IPO companies that are profitable	27%	41%
IPOs with selling stockholders and median percentage of offering represented by those shares	Percentage of IPOs—20% Percentage of offering—32%	Percentage of IPOs—9% Percentage of offering—16%
IPOs with directed share programs and median percentage of offering represented by those shares	Percentage of IPOs—44% Percentage of offering—5%	Percentage of IPOs—18% Percentage of offering—5%
IPO companies disclosing adoption of an ESPP	69%	25%
IPO companies using a "Big 4" accounting firm	74%	32%
Stock exchange on which the company's common stock is listed	Nasdaq—78% NYSE—22%	Nasdaq—82% NYSE—18%
Median underwriting discount	7%	7%
Number of SEC comments contained in initial comment letter	Median—16 25th percentile—12 75th percentile—21	Median—20 25th percentile—16 75th percentile—26
Median number of Form S-1 amendments filed before effectiveness	Four	Seven
Number of days from initial submission to effectiveness of Form S-1	Median—104 25th percentile—83 75th percentile—158	Median—239 25th percentile—154 75th percentile—371

Prevalence of EGC Elections

Practices Continue to Evolve Regarding Financial Disclosure and Adoption of New or Revised Accounting Standards

One of the most successful efforts to encourage capital formation as an engine of economic growth was the passage of the JOBS Act in 2012. The cornerstone of the JOBS Act is the creation of an "IPO on-ramp" that provides emerging growth companies (EGCs) with a phase-in period to come into full compliance with certain disclosure and accounting requirements. The phase-in period can continue until the last day of the fiscal year following the fifth anniversary of an IPO but will be shorter for many companies.

The prevalence of elections for some items of EGC relief—such as the ability to submit a draft Form S-1 registration statement for confidential SEC review and to provide reduced executive compensation disclosure—has remained consistently high across different types of EGCs.

Practices with respect to other items of relief—particularly those related to financial disclosure and the application of new or revised accounting standards—have varied, often reflecting the company's size, maturity or industry, and have exhibited strong trends over time as investor expectations and market practices have evolved.

CONFIDENTIAL SUBMISSION OF FORM S-1

— *Description:* An EGC is able to submit a draft Form S-1 registration statement to the SEC for confidential review instead of filing it publicly on the SEC's EDGAR system (and in 2017, a similar nonpublic review process became available to all companies going public). A confidentially submitted Form S-1 need not be filed publicly until 15 days before the road show commences, enabling an EGC to delay disclosure of its IPO plans and sensitive information to competitors and employees. Confidential review can also enable an EGC to abandon its IPO plans without requiring public disclosure if market conditions preclude an offering.

— *Prevalence:* Overall rates of adoption have consistently remained very high—96% of all EGCs since enactment of the JOBS Act.

REDUCED EXECUTIVE COMPENSATION DISCLOSURE

— *Description:* An EGC is allowed to provide "scaled" executive compensation disclosure and therefore need not provide Compensation Discussion and Analysis (CD&A); compensation information is required only for three named executive officers (including the CEO); and only three of the seven compensation tables otherwise required must be provided.

— *Prevalence:* EGCs have uniformly and overwhelmingly embraced the ability to provide reduced executive compensation disclosure. Overall, 99% of all EGCs (including all EGCs since 2020) have excluded CD&A from their Form S-1.

REDUCED FINANCIAL DISCLOSURE

— *Description:* An EGC is required to provide only two years of audited financial statements (instead of three years), plus unaudited interim financial statements, and is only required to include MD&A for the periods presented in the required financial statements.

— *Prevalence:* Overall, the percentage of EGCs electing to provide only two years of audited financial statements has increased dramatically, from 27% in 2012 to 93% in 2023. From the outset, life sciences companies—for which older financial information is often irrelevant—were likely to provide only two years of audited financial statements, with the percentage choosing this option reaching 100% in both 2022 and 2023. Technology companies—which generally have substantial revenue and often have profitable operations—were slower to adopt this practice, but the percentage providing only two years of audited financial statements grew from 22% in 2012 to 91% in 2022 and 100% in 2023.

Two Years of Audited Financial Statements

	2012–2016	2017–2019	2020–2023	Overall
Life Sciences	87%	97%	99%	94%
Technology	37%	63%	89%	64%
All EGCs	65%	84%	93%	80%

ACCOUNTING STANDARDS ELECTION

— *Description:* An EGC may elect not to be subject to any accounting standards that are adopted or revised on or after April 5, 2012, until these standards are required to be applied to nonpublic companies.

— *Prevalence:* Through 2016, the vast majority of EGCs opted out of the extension of time to comply with new or revised accounting standards. At that time, the decision appears to have been motivated by the uncertain value of the deferred application of future, unknown accounting standards and concerns that a company's election to take advantage of the extended transition period could make it more difficult for investors to compare the company's financial statements to those of its peers. Starting in 2017, a major shift has occurred, with the percentage of EGCs adopting the extended transition period jumping from 11% for the period through 2016 to 50% between 2017 and 2019 and to 93% between 2020 and 2023. This trend appears to have been motivated by the desire of many EGCs to delay the application of new revenue recognition and lease accounting standards (which became mandatory for public companies in 2018–2019) or, at a minimum, to take more time to evaluate the effects of these standards before adopting them. ■

Delayed Application of New or Revised Accounting Standards

	2012–2016	2017–2019	2020–2023	Overall
Life Sciences	10%	45%	92%	51%
Technology	12%	62%	93%	57%
All EGCs	11%	50%	93%	52%

EXITING EGC STATUS

In many cases, a company exiting EGC status qualifies as a "smaller reporting company" (SRC) under SEC rules and can continue to enjoy most of the disclosure and financial reporting accommodations that are available to EGCs. Generally, a company qualifies as an SRC if it has:

— Public float of less than $250 million; or
— Less than $100 million in annual revenues and either no public float or a public float of less than $700 million.

Duty of Oversight Applies to Directors (and Officers, Too)

Recent Cases Clarify *Caremark* Duties of Officers and Focus on Legal Compliance Risks

While the fiduciary duties of directors and officers are the same whether a company is privately owned or publicly traded, the risk of claims by dissatisfied stockholders alleging breaches of these fiduciary duties becomes much more significant once a company is public.

One particular type of breach of fiduciary duty claims—those based on an alleged failure of the duty of oversight—has become especially common in recent years against directors. In 2023, Delaware courts explicitly held for the first time that officers also have a duty of oversight and, therefore, face exposure to claims for alleged failure to fulfill their oversight duties. These developments highlight how important it is for the directors and officers of an IPO company to ensure the company has appropriate reporting systems and controls in place from its first day as a public company.

WHAT IS REQUIRED?

