

# the Corporate Governance I a d v i s o r

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## DEFINITION OF “DISCLOSURE MATERIALITY”

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### A Senior Executive Is Seriously Ill. When Should a Company Disclose the News?

*By Mike Dicke, Susan Muck, David Bell,  
and Alison Jordan*

The death of Oracle CEO Mark Hurd in October has highlighted a longstanding public company dilemma: whether and when to disclose the news that a senior leader has a serious health challenge.

Not only is the topic sensitive from a personal and privacy perspective, but there is no specific rule or duty that requires disclosure of a CEO’s or other executive’s adverse health information—unless the executive is incapacitated.<sup>1</sup> Although commentators and news articles sometimes suggest companies should publicly disclose any serious health issue affecting a CEO, the law leaves substantial discretion for the board of directors to evaluate the specific facts, and allows for a non-disclosure approach when the CEO can continue to perform his or her key duties.

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This is partly because health falls into a category of information that has over time been treated differently from core business information for purposes of judging materiality—that is, information a reasonable investor would consider important—under the federal securities laws.

Not surprisingly, company executives and boards have chosen various approaches to disclose high-profile health conditions. The three main paths companies have taken are full disclosure, partial disclosure, and silence. This article explores the pros and cons of each approach given the complexities of defining “material” information in the context of health. It also explains the duties of the board and the CEO, which include keeping one another informed, and offers principles-based recommendations to limit risk exposure under securities laws.

## What the Legal Framework Covers

U.S. securities laws do not specifically mandate disclosure of a CEO’s illness or other health-related information. Public disclosure of a CEO’s health condition becomes necessary only when there is “a present duty to disclose” and the information is considered “material”—the framework applicable to non-public information generally.

Securities laws require companies to disclose material information in certain circumstances that trigger the “present duty” threshold—for example, where an insider is selling shares outside the parameters laid out in a so-called 10b5-1 plan for trading shares according to a pre-arranged schedule. In addition, Form 8-K requires disclosure of the departure of individuals from specified executive roles.<sup>2</sup>

However, the determination of whether an executive’s health issue is material is generally left to the board’s judgment. Even then, there appears to be a gloss on the materiality test that weighs against disclosure when it comes to health

information. Academics and commentators disagree about when a CEO’s illness becomes material to investors and whether the U.S. Securities and Exchange Commission should mandate its disclosure.

There is a dearth of case law on point; neither courts nor the SEC have concluded that adverse information about a CEO’s health was so material that (in hindsight) it should have been disclosed. Because the courts have not provided standards by which to make decisions on these questions and there are no indications that the SEC will issue a rule or give further guidance in the near term, each company must navigate its particular set of facts and circumstances.

## When Is a Health Condition So Material That a Company Needs to Disclose It?

Determining that information is “material” enough to trigger disclosure is not a straightforward task. Legally, information is material if there is a substantial likelihood that a reasonable investor would consider that information in deciding whether to buy or sell the company’s securities. Existing case law indicates that just because investors might like to know about the CEO’s health, that does not mean the information is material.<sup>3</sup> Below are some of the methods for assessing materiality.

- ***Weighing Probability and Magnitude.*** Under *Basic v. Levinson*, materiality is a fact-specific test that is measured by comparing the probability that an event will occur with the anticipated impact of that event on the corporation (also known as the probability-magnitude test). For instance, when an executive is permanently or temporarily incapacitated to the point of inability to perform the duties of her role, and her role (during the period of incapacity, if temporary) is reasonably believed to be critical to the success of a company over the long term, there is a strong argument that the materiality test has been met.