The duty of oversight requires directors and officers to make good faith efforts to implement an oversight system and then monitor it. Allegations that directors and officers violated their duty of oversight are often referred to as *Caremark* claims, referring to a landmark 1996 case involving that company.

THE FIDUCIARY DUTIES OF BOARDS AND MANAGEMENT

The fiduciary duties of directors and officers under Delaware law generally consist of:

— The *duty of care*—an obligation to act on an informed basis after due consideration of relevant materials and appropriate deliberations; and

— The *duty of loyalty*—an obligation to refrain from deriving a benefit from a transaction not generally available to all stockholders, and to otherwise act in good faith.

While almost every company going public will include in its charter a provision eliminating the personal monetary liability of directors and officers for violations of the duty of care, breaches of the duty of oversight are considered to be non-exculpable breaches of the duty of loyalty, and directors and officers who violate the duty of oversight may therefore face personal liability.

Oversight liability can arise if directors or officers either:

— utterly fail to implement any reporting or information systems or controls (“information-systems claims”); or

— having implemented such systems or controls, consciously fail to monitor or oversee the operation of those systems or controls, thus disabling themselves from being informed of risks or problems requiring their attention (“red-flag claims”).

While *Caremark* claims have frequently been described as “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment,” since mid-2019 Delaware courts have allowed *Caremark* claims in at least 10 cases to proceed past the motion to dismiss stage, meaning that plaintiffs adequately alleged that directors or officers had failed in implementing or monitoring an oversight system.

MORE *CAREMARK* CLAIMS SURVIVING DISMISSAL – *MARCHAND* THROUGH 2022

Since the 2019 Delaware Supreme Court ruling reviving claims in *Marchand v. Barnhill*, several plaintiffs’ claims have survived motions to dismiss. In *Marchand*, a listeria outbreak that contaminated Blue Bell ice cream resulted in three deaths and caused the company to recall all of its products, cease production at all plants and dismiss over a third of its employees. These catastrophes caused the Delaware Supreme Court to reverse the Delaware Chancery Court’s dismissal, allowing an information-systems claim against directors to proceed because:

— Food safety was a mission-critical compliance issue for Blue Bell, an ice cream maker;

— The board did not have a committee- or board-level process to oversee and address food safety issues; and

— Board minutes did not mention discussion about food safety concerns existing prior to the listeria outbreak or generally reflect discussion of food safety matters.

Since *Marchand*, and through 2022, the Chancery Court allowed *Caremark* claims against directors to proceed in cases involving, among others, a life sciences company whose lead product candidate suffered from a low confirmed success rate and ultimately ran into FDA problems; an

BOARD ACTIONS TO FULFILL OVERSIGHT OBLIGATIONS

Some of the actions a board of directors can take to help fulfill and document its oversight obligations and minimize the risk of liability under the *Caremark* standards of liability are summarized below.

To address its obligation to implement appropriate reporting or information systems or controls, the board (or designated board committee) may:

— Ensure both management and the board have installed processes for identifying and regularly reviewing mission-critical risks, and document those processes;

— Explicitly assign responsibility for oversight of key risks to the full board or a specific committee, being sure to include corresponding proxy disclosure once public;

— Not rely solely on the existence of regulatory requirements—such as SEC or FDA requirements—as a basis for assuming an adequate reporting system exists;

— Avoid being completely dependent on senior management reporting, including by hearing directly from chief compliance and risk officers, and ensure there are systems in place for employees and corporate partners to raise concerns; and

— Establish protocols for management to promptly elevate significant regulatory or compliance developments.

To address its obligation to monitor or oversee the operation of the implemented systems or controls, the board (or designated board committee) may:

— Be vigilant for warning signs (often referred to as yellow or red flags) and follow up when identified, including giving consideration to the engagement of outside advisors;

— Receive regular reports on mission-critical risks and regulatory issues;

— Ensure that meeting minutes demonstrate regular oversight and follow-up on potential concerns; and

— Exercise care in informal communications (such as emails and texts), because such materials may in some situations be discoverable in response to a books and records request.

OFFICER ACTIONS TO FULFILL OVERSIGHT OBLIGATIONS

Some of the actions officers can take to help fulfill and document their oversight obligations under the *Caremark* standards of liability include:

- Ensure reporting or information systems or controls are in place and well-documented, for matters within a specific officer's areas of responsibility;
- Identify and understand the company's key risks in order to be better able to recognize and respond to red flags, including those that do not relate to direct areas of responsibility; and
- Escalate any significant inadequacies in the information systems, as well as red flags.

auto parts manufacturer that had persistent problems with internal controls and oversight of related person transactions ultimately requiring it to restate its financial statements; and a pharmaceutical company whose subsidiary pleaded guilty to criminal charges related to inappropriate repacking of oncology drugs into syringes.

MCDONALD'S CLARIFIES THAT OFFICERS ALSO HAVE *CAREMARK* DUTIES – 2023 AND THE ROAD AHEAD

In 2023, for the first time, the Chancery Court explicitly held that officers also have *Caremark* duties. Despite ultimately dismissing the suit on other grounds, in *In re: McDonald's Corp. Stockholder Derivative Litigation*, the Court found plaintiffs adequately pled a red-flag claim against the chief people officer, concluding a litany of HR and EEOC complaints, as well as employee strikes and letters from US Senators, constituted awareness of an allegedly harassment-friendly company culture. The chief people officer was also personally alleged to have committed sexual harassment.

The *McDonald's* opinion noted that an officer's duty of oversight will typically be limited to the officer's areas of responsibility but also noted that "particularly egregious red flag[s]" may trigger an officer's duty to act, even if it is outside the officer's domain.

Following *McDonald's*, *Caremark* claims against officers have been allowed to proceed in at least three cases, including one involving a dispenser of opioids whose management of its controlled substance compliance programs allegedly violated a DEA settlement and the Controlled Substances Act.

To close out a whirlwind year for *Caremark* claims, a December 2023 Chancery Court decision clarified that officer claims are held to the same standard as director claims. In *Segway v. Cai*, the Court considered *Caremark* claims against a corporate officer for alleged failure to escalate substantial financial performance issues to the board. In dismissing the plaintiffs' claims, the Court explained that the standard for *Caremark* claims against officers is the same as for directors, and to think, as the plaintiffs had argued, that *McDonald's* created a lower standard for claims against officers is "a distressing reading of our law."

NO ONE-SIZE-FITS-ALL APPROACH TO OVERSEEING RISK

Discharging the duty of oversight requires directors and officers to demonstrate that they have used good faith efforts to put in place a reasonable system of monitoring and reporting the company's key risks, especially those that relate to mission-critical regulatory, legal compliance and public safety matters.