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- **Significant Stock Price Drops.** Another way to look at materiality is whether public disclosure of the information would cause the stock price to drop significantly. Although no court has deemed a CEO's illness to be material, at least two high-profile CEO departures were followed by significant stock price drops. Commentators have opined that in those contexts, the CEO's illness must have been material: (1) CSX stock dropped 7% upon its announcement of the CEO's medical leave; and (2) Apple stock dropped over 5% (but soon rebounded) upon Steve Jobs' resignation as CEO.<sup>4</sup>
  - **The Materiality Gloss: Health Information as a De Facto Exception.** Despite the legal framework discussed above, it is clear in practice that courts and commentators struggle to apply the materiality framework—developed in the context of business information like revenue forecasts and merger discussions—to an executive's personal medical information. A gloss—or commonly accepted legal interpretation—covers the materiality test, and that gloss weighs against finding that an executive's health condition that does not incapacitate the executive is so material as to require immediate disclosure, except in extreme cases. Put simply, executive health appears to be almost a *de facto* exception to materiality because those who consider the health disclosure issue are uncomfortable deeming an individual's personal medical information to be material even where the information might appear to matter to investors to some degree.

## Privacy versus Disclosure: Companies Walk a Fine Line

Commentators have noted the tension between privacy rights and disclosure obligations under the federal securities laws.<sup>5</sup> Executive health is becoming a category of information that is deemed "immaterial" even though the information might be significant to investors. In the context of personal information, the materiality test may be overbroad and over-inclusive, which

appears to have led decisionmakers to create a *de facto* exception for CEO health without actually calling it an exception.

Those who are uncomfortable deeming personal medical information to be material even where it would otherwise matter to investors may be relying on decisions about non-materiality related to other business matters. Health would not be the only exception to the materiality standard, as there are several other judicially created exceptions to the materiality analysis, including cases involving business-sensitive information, ubiquitous business conduct, deference to state courts and the misuse of sensitive information.<sup>6</sup> In these situations, courts seem to be choosing to not require disclosure of certain significant information by deeming it not material. The same approach has filtered down to executive health information.

In sum, decisionmakers enforcing a company's disclosure obligations appear to be making (whether consciously or unconsciously) policy choices to treat health information differently from typical business information. This may be influenced by privacy concerns, as well as the fact that medical science is inexact and the hard "facts" about a CEO's health are often unknowable.

Predicting the outcome from a prognosis is no easy task for a doctor, let alone a board of directors, the courts or the SEC. This explanation lends further support to the conclusion that unless a CEO's health issue is so acute that it raises concerns of his or her incapacity or inability to perform critical duties, disclosure is not required.

## Voluntary or Partial Information Can Lead to Increased Disclosure Obligations

Although there is no law or regulation that specifically requires a company to disclose a CEO's illness to investors (other than Item 5.02 of Form 8-K, which covers departure of certain

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executive officers), particularly when the executive continues to work, companies and boards have increased disclosure obligations—and face increased litigation risk—when they make a voluntary disclosure. The “half-truth” doctrine provides that if a company speaks, it must include all information necessary to make the statement not misleading.<sup>7</sup> Although the SEC and courts have not yet applied this doctrine to health information, they could do so, particularly when companies voluntarily choose to provide health information that turns out not to be entirely accurate, or if they make partial or incomplete disclosures that could be viewed as misleading.

Where a company has made CEO health-related disclosure, the board should engage in a periodic materiality assessment and stay apprised of conditions that would trigger a public disclosure if the CEO can no longer perform the duties of a chief executive—for example, if an executive’s illness is physically incapacitating but the role requires extensive travel. Shareholders have brought derivative litigation in the wake of a company’s disclosures about CEO illness and death, demonstrating that some litigation risks do exist.

## Company Approaches Range from Full Disclosure to Putting Executive Privacy First

In determining whether and how to disclose a CEO’s medical condition, companies are often guided by considerations other than mandatory disclosure requirements. Over the years, several boards and their CEOs have chosen to make voluntary public disclosures based on what they believed to be good corporate governance, transparent investor relations or assessments that the information would eventually become public.

Other companies that prioritized privacy followed the approach of keeping CEO health information closely guarded. The wide spectrum of disclosure approaches highlights the uncertainty of the law regarding how a board should balance the CEO’s interest in privacy

against the shareholders’ desire to know all material information.

### Best Practices:

Because materiality is considered to be one of the most difficult judgment calls in complying with securities regulations and requirements, boards that are considering how best to handle potential health disclosures can mitigate the risks surrounding this decision through other disclosures:

- The board should consult counsel in the discussion and analysis of appropriate disclosure.
- The board should engage in succession planning while also strengthening its risk factor disclosures on the next Form 10-Q. The board should also remember that it must revisit the materiality disclosure analysis if the CEO’s health declines or he or she is no longer able to perform key duties that are critical to the company’s success.

## Full Disclosure

Because of executives’ personal beliefs or corporate policies, some companies have chosen to disclose the full scope of health issues affecting their CEOs or other top executives.

- ***Berkshire Hathaway.*** Berkshire Hathaway’s CEO Warren Buffett rather famously boasts that he communicates with shareholders as if they are his family, adopting a transparent approach to deciding what information might be important to investors. In 2000, Berkshire Hathaway announced in a detailed press release that Buffett was going to have colon surgery. In 2012, the company again disclosed that Buffett was diagnosed with early-stage prostate cancer and would undergo radiation treatment. This approach is primarily a reflection of Buffett’s personal views on disclosure versus privacy and falls on the most

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transparent end of the disclosure continuum with respect to CEO health.

- **Google.** Company co-founder Sergey Brin chose to disclose a health condition before any possible affirmative duty to disclose arose (indeed, before the health condition actually materialized) when he announced in 2008 that he has a gene mutation increasing his likelihood of contracting Parkinson's disease. The announcement was made in Brin's personal blog post and was not accompanied by any formal disclosures.
- **General Motors.** In 1998, GM publicly announced as soon as it was diagnosed that Harry Pearce, its CEO at the time, had leukemia. Like Buffett, Pearce has expressed his personal belief that, with respect to a CEO's illness, "[t]here is an absolute requirement to make full disclosure. And by full disclosure I mean full public disclosure."
- **United Airlines.** Regardless of the CEO's personal views, disclosure is sometimes required. United's board responded to the sudden heart attack of Oscar Munoz in 2015 by issuing a press release and later announcing that the general counsel would serve as acting CEO. The company filed a Form 8-K disclosing Munoz's temporary medical leave (under Item 5.02 covering departure of certain officers). Although United was only required to disclose the change in leadership, it chose to provide updates on Munoz's heart transplant surgery, recovery and planned return to work in 2016.

### Best Practices:

As noted earlier, the SEC and federal securities laws do not require publicly traded companies to disclose any and all material information. That said, when companies choose full disclosure, their board should:

- Develop a full communications plan and ensure that all material information being disclosed is complete and accurate.

- Ensure that either formal or informal controls are in place for the CEO to report updates on his or her health to the company so that the board may engage in a materiality assessment and update the disclosure if needed.
- Ensure that insiders refrain from trading in issuer securities unless they disclose all material information to the market.

### Mixed Approach: Disclosing Partial Information

Some companies choose to disclose partial information about the CEO's health, balancing privacy with disclosure obligations.

- **Time Warner.** CEO Steven Ross kept his heart condition and cancer treatment confidential throughout the 1980s. Then in 1991, Time Warner publicly disclosed Ross's cancer and his need to undergo further treatment. A year later, Ross updated the disclosure to include details about the seriousness of his illness and his medical leave.
- **Kraft Foods.** The company announced in 2004 that CEO Roger Deromedi was hospitalized, but declined to provide details about his "undiagnosed medical condition," drawing criticism from the media and shareholders.

### Best Practices:

If the company does choose to speak about the CEO's health, it or its board should:

- Adequately accompany any voluntary disclosure with meaningful caveats and cautionary statements about the executive's prognosis, including anything that could change the situation described.
- Ensure that either formal or informal controls are in place for the CEO to report updates on his or her health to the company so that the



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board may engage in a materiality assessment and update the prior disclosure if needed.

- Make disclosures about the CEO's health only after receiving full verification of the statement and condition from a medical professional, including the uncertainties in the prognosis.
- Expressly disclaim any obligation or intent to provide updates on the CEO's health. Although companies generally do not have a duty to update information that was accurate at the time it was disclosed, if the company states publicly that "we will let you know if the CEO's condition changes," the company would arguably have assumed a duty to update.
- Avoid commenting on third-party rumors, including about the CEO's health. If the company does comment, its statement must be accurate and not misleading.