There is no one-size-fits-all approach. Boards and management have discretion to implement context-dependent and industry-specific approaches to risk oversight tailored to the activities and resources of the businesses they oversee, which may include delegating oversight of specific market or industry risks to board committees. That said, it is not sufficient to solely rely on government regulation of a company's industry or simply hold general discussions with management about operational issues at periodic board and committee meetings.

Other cases in 2023 helped clarify the focus of *Caremark* on legal compliance risks rather than on general business risks, as the Delaware courts have consistently drawn the distinction between these two types of risks when determining whether a breach of the duty of oversight has occurred. The facts underlying the October 2023 Chancery Court dismissal in *In re: ProAssurance Corp. Stockholder Derivative Litigation* offer a helpful illustration. In that case, an insurance company deviated from its typical practice of underwriting policies for smaller physician groups and agreed to underwrite a policy for a national provider, which created increased risk that loss reserves held by the company would become inadequate. The Court ruled that the board's decision to pursue a higher-risk strategy did not result in *Caremark* liability because "[t]he only so-called red flags were of business risks—not illegality." This distinction was echoed in *Segway*, with the Court stating that *Caremark* was not intended to create officer liability for "everyday business problems" like the financial discrepancies in that case.

At a minimum, directors and officers should ensure that key regulatory, legal compliance and public safety risks are monitored at the company level and included in the agenda for every regular board meeting, and that the board itself includes directors who have sufficient experience in those key risk areas or consults independent external experts who do.

DO YOUR WORK AND DOCUMENT IT

Practically speaking, directors and officers need to be able to demonstrate that they have been proactive in discharging their risk oversight responsibilities. This generally means being able to show that:

- the company has sufficient reporting and compliance systems;
- regulatory and compliance issues are effectively reported up; and
- when issues are reported, actions are taken to investigate and, if appropriate, address such issues.

It is important to contemporaneously document oversight activities, including in board meeting minutes, given that it is now common for plaintiffs' lawyers to use information gathered through books and records requests in an effort to craft a complaint that is more likely to withstand a company's motion to dismiss. ■

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S&P Global
Exchange Offer
$7,049,783,000
March 2023
Rule 144A Placement of Senior Notes
$750,000,000
September 2023
Counsel to Issuer

Analog Devices
Public Offering of Senior Notes
$300,000,000
September 2022
Exchange Offer
$427,480,000
September 2023
Counsel to Issuer

Thermo Fisher Scientific
Public Offerings of Senior Notes
€1,250,000,000
$1,200,000,000
November 2022
$5,450,000,000
August and December 2023
Counsel to Issuer

Veralto
Rule 144A/Regulation S Private Placements of Senior Notes
$2,100,000,000
€500,000,000
September 2023
Counsel to Issuer

State Street
Public Offerings of Senior Notes
$10,000,000,000
February, May, August, November 2022 and January, May, August, November 2023
Counsel to Issuer

Medtronic
Public Offerings of Senior Notes
€3,500,000,000
September 2022
$2,000,000,000
March 2023
Counsel to Issuer

Akamai
Rule 144A Placement of Senior Notes
$1,265,000,000
August 2023
Counsel to Issuer

DTCC
Rule 144A Placement of Senior Notes
$1,000,000,000
May 2023
Counsel to Issuer

Casella
Public Offering of Common Stock
$517,500,000
June 2023
Counsel to Issuer

Eastman
Public Offerings of Senior Notes
$500,000,000
Green Bond
March 2023
$750,000,000
February 2024
Counsel to Issuer

McCormick
Public Offering of Senior Notes
$500,000,000
April 2023
Counsel to Issuer

Nuvalent
Public Offerings of Common Stock
$264,500,000
November 2022
$345,000,000
October 2023
Counsel to Issuer

MKS Technology for Productivity
Public Offering of Common Stock by Selling Stockholders
$193,520,000
June 2023
Counsel to Issuer

Disc Medicine
Public Offering of Common Stock and Pre-Funded Warrants
$157,780,000
June 2023
Counsel to Underwriters

Avadel
Public Offering of Ordinary Shares and Non-Voting Convertible Preferred Shares
$143,750,000
April 2023
Exchange Offer
$106,268,000
April 2023
Counsel to Underwriters

Editas Medicine
Public Offering of Common Stock
$125,000,000
June 2023
Counsel to Issuer

Astria Therapeutics
Public Offering of Common Stock, Common Stock Warrants and Pre-Funded Warrants
$63,998,500
October 2023
Public Offering of Common Stock
$125,010,500
February 2024
Counsel to Issuer

Inozyme Pharma
Public Offering of Common Stock and Pre-Funded Warrants
$73,061,500
April 2022
Public Offering of Common Stock
$69,000,000
August 2023
Counsel to Issuer

Ikena Oncology
Public Offering of Common Stock
$40,020,500
May 2023
Counsel to Underwriters

Verve Therapeutics
Public Offerings of Common Stock
$258,750,000
July 2022
$143,750,000
December 2023
Counsel to Issuer

Celldex Therapeutics
Public Offerings of Common Stock
$230,546,000
November 2023
$460,506,000
March 2024
Counsel to Underwriters

Ocular Therapeutix
Public Offering of Common Stock
$115,115,000
December 2023
PIPE Placement of Common Stock and Pre-Funded Warrants
$325,000,000
February 2024
Counsel to Issuer

Dynatrace
Public Offerings of Common Stock by Selling Stockholders
$1,252,250,000
February and November 2023
Counsel to Underwriters

Apellis
Public Offering of Common Stock
$402,500,000
March 2022
Public Offering of Common Stock and Pre-Funded Warrants
$402,500,000
February 2023
Counsel to Issuer

Syros
Public Offering of Common Stock and Pre-Funded Warrants
$45,000,000
December 2023
Counsel to Issuer

Viridian
Public Offering of Common Stock and Preferred Stock
$310,787,500
August 2022
Public Offering of Common Stock
$150,000,000
January 2024
Counsel to Underwriters

Voyager Therapeutics
Public Offering of Common Stock and Pre-Funded Warrants
$99,996,500
January 2024
Counsel to Issuer

Cincor
Initial Public Offering of Common Stock
$212,653,000
January 2022
Public Offering of Common Stock and Pre-Funded Warrants
$258,750,000
August 2022
Counsel to Underwriters

Amylyx
Initial Public Offering of Common Stock
$216,018,000
January 2022
Public Offering of Common Stock
$246,330,000
October 2022
Counsel to Underwriters

Dyne Therapeutics
Public Offering of Common Stock
$345,143,750
January 2024
Counsel to Issuer

Arcellx
Initial Public Offering of Common Stock
$142,312,500
February 2022
Public Offering of Common Stock
$128,800,000
June 2022
Counsel to Underwriters

Arvinas
PIPE Placement of Common Stock and Pre-Funded Warrants
$350,000,000
November 2023
Counsel to Issuer

Kymera
Public Offering of Common Stock and Pre-Funded Warrants
$316,249,000
January 2024
Counsel to Underwriters

Solid Biosciences
PIPE Placement of Common Stock
$75,000,000
December 2022
PIPE Placement of Common Stock and Pre-Funded Warrants
$108,858,550
January 2024
Counsel to Issuer

In recent years, a variety of alternative paths to public ownership and trading liquidity have emerged. The reverse merger is one of the newest—and among the oldest—alternatives to a conventional IPO for a private company seeking to become publicly traded, and, due to a confluence of factors, we have seen a marked uptick in reverse merger activity, as well as important legal and business developments impacting this transaction structure.