### Protecting Privacy: The Silent Treatment

Where the CEO continues to perform his or her duties and there is no mandatory requirement to announce a temporary replacement, several companies have opted not to disclose the CEO's health condition. A few examples follow, and we expect there are others that were never disclosed (even after the fact).

- **Bear Stearns.** During the financial crisis, CEO Jimmy Cayne kept his serious illness and hospitalization private.
- **Intel.** Former CEO Andrew Grove also chose not to disclose his cancer diagnosis for over a year, and later revealed that his treatments kept him out of the office for only three days and did not interrupt his normal work schedule.
- **Reliance Group Holdings.** This insurance company did not disclose that its CEO and major shareholder, Saul P. Steinberg, had suffered a stroke that left him partially paralyzed.

**Best Practices:** One of the board's most important roles is to plan for succession in the event of a departure of a senior executive, whether that transition is planned or unexpected. If the company chooses to not disclose any information, key steps to take include:

- Put effective emergency/short- and long-term succession plans in place in the event that a change in leadership is required, and engage in a structured process to review the plans on an annual basis.
- Discuss further succession planning with counsel.
- Consider disclosing succession plans in order to reassure stakeholders and prevent major stock price impacts if the CEO announces an illness or takes a leave of absence.
- Revise key-person risk factor in the company's next Form 10-Q, as appropriate. The language should be updated to explicitly discuss the material impact of a departure or unavailability of key executives and the company's dependence on the CEO.

### Internal Disclosures: Duties of the CEO, Executive Officers, and the Board

Although public disclosure of a CEO's illness requires the board to apply the specific facts to the law, the general consensus of legal scholars and commentators seems to be that the CEO is legally obligated to inform the board generally about a serious medical condition so they can plan an adequate succession strategy.<sup>8</sup> CEOs who keep their boards in the dark have been criticized for thwarting succession planning. The duty to keep the board informed extends to other corporate officers who, if they thought the CEO was slipping in carrying out his or her duties, would have a duty to report a clear enterprise risk to the board if the CEO would not tell the board directly.

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The board itself can also affirmatively set expectations that the CEO and other key executives disclose personal information that is material to the company. This means the board can decide what information they would like to know from the CEO, either formally (such as in a company's bylaws) or informally (such as in discussions with the CEO). The board could also use the company's code of ethics or the CEO's employment agreement to require the CEO to disclose material information to the board. The contractual obligation might include requiring that the CEO provide periodic updates on his or her condition to the extent it impacts the board's materiality analysis and mandatory disclosure requirements discussed above.

Accordingly, if there are obvious indications that the CEO is sick, missing work or getting medical treatment, the board has a duty to investigate to evaluate disclosure obligations. Directors, officers, and spokespersons should also not make any representations that are inconsistent with the known facts (such as that the CEO is in good health), as these could conceivably violate federal anti-fraud protections.

### **Best Practices:**

Management is obligated to keep the board informed and to actively seek out information, including the following:

- Officers have a duty to keep their boards informed of potential risks and liability faced by the company, which includes internally disclosing health-related information to directors who can then evaluate disclosure obligations and engage in adequate succession planning. Withholding relevant medical information from the board may be a breach of an officer's duty of good faith.
- Board members have a duty to investigate perceived "red flags." Upon becoming aware of any problem warranting board attention, directors should make further inquiry until they are reasonably satisfied that the issue has been handled appropriately. Directors should

also revisit the materiality analysis and discussions on an ongoing basis to stay apprised if the circumstances have changed.

## **Summary of Key Takeaways**

Although a company does not have a general duty to disclose an executive's health issues, a bright-line rule is that if a senior executive is incapacitated and therefore unable to perform his or her duties, disclosure is required (particularly if the executive performs certain roles<sup>9</sup> or is otherwise reasonably believed to be critical to the success of the company). Otherwise, the board must evaluate the specific factual circumstances in light of the above legal framework to determine whether the information is material and whether there is a duty to speak. Voluntary disclosure is permissible but comes with risks.