THE NEW REVERSE MERGER

Despite historical abuses of the technique, reverse mergers remain a potentially attractive transaction structure for private companies with significant cash needs, such as life sciences companies that, for various reasons, may not be able to immediately access the IPO market. But it takes two parties to make a reverse merger, and private companies look for public companies with the following attributes:

— material net cash, replicating the proceeds that would be raised in a traditional IPO;

— limited operations and limited and known (and quantifiable) liabilities;

— a reasonably high degree of confidence that it can deliver the requisite stockholder votes to approve the transaction, given its stockholder base; and

— a national securities exchange listing (preferably Nasdaq or the NYSE) that will remain following completion of the transaction.

The trend of declining public company valuations (including a surprising number of companies trading at values below their net cash), coupled with challenging conditions in the traditional IPO market, has led to a significant uptick in reverse mergers with publicly held life sciences companies since the beginning of 2022. These transactions have originated most frequently with pre-commercial life sciences companies that are listed on a major exchange and suffer a scientific setback or other disruption leading to a restructuring (or winding down) of operations—often while holding significant amounts of cash. In these circumstances, the reverse merger transaction results in the public company effectively reinvesting its cash into the business of the private company, giving the public company's legacy stockholders the opportunity to continue to hold stock in a new business while the formerly private company takes advantage of the public company's existing cash and stock exchange listing.

BASIC STRUCTURE OF A REVERSE MERGER

In a typical reverse merger:

— a privately held company merges with a publicly listed company;

— the pre-merger stockholders of the private company own a majority of the stock of the combined company;

— the management and other employees of the private company become the management and employees of the combined company;

— the composition of the combined company board reflects representation proportional to the post-closing ownership split;

— the business of the private company becomes the business of the public company; and

— the combined company changes its name to that of the private company.

In many cases, the combined company will seek to raise additional capital (either privately, concurrently with the completion of the merger, or publicly, following the merger) to extend its cash runway.

TRANSACTION CONSIDERATIONS

Exchange Ratio

The exchange ratio for a reverse merger transaction is typically based on the relative valuations of the public and private companies. Although the private company's valuation is often tethered to its valuation from its most recent private financing, the final value ascribed to the private company will ultimately be the product of negotiations between the parties, including feedback from any investors providing capital to the combined company. The public company's valuation, by contrast, will typically be based on its anticipated available net cash at closing (after customary deductions and excluding any capital concurrently raised by the combined company) plus a negotiated premium for its public stock listing. As noted below, little to no value is often ascribed to the public company's legacy assets, which fact raises its own set of considerations.

BACKGROUND

In a typical "reverse merger," a private company merges with and into a publicly traded company, with the combined company remaining publicly held. The mechanism is referred to as a "reverse" merger because, while the public company is the legal acquiror, the private company's *stockholders* acquire the public company, as the pre-merger stockholders of the private company own a majority of the stock of the combined company.

SEC Filing and Review

A reverse merger transaction typically requires a merger proxy statement and/or a Form S-4 registration statement to be prepared and filed with the SEC, although as noted below there are certain structures that offer some hope for increased speed. The merger proxy/Form S-4 is at least as complicated as—and is often more complicated and time intensive than—the Form S-1 for a conventional IPO for several reasons:

— The merger proxy/Form S-4 must include separate audited financial statements for each company, plus pro forma combined financial statements reflecting the combination of the two companies.

— The merger proxy/Form S-4 must include detailed descriptions of each company's process leading up to execution of the merger agreement and its boward's reasons for recommending approval of the merger. A description of the fairness analysis provided by the public company's financial advisor to the board (including relevant inputs to the fairness analysis, such as financial projections for the private company) must also be included.

— Scrutiny by the Staff of the SEC of merger proxy/Form S-4 filings for reverse mergers has been increasing, particularly in the background, fairness analysis and financial projections sections. The Staff often focuses on the process undertaken by each company, including measures taken by the public company to mitigate potential conflicts of interest, the reasons the public company elected to pursue a reverse merger rather than a liquidation, wind-down or other alternative, and the reasons the private company decided to pursue a reverse merger rather than a traditional IPO.

— Merger proxy/Form S-4 filings often attract strike lawsuits claiming deficient disclosures and/or an inadequate board process, and activist investors sometimes publicly state that they intend to vote against the transaction unless the terms are modified or that the transaction should be abandoned altogether—in either case introducing delays until a resolution is reached.

These factors can contribute to a longer timeline than that for a conventional IPO, with the period between signing and closing often ranging from three to six months (and sometimes longer).

SIMULTANEOUS SIGNING AND CLOSING

Parties to reverse merger transactions in the life sciences sector often seek to maximize the speed to closing, as the public company's net cash is directly related to both the exchange ratio (and the resulting ownership percentages of each party) and the post-closing public company's cash runway, and every day that goes by means more cash burned prior to the closing of a transaction. As a result, parties often consider whether it is feasible to simultaneously sign and close such a transaction.

Generally, Nasdaq and NYSE rules require pre-closing stockholder approval (i) in respect of the issuance of securities in connection with an acquisition of the stock or assets of another company if the shares of common stock to be issued in the transaction exceed 20% of the issuer's total shares outstanding or represent more than 20% of the voting power of the issuer's total voting securities outstanding prior to the transaction and/or (ii) if the transaction would result in a "change of control" of the issuer. Neither Nasdaq nor the NYSE specifically defines the parameters in which a transaction will constitute a "change of control." For example, in determining whether a "change of control" has occurred, Nasdaq considers "all relevant factors including, but not limited to, changes in the management, board of directors, voting power, ownership, and financial structure of the company."

Under the "sign and close" structure, the need for stockholder approval of the transaction prior to closing is avoided by first, limiting the amount of common stock issued in the transaction to up to 19.9% of the outstanding common stock and issuing any remaining balance of shares as non-voting convertible preferred stock that does not convert until stockholder approval of the issuance is obtained, and second, ensuring that the transaction does not constitute a change of control for Nasdaq purposes.