Regardless of whether disclosure is required, the CEO should provide the board with sufficient information to engage in a materiality analysis and evaluate the company's disclosure obligations on an ongoing basis. Other officers and directors should also be cognizant of their duties to inform the board of any enterprise risks, and to investigate any perceived issues until they are reasonably satisfied that the situation is being handled appropriately.

The company should consider enhancing the key person risk factors on its next form 10-Q in order to mitigate any risks going forward. Most risk arises from partial disclosures or "half-truths"—which should be avoided. Sometimes silence with respect to executive health is the best policy.

## **Notes**

1. Although this article focuses on CEOs, the analysis and best practices apply to other critical executives or key employees.
2. See Item 5.02 ("If the registrant's principal executive officer, president, principal financial officer, principal

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accounting officer, principal operating officer, or any person performing similar functions, or any named executive officer, retires, resigns or is terminated from that position ... disclose the fact that the event has occurred and the date of the event”).

3. See *TSC Industries v. Northway*, 426 U.S. 438, 449 (1976); see also *Basic*, 485 U.S. at 231–32 and *In re Time Warner Securities Litigation*, 9 F.3d 259, 267 (2d Cir. 1993).

4. Allan Horwich, *The Securities Law Disclosure Rules of the Road Regarding Executive Illness*, 46 No. 1 Sec. Reg. L.J. art. 1 at 9 (2018).

5. See Andrew K. Glenn, Note “Disclosure of Executive Illnesses Under Federal Securities Law and the Americans with Disabilities Act of 1990: Hobson’s Choice or Business Necessity?” 16 *Cardozo L. Rev.* 537 (1994).

6. See Dale A. Oesterle, “The Overused and Under-Defined Notion of ‘Material’ in Securities Law,” 14 *U. Pa. J. Bus. L.* 167, 192–207 (2011).

7. See 17 C.F.R. §§ 230.408, 240.12b-20 (2013) (codifying the “half-truth” doctrine in SEC Rules 408 and 12b-20 for public filing purposes); see also *Craftmatic Securities Litigation v. Kraftsow*, 890 F.2d 628, 641 (3d Cir. 1989) (reading “half-truth” doctrine into SEC Rule 10b-5).

8. See Deborah Ball and Eric Sylvers, *The Wall Street Journal*, “Fiat Chrysler’s Sergio Marchionne Was Seriously Ill for Over a Year Before Dying,” (July 26, 2018); see also Donald C. Langevoort, *Agency Law Inside the Corporation: Problems of Candor and Knowledge*, 71 *U. Cin. L. Rev.* 1187, 1195 (2003).

9. See footnote 2 and accompanying text.



## SEC Senior Staff Joint Statement for Audit Committees

By Robert E. Buckholz, Robert W. Downes, and Benjamin H. Weiner

On December 30, 2019, SEC Chairman Jay Clayton, Sagar Teotia, Chief Accountant, and William Hinman, Director of the Division of Corporation Finance, issued a joint statement providing observations and reminders on a number of key areas of focus for audit committees as they approach the calendar year-end financial reporting season.<sup>1</sup>

The statement includes a number of general observations about the audit committee's role in the oversight of financial reporting, followed by specific discussion on the audit committee's role in oversight of the use of non-GAAP financial measures, risks related to LIBOR reform and the implementation of critical audit matters. The statement stresses the significant oversight responsibility expected of independent audit committees.

### GENERAL OBSERVATIONS

- **"Tone at the Top."** Audit committees should set the tone for an issuer's financial reporting and the relationship with the independent auditor, including by actively communicating with the independent auditor to understand the audit strategy and status and to understand issues presented by the auditor and their ultimate resolution.
- **Auditor Independence.** Audit committees have an integral role in supporting the issuer and the auditor in the auditor's compliance with the auditor independence rules. Among other items, audit committees should consider corporate changes or other events that might affect auditor independence and timely

communicate these events and changes to the auditor.