The issuer (i.e., the public company) agrees to seek stockholder approval of the conversion of the preferred stock following the closing. Typically, if stockholder approval is not obtained, the issuer would be required to continue to seek stockholder approval and, in certain circumstances (generally beginning six months after closing), various adverse consequences would attach, including that the preferred stock would become redeemable for cash. The shares of preferred stock are issued in a private placement, and so, following closing, a resale registration statement is filed. The "sign and close" structure also assumes that there is no new listing process on Nasdaq required.

Determination of a change of control is a facts and circumstances analysis that considers:

— voting power;

— continuity of management;

— board continuity;

— consistency in corporate headquarters;

— corporate name (no current plan to change the company's name/stock symbol); and

— accounting treatment (that the public company is the "acquirer" of the private company for accounting purposes).

The parties will need to approach the applicable securities exchange prior to the execution of definitive agreements to seek input on whether the proposed transaction structure requires stockholder approval. Frequently, the parties will determine in dialogue with the exchange and each other that the transaction would constitute a change of control and the parties are unwilling to alter the business arrangements to avoid that conclusion; for example, the purpose of these transactions is often to effectively bring the private company public—such that the combined company will reflect the board, management, operations and even name of the private company—factors that are all indicia of the occurrence of a change of control. Nevertheless, there are times, for example in transactions that constitute more traditional "mergers" or where the private company is more of an asset than a standalone business, that the simultaneous "sign and close" structure can be a viable and speedy alternative.

SHELL COMPANY CONSIDERATIONS

Typically, the parties to a reverse merger have taken the view that the public company is not, as a technical matter, a "shell company," even if it is actively looking for a merger partner and not prioritizing its historical business. A "shell company" is defined as a registrant that has: "(1) no or nominal operations; and (2) either: (i) no or nominal assets; (ii) assets consisting solely of cash and cash equivalents; or (iii) assets consisting of any amount of cash and cash equivalents and nominal other assets." Because the public companies involved in reverse mergers typically have more than "no or nominal" operations or assets, generally still employ a management team and other personnel, and own assets, including intellectual property assets, most recent reverse merger transactions proceeded on the basis that the public company was not a "shell company."

The SEC has begun to challenge those assumptions, however, with significant consequences. In the adopting release for the SEC's final rules related to "Special Purpose Acquisition Companies, Shell Companies and Projections," issued in January 2024, the Staff specifically stated that shell companies will include any "company that has assumed the appearance of having more than 'nominal' assets or operations," and further that the applicable rules will apply "in situations where, in substance, a shell company business combination is used to convert a private company into a public company," including to "any company that sells or otherwise disposes of its historical assets or operations in connection with or as part of a plan to combine with a non-shell private company in order to convert the private company into a public one." This would include the increasingly common "fire sale CVR," in which the public company issues, in a pre-closing dividend to its pre-closing stockholders, a contingent value right (CVR) in respect of the right to receive the proceeds of the sale or other monetization of any and all legacy assets of the public company. The Staff has indicated it views this sort of arrangement as essentially ensuring that the public company is a shell company.

If one of the parties in a business combination transaction is deemed to be a "shell company," other than a "business combination related shell company" (i.e., a SPAC), then there are a number of consequences, including:

— ***Form S-3:*** The combined company will not be eligible to use a registration statement on Form S-3 until 12 months after the business combination/reverse merger, meaning the combined company must use a registration statement on Form S-1 within the first 12 months.

— ***Form S-8:*** The combined company will not be eligible to use a registration statement on Form S-8 for any equity plans or awards until at least 60 calendar days after the closing of the transaction.

— ***Financial Statements:*** The combined company must file the financial statements for the acquired company within four business days of completion of the business combination/reverse merger (with no available extensions).

— ***"Ineligible Issuer":*** The combined company will be an "ineligible issuer" for three years following closing of the business combination/reverse merger. During that three-year period, the combined company cannot, among other things, (i) qualify as a well-known seasoned issuer (WKSI), meaning it may not file an automatically effective shelf registration statement on Form S-3 even if the combined company had a public equity float greater than $700 million; (ii) rely on the safe harbor under Rule 163A, which establishes a broad exemption from quiet period restrictions for certain communications made more than 30 days prior to the public filing of a registration statement; or (iii) use a free writing prospectus.

— ***Rules 144/145:*** Importantly, affiliates of the private company that receive shares of the public company in the merger are presumptively deemed to be statutory underwriters with respect to resales of those securities, and as a result those securities may not be included in the Form S-1 resale registration statement and would not be eligible for resale until one year after closing, other than in a fixed price offering in which such investors are named as underwriters in the prospectus.

Care must be taken early in the structuring discussions regarding a potential reverse merger transaction to avoid being deemed a "shell company." For example, the parties should consider what personnel and operations are at the public company, how the value of the public company is determined in the transaction (including whether any value is ascribed to the company's legacy assets and operations), and whether the combined company will retain any of the legacy assets or operations following the closing, rather than including a CVR that contemplates all legacy assets being liquidated with the proceeds distributed to pre-closing stockholders.

MERGER AGREEMENT

In a typical reverse merger transaction, the merger agreement is structured as a "public style" agreement, in which there are no post-closing remedies for either party and the representations and warranties and covenants are, to a large degree, reciprocal. However, the following points typically are the subject of particular focus in negotiations:

— ***Minimum Net Cash Closing Condition:*** Most merger agreements for reverse mergers require the public company to have at closing a specified minimum amount of "net cash" (below which the private company could refuse to close), a mechanism to adjust the exchange ratio if net cash is below a specified threshold, or both.

— ***Net Cash Definition:*** Given the minimum net cash closing condition and the importance of the amount of net cash to the premise and economics of a reverse merger transaction, the parties typically spend significant time understanding and negotiating the specific liabilities and obligations—including contingent or potential liabilities—that will be deducted from available cash to determine the amount of "net" cash at closing.

— ***CVRs/Dividends:*** Because the valuation of the public company in a reverse merger transaction often ascribes no value to its legacy assets, it is not uncommon for the public company to issue to its pre-closing stockholders CVRs representing the right to receive proceeds, if any, from the post-closing monetization of its legacy assets. Depending on the amount of its available cash, the public company may also negotiate the right to pay a cash dividend to its stockholders prior to closing, subject to the minimum net cash closing condition.