- **Generally Accepted Accounting Principles.** The statement encourages audit committees to promote an environment for management's successful implementation of new accounting standards, particularly in light of recently implemented standards, such as the new revenue and leases standards. Audit committees should regularly engage with management and understand the processes established by management to adopt and implement the new standards.
- **ICFR.** Audit committees are responsible for overseeing internal control over financial

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### the Corporate Governance Advisor

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reporting (ICFR), including in connection with their consideration of management's assessment of ICFR effectiveness and, when applicable, the auditor's attestation. If material weaknesses exist, audit committees must understand and monitor management's remediation plans and set an appropriate tone that prompt, effective remediation is a high priority.

- **Communications to the Audit Committee from the Auditor.** The statement reminds audit committees that under PCAOB AS 1301, *Communications with Audit Committees*, the auditor is required to communicate with the audit committee regarding certain matters related to the conduct of the audit and to obtain certain information from the audit committee relevant to the audit, including, among other items, matters related to certain accounting policies and practices, estimates, and significant unusual transactions. Audit committees are encouraged to incorporate this dialogue in carrying out their responsibilities.

## SPECIFIC TOPICS

- **Non-GAAP Financial Measures.** The statement reminds audit committees to be actively engaged in the review and presentation of the issuer's non-GAAP financial measures. The statement specifically notes that this obligation includes an understanding of how and why management is using particular non-GAAP financial measures.

The audit committee should also ensure that non-GAAP measures are presented fairly and in compliance with all applicable rules and that they are consistently prepared and presented from period to period. The statement encourages audit committees to be involved in the company's disclosure controls and procedures relating to non-GAAP financial measures.

- **LIBOR Reform.** The statement encourages audit committees to assist management in identifying and addressing risks associated with LIBOR discontinuation, including specifically the impact on accounting and financial reporting and any related issues associated with financial products and contracts that reference LIBOR.<sup>2</sup>

- **Critical Audit Matters.** The statement encourages audit committees to continue ongoing efforts to understand the new standard for critical audit matters and to remain engaged with auditors during the implementation process.<sup>3</sup>

## IMPLICATIONS

In light of prior and continued focus on the three specific topics described above, audit committees that have not already spent significant time on these matters may wish to consider including them on the agenda for their review of the year-end financial statements.

More generally, audit committees should take the statement's general observations into account as they identify areas of focus and evaluate their processes and procedures for financial reporting oversight. Finally, management should also keep the statement's guidance in mind as management fulfills its role in providing audit committees with the resources and support they need in connection with their oversight responsibilities.

## Notes

1. For the full text of the statement, please see, "Statement on Role of Audit Committees in Financial Reporting and Key Reminders Regarding Oversight Responsibilities," dated December 30, 2019, *available at* <https://www.sec.gov/news/public-statement/statement-role-audit-committees-financial-reporting..>

2. For a detailed discussion of risks to consider associated with the expected discontinuation of LIBOR, please see our Memorandum to Clients, "Key Considerations for

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Fiscal Year 2019 Form 10-K and 20-F Filings” (Jan. 7, 2020) *available at* <https://www.sullcrom.com/files/upload/SC-Publication-Key-Considerations-for-Fiscal-Year-2019-Form-10-K-and-20-F-Filings.pdf>.

3. For a detailed discussion of items to consider with respect to the implementation of the critical audit

matters requirement, please see our Memorandum to Clients, “Key Considerations for Fiscal Year 2019 Form 10-K and 20-F Filings” (Jan. 7, 2020) *available at* <https://www.sullcrom.com/files/upload/SC-Publication-Key-Considerations-for-Fiscal-Year-2019-Form-10-K-and-20-F-Filings.pdf>.

# Delaware Court Rules that Oracle's Special Litigation Committee Must Turn Over Privileged Documents to Shareholder Plaintiff

By Peter Welsh, Nicholas Berg, Gregory Demers, and Mary Zou

On December 4, 2019, Vice-Chancellor Samuel Glasscock of the Delaware Court of Chancery issued a significant decision in *In re Oracle Corporation Derivative Litigation*, holding that a stockholder pursuing a derivative suit challenging Oracle Corporation's ("Oracle" or the "Company") 2016 acquisition of NetSuite Inc. (NetSuite) was presumptively entitled to receive all documents—even Oracle's privileged documents—that had been reviewed and relied upon by Oracle's special litigation committee (SLC) in determining not to seek to dismiss the suit and to allow the stockholder to pursue the litigation.<sup>1</sup>

Although the Court noted that this outcome arose from "unusual circumstances" which presented "unusual questions," the ruling has potentially significant implications for companies and SLCs in fashioning the scope and parameters of documents produced in an SLC investigation, and in considering how to best protect privilege in the context of such an investigation.