— ***Termination Fees; Reimbursement of Expenses:*** The circumstances in which one party to a reverse merger must pay a termination fee and/or reimburse the other party's expenses are broader than in the typical public M&A context. ■

REVERSE MERGERS ON MAJOR US EXCHANGES BY INDUSTRY SECTOR AND YEAR

INDUSTRY	2019	2020	2021	2022	2023	TOTAL
Healthcare and Life Sciences	14	12	13	6	14	59
Technology	2	4	4	1	3	14
Consumer Goods and Services	2	3	4	1	–	10
Energy	1	2	4	2	1	10
Financials	1	1	2	2	2	8
Other	5	2	5	3	3	18
Total	**25**	**24**	**32**	**15**	**23**	**119**

Source: S&P Global Market Intelligence

The Form S-1 for an IPO must include specified information about a company's directors, officers and 5% stockholders. The required information is elicited from these parties through a questionnaire (commonly called the D&O Questionnaire). D&O Questionnaires typically are timed so that they will be completed and returned shortly before the initial Form S-1 filing or submission to avoid the need for immediate updates.

A number of recent SEC enforcement actions alleging failure of companies to disclose perquisites and related party transactions highlight the importance of D&O Questionnaires, including the care taken by directors and officers in completing, and by companies in reviewing, D&O Questionnaires.

SEPTEMBER 2023

— The SEC settled charges against a rideshare company for allegedly failing to disclose a director's role in a stockholder's private sale of approximately $424 million of shares prior to the company's IPO in March 2019. According to the SEC's order, a director of the rideshare company arranged for a stockholder to sell its shares to a special purpose vehicle (SPV) set up by an investment adviser affiliated with the director; then the director contacted an investor interested in purchasing the shares through the SPV. The company allegedly approved the sale and secured a number of terms in the contract. The director (who left the board at the time of the transaction) received millions of dollars in compensation from the investment adviser for his role in structuring and negotiating the deal. The SEC order stated that the director did not disclose his compensation or his material interest in the transaction to the company. As a result, the company failed to disclose information regarding the sale in its Form 10-K for 2019. Without admitting or denying the SEC's allegations, the company agreed to pay a $10 million fine.

— The SEC settled charges against a government contractor for allegedly failing to make required disclosures related to its employment of an executive officer's siblings. According to the SEC's order, the company appointed a longtime employee as an executive officer in 2019. The officer's two siblings were also longtime employees of the company who each received annual compensation in excess of $120,000 (the threshold amount for disclosure of related party transactions). The company filed annual reports and proxy statements for 2019 through 2021 that did not disclose this information. Without admitting or denying the SEC's allegations, the company agreed to pay a $500,000 fine.

JUNE 2023

— The SEC settled charges against Stanley Black & Decker Inc. for allegedly failing to disclose perquisites provided to executives, as well as charges against a former Stanley Black & Decker executive for his role in the company's alleged failure to disclose perquisites and personal benefits provided to him. In charging the former executive, the SEC focused on the company's D&O Questionnaire and claimed that the former executive failed to disclose certain of his perquisites and benefits in response to questions relating to compensation. These undisclosed perquisites and benefits were comprised of chauffeur services, other travel items, meals, apparel, car repair services, approved use of the corporate aircraft, personal services provided to the former executive by company employees, and certain gifts and products. The SEC also noted the former executive's receipt of various drafts of the company's proxy statement to highlight that he had the opportunity to correct any misstatements made in his D&O Questionnaire but failed to do so. Neither the company nor the former executive admitted or denied the SEC's allegations. The company's remedial measures, which included an internal investigation, cooperation with the SEC's investigation and disclosure in its Form 10-K, were sufficient to prevent monetary penalties against the company. However, the former executive was ordered to pay a $75,000 fine.

MARCH 2023

— The SEC settled charges against The Greenbrier Companies, Inc., for allegedly failing to disclose perquisites given to its named executive officers (NEOs) and certain information regarding related party transactions, and against its founder and former CEO for his role in the company's alleged failure to disclose such information. In the SEC's orders against both the company and the former CEO, the SEC focused on the D&O Questionnaires that the former CEO completed from 2017 to 2021 and, in each such questionnaire, the former CEO's alleged failure to disclose (a) some of his perquisites, including travel expenses for his spouse and personal security expenses, and (b) the dollar amount of his related party transactions. In accepting the settlement offer, the SEC considered the company's training of NEOs and employees on the D&O Questionnaires as a remedial measure. However, despite remedial measures, the company was ordered to pay a $1 million fine, and the former CEO was ordered to pay a $100,000 fine, in each case, without admitting or denying the SEC's allegations.

These actions demonstrate the need for careful review of the questions included in D&O Questionnaires, to ensure that they prompt fulsome responses, and careful review of the answers to completed D&O Questionnaires, to ensure that all required information is properly disclosed in the Form S-1. ■

THE REQUIRED INFORMATION

The D&O Questionnaire gathers information that is required to be included in the Form S-1, including biographical and background information for each director and executive officer; compensation information for the company's NEOs and directors; beneficial stock ownership of each director, NEO and 5% stockholder; and information regarding related party transactions.

Other important information is collected through separate questionnaires including (a), a FINRA Questionnaire provided to directors, officers, 10% stockholders and the company in order to support the required representations and disclosures made by the managing underwriters to FINRA and (b), a Selling Stockholder Questionnaire provided to all selling stockholders in order to elicit beneficial stock ownership information, the nature of any material relationship that the selling stockholder has with the company and other required disclosures.

OVERVIEW

An employee stock purchase plan (ESPP) that satisfies the requirements of Section 423 of the Internal Revenue Code (Section 423) permits employees (but not non-employee directors, consultants or advisors) of a public company to purchase shares of common stock at a discount from the market price with favorable tax treatment.

Among other requirements, Section 423:

— requires that substantially all employees (excluding 5% stockholders) be allowed to participate in the ESPP;

— requires that all employees granted options under the ESPP have the same rights and privileges;

— imposes an annual limit of $25,000 per employee on the value of the stock purchased under the ESPP;

— requires the company's stockholders to approve the ESPP; and

— sets the minimum purchase price at 85% of the lesser of the fair market value of the stock at the beginning of the offering period and the fair market value of the stock on the purchase date.

Accounting rules (ASC Topic 718) require companies to recognize compensation expense over the requisite service period for rights to purchase stock granted under an ESPP, unless the discount is 5% or less and there is no "lookback" feature allowing the discount to be taken from the market price at the beginning of the offering period (rather than the purchase date).

Notwithstanding the compensation charges, the incidence of ESPPs among IPO companies has grown significantly over the past 15 years, with ESPPs generally including a 15% discount and a lookback feature. For example, the percentage of all IPO companies adopting an ESPP increased from 33% in the years from 2010 to 2013 to 60% in the years from 2020 to 2023. All but two of the ESPPs adopted by companies going public since the start of 2020 had a 15% discount, and all but eight had a lookback feature.

Some of the key pros and cons of an ESPP are summarized as follows:

PROS

— An ESPP can encourage broad-based employee ownership of company stock.

— Through the use of payroll deductions, purchases under an ESPP are convenient and typically avoid brokers' commissions.

— Although not a perfect substitute for a directed share program (DSP), an ESPP structured to commence at the time of the IPO may help reduce employee disappointment if the company decides not to make IPO shares available to employees in a DSP.

— Participants can acquire shares at a discount from the market price. With proper structuring, an ESPP can even be used as a means to permit employees to invest at a discount from the IPO price.

— If the ESPP complies with Section 423, participants receive favorable tax treatment for the shares purchased under the ESPP, including deferral of any tax on the discount until the shares are sold, and the possibility of long-term capital gains treatment for further appreciation if applicable holding periods are met.

— If other employers with which the company regularly competes for employees offer ESPPs and the company does not, it may be at a competitive disadvantage in hiring.

CONS

— In practice, many employees immediately sell the shares received under an ESPP, defeating the goal of encouraging employee stock ownership in the company.

— Unless the ESPP is structured with a discount of 5% or less and there is no lookback feature, the company will incur stock-based compensation charges, which will reduce its GAAP income (though this is less important to companies that report EBITDA measures from which stock-based compensation charges have been removed).

— If the ESPP is structured to avoid compensation charges, the attractiveness of the plan to employees is substantially reduced.

— Legal requirements may force foreign employees to be excluded from the ESPP, potentially alienating a portion of the company's workforce.

— To the extent employees hold the stock acquired under the ESPP and the market price declines below the purchase price, ill will and disappointment among employees may result.

— The ESPP creates administrative obligations for the company, including annual IRS reporting requirements, and administrative foot faults can be costly and time-consuming to remedy.

— Special arrangements are required if the company desires to have the first offering period commence upon effectiveness of the Form S-1 at the IPO price. The company may enroll employees in the ESPP prior to the effectiveness of the Form S-8 (pursuant to which the shares will be registered) only if no money is collected before such effectiveness and if the initial deemed election for all participants is set at the highest permitted level. Ensuring that the arrangement is appropriately structured at a time when the company may not yet have engaged with a third-party plan administrator may create a significant administrative burden on management at an already demanding time. ■

PREVALENCE AND TERMS OF ESPPs IN IPOs

YEAR	COMPANIES WITH ESPP	ESPP DISCOUNT EQUALS 15%	ESPP INCLUDES LOOKBACK FEATURE	INITIAL ESPP OFFERING PERIOD COMMENCES UPON IPO
2014 to 2016	47%	95%	97%	25%
2017 to 2019	57%	97%	97%	20%
2020 to 2023	60%	99%	97%	9%

Source: WilmerHale analysis of SEC filings

An IPO closing heralds the start of Exchange Act reporting obligations, which apply not only to companies but also to their directors, officers and significant stockholders. In October 2023, the SEC amended the rules governing beneficial ownership reporting obligations under Regulation 13D-G. These amendments impact stockholders by accelerating the filing deadlines for initial and amended beneficial ownership reports on Schedules 13D and 13G, among other changes, and stockholders will need to adjust their reporting processes accordingly.

BACKGROUND

Section 13 of the Exchange Act imposes reporting obligations on beneficial owners of more than 5% of any class of equity securities registered under the Exchange Act. For most public companies, their "covered class" is their common stock. Stockholders must make a Schedule 13D or 13G filing with the SEC to publicly report their initial acquisition of the company's common stock and must amend this filing if material changes occur in the disclosed information. While there is overlap in the disclosure required by the two forms, Schedule 13G is shorter and easier to complete than Schedule 13D. In general, Schedule 13G is available to any stockholder that falls within one of the following three groups:

— ***Qualified institutional investors* (QIIs)** include investors that fall into one of several enumerated categories (such as banks and broker-dealers), where the acquisition that triggered the filing obligation was made in the ordinary course of business and not to influence the control of the company, and where the investor gave prompt notice if the acquisition was made on behalf of other specified persons.

— ***Exempt investors* (EIs)** include investors that beneficially owned more than 5% of the company's common stock prior to the registration of the company's common stock under the Exchange Act in connection with the IPO (such as founders and pre-IPO investors) and that do not subsequently acquire additional shares representing more than 2% of the company's common stock in a 12-month period.

SCHEDULE 13D AND 13G FILING REQUIREMENTS UNDER THE AMENDED RULES

Filing Type	Schedule 13D Filing Deadlines	Schedule 13G Filing Deadlines
Initial Filing	Within ***5 business days*** after acquiring beneficial ownership of more than 5% or losing eligibility to file on Schedule 13G	QII & EI: ***45 days*** after calendar quarter-end in which beneficial ownership exceeds 5% QII: ***5 business days*** after month-end in which beneficial ownership exceeds 10% PI: Within ***5 business days*** after acquiring beneficial ownership of more than 5%
Amendment Filing	Within ***2 business days*** after the occurrence of a "material change"* in the facts set forth in the previous Schedule 13D	QII, EI & PI: ***45 days*** after calendar quarter-end in which a material change in the facts set forth in the previous Schedule 13G occurred QII: ***5 business days*** after month-end in which beneficial ownership exceeds 10% or a 5% increase or decrease in beneficial ownership PI: ***2 business days*** after exceeding 10% beneficial ownership or a 5% increase or decrease in beneficial ownership

** Although Regulation 13D-G does not define "material," the SEC has indicated that a material change includes any acquisition or disposition of 1% or more of the company's common stock.*

— ***Passive investors* (PIs)** include investors that beneficially own between 5% and 20% of the company's common stock and that do not seek to acquire influence or control over the company.

FILING MECHANICS

Section 13 filings are made electronically via the SEC's EDGAR system. The recent amendments extend the cutoff time for Schedule 13D and 13G filings to 10 p.m. ET, which aligns with the cutoff time for Section 16(a) ownership reports (i.e., Forms 3, 4 and 5), and require use of a new Schedule 13D- or 13G-specific extensible markup language (XML).

SELECTED OTHER CHANGES

Other key rule changes in the SEC's October 2023 adopting release include:

— ***Item 6:*** The amendments revise Rule 13d-101 to expressly state that under Item 6 of Schedule 13D, stockholders must disclose any contracts, arrangements, understandings and relationships with respect to any company securities, including derivative securities that use a covered class as their reference security (such as call options, put options or security-based swaps).

— ***Rule 13d-5:*** The amendments revise Rule 13d-5 to clarify that a "group"—which is formed when two or more persons agree to act together for the purpose of acquiring, holding, voting, or disposing of a company's securities—is deemed to acquire any additional equity securities acquired by a group member after the group's formation, although the rule includes a carve-out for certain intragroup securities transfers.

— ***Technical Amendments:*** The SEC also adopted a number of technical amendments to reflect the impact of the substantive rule changes (e.g., updating titles and designations and incorporating conforming changes, as well as utilizing gender-neutral phrasing).

The SEC also provided guidance regarding its views on certain nuanced aspects of beneficial ownership reporting, including group formation and the application of existing rules to cash-settled derivative securities. ■

IMPLEMENTATION TIMELINE

The amendments became effective on February 5, 2024, with compliance generally required as of that date, subject to the following exceptions:

— Compliance with the XML requirement is mandatory beginning on December 18, 2024.

— Compliance with the revised Schedule 13G filing deadlines, for both initial and amended filings, is required beginning September 30, 2024.

OVERVIEW

2023 marked a busy year for public company accounting and auditing standard setting, and audit committees and IPO companies should take note. Importantly, the Financial Accounting Standards Board (FASB) published two Accounting Standards Updates that are expected to meaningfully affect public company disclosures regarding segment reporting and income taxes. The Public Company Accounting Oversight Board (PCAOB) also issued a proposal on auditor responsibilities with respect to noncompliance with laws and regulations (NOCLAR) that, if adopted, will likely have sweeping effects on existing audit systems and processes. Plus, SEC Chief Accountant Paul Munter made remarks expressing concern around internal control over financial reporting (ICFR), particularly about strengthening companies' and auditors' risk assessments.

FASB ACCOUNTING STANDARDS UPDATES

Segments. Described by FASB Chair Richard Jones as "FASB's most significant change to segment reporting since 1997," the amended segment reporting standard will require that companies:

— Disclose significant segment expenses that are both regularly provided to the chief operating decision maker (CODM) and included in reported segment profit or loss, along with certain other significant expense items.

— Disclose the title and position of the CODM and explain how the CODM uses reported measure(s) of segment profit or loss in assessing segment performance and allocating resources. Multiple measures may be reported if actually used by the CODM as long as the measure most consistent with US GAAP is disclosed.

— Provide all annual disclosures about a reportable segment's profit or loss and assets in interim periods.

— Make all required segment disclosures even if there is only one reportable segment.

Amended Segment Standard (ASU 2023-07)

Effective for annual periods beginning after December 15, 2023 and for interim periods within fiscal years beginning after December 15, 2024

Amended Income Taxes Standard (ASU 2023-09)

Effective for annual periods beginning after December 15, 2024 for public companies

Taxes. The FASB has responded to investor requests for additional transparency concerning income tax information. Under the amended income tax disclosure requirement, companies will be required to provide more granular detail in the financial statement footnotes, explaining the difference between their effective tax rate and statutory tax rate while highlighting tax risks, opportunities and management in a global context. This disclosure will include a new tax rate reconciliation table with a number of reconciling items, including state, local and foreign taxes by jurisdiction, tax credits, changes in valuation allowances, and nontaxable/nondeductible items, among others.

AUDITING DEVELOPMENTS

2023 was one of the PCAOB's busiest years in recent memory. Of note, its NOCLAR proposal has attracted significant public attention and aims to expand auditors' responsibilities for considering a company's noncompliance with laws and regulations, including fraud. The current audit guidance, AS 2405 *Illegal Acts by Clients*, works in conjunction with Section 10A of the Exchange Act, which establishes investigation procedures and required communications for when an auditor "detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements of the issuer) has or may have occurred."

The NOCLAR proposal would significantly expand auditors' obligations to plan and perform specific procedures for identifying laws and regulations with which noncompliance could reasonably have a material effect on the financial statements, *whether directly or indirectly*, which goes beyond the current auditing requirements and Section 10A. The proposal may result in increased auditor fees, changes to the way audits are conducted, and increased pressure on maintaining a client's attorney-client privilege and other legal protections. The PCAOB is reviewing comments on the proposal and is targeting adoption of a NOCLAR auditing standard in 2024.

ICFR RISK ASSESSMENTS

SEC Chief Accountant Paul Munter noted in a public statement released in August 2023 that members of the Office of the Chief Accountant "are troubled by instances in which management and auditors appear too narrowly focused on information and risks that directly impact financial reporting, while disregarding broader, entity-level issues that may also impact financial reporting and internal controls." The statement signals an expectation for a broader consideration of, and even greater disclosure around, risks to a company's ICFR.

Speaking to risk assessments specifically, the statement emphasized the need for management to monitor for new or changing business risks, including loss of financing, customer concentrations, declining conditions affecting the company's industry, and changes in technology. Consideration of these risks could be viewed as potentially expanding the matters to be considered by management in assessing the effectiveness of a company's ICFR.

The statement implored that when ICFR control deficiencies are identified, management and auditors take a comprehensive approach to consider not only the actual misstatement but also the magnitude of potential misstatement which can extend to a wider population of potential misstatements beyond the identified misstatement. ■

EGC RELIEF

The ability of EGCs to elect not to be subject to new or revised accounting standards until those standards are required to be applied to nonpublic companies, and to provide only two years of audited financial statements (instead of three years), is discussed on page 9.

Want to know more about the venture capital and M&A markets?

See our *2024 Venture Capital Report* for an in-depth US venture capital market analysis and outlook, including industry and regional breakdowns. We review changes in market practices and state laws regarding noncompete provisions and provide guidance on how to address the changing landscape. We explore the business, legal and process considerations private companies must balance in evaluating whether and how to implement an option repricing. We provide an overview of fundraising challenges and opportunities for emerging defense tech companies. We discuss developments in laws governing foreign investments, including both the inbound investment review regime of the Committee on Foreign Investment in the United States (CFIUS) and outbound investment regime proposed by the Biden Administration's recent executive order. Finally, we offer a roundup of deal term trends in VC-backed company M&A transactions and convertible note, SAFE and venture capital financings.

See our *2024 M&A Report* for a global M&A market review and outlook, plus an update on takeover defenses for public companies. We review key developments in US antitrust enforcement, look at the recently announced DOJ M&A safe harbor policy, compare public and private company M&A deal terms, and review deal term trends in VC-backed company sales.

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Data Sources: WilmerHale compiled all data in this report unless otherwise indicated. Direct listings and offerings by special purpose acquisition companies, REITs, bank conversions, closed-end investment trusts, oil & gas limited partnerships and unit trusts are excluded from IPO data, except as otherwise indicated. Offering proceeds generally exclude proceeds from exercise of underwriters' over-allotment options, if applicable. Venture capital data is sourced from SEC filings and PitchBook. Private equity–backed IPO data is sourced from SEC filings and Refinitiv.

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