## Background of the Litigation

Oracle is a technology corporation co-founded in 1977 by Larry Ellison with a market capitalization exceeding \$200 billion. Ellison still serves as a director and Chief Technology Officer of Oracle and owns a 35.4% interest in the Company. Ellison also co-founded and owns a 39.2% interest in NetSuite, a cloud-based financial management and enterprise resource planning company that competed with Oracle. In November 2016, Oracle completed a \$9.3

billion acquisition of NetSuite. Stockholder derivative litigation ensued, against various directors and officers of Oracle, alleging that they breached their fiduciary duties to Oracle by structuring the acquisition to benefit Ellison and other corporate insiders at Oracle's expense.

In May 2018, after the complaint partially survived a motion to dismiss, Oracle formed a special litigation committee of the Board (the "SLC") to evaluate the claim. The SLC retained independent legal counsel and financial advisors, and investigated and evaluated the claim over the eighteen months, during which time the derivative litigation was stayed. In the course of its investigation, the SLC requested documents from Oracle, Ellison, Oracle's CEO, and sixteen other relevant persons and entities; met with counsel to the derivative plaintiffs; and interviewed forty witnesses.

Oracle produced approximately 1.4 million documents in response to the SLC's document requests from over a dozen custodians. Notably, because the SLC was comprised of Oracle directors (who have a "virtually unfettered right to information"), Oracle produced these documents "as they were found on Oracle's servers," did not review the documents before they were produced, and "did not screen the documents for relevance or privilege." Thus, Oracle's production to the SLC included more than 400,000 documents marked potentially privileged, and many irrelevant materials.

After completing its investigation, and unsuccessfully pursuing a potential settlement of the claims, the SLC notified the Court that it had determined it was in the Oracle's best interest for the SLC to step aside and allow the original plaintiff to proceed with the suit, derivatively. The plaintiff's first move in the aftermath of the

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SLC's decision was to subpoena the SLC and its legal counsel requesting, among other things, all 1.4 million documents that had been produced by Oracle to the SLC. After Defendants (and the SLC) objected, plaintiffs moved to enforce the subpoenas, arguing that because it was stepping into the SLC's shoes to continue pursuing the claim, and therefore believe that it should not be forced to start discovery from scratch, without the benefit of the documents that the SLC had already received.

### **The Court Compels the SLC to Produce All Documents It Reviewed or Relied Upon, Including Oracle's Privileged Materials**

On December 4, 2019, the Court issued a written decision granting the plaintiff's motion in part, and ruling that the plaintiff was presumptively entitled to the production of all documents and communications *reviewed* and *relied upon* by the SLC or its counsel in forming its conclusions.

In so ruling, the Court reasoned that the claims in litigation were a "corporate asset," which the SLC had "enhanced" through its lengthy and thorough evaluation and investigation. Because the SLC had determined that "Oracle's interests required [that the litigation asset] be administered by [the plaintiff] on behalf of Oracle," the Court concluded that it would "at least in part, *against* Oracle's best interests to allow the [plaintiff] to proceed with the litigation asset stripped of all value created by the SLC."

Nonetheless, the Court recognized that allowing complete discovery of *all* 1.4 million documents provided to the SLC could chill candor and cooperation between SLCs and corporations, limiting the effectiveness of SLCs going forward. In addition, the Court noted that under Court of Chancery Rule 26, the plaintiff was only entitled to "relevant" documents and communications, and many of the documents produced to the SLC were likely "not relevant to the litigation asset." Accordingly, the Court

ruled that the plaintiff was presumptively entitled to the production of only those materials that the SLC actually *reviewed* and *relied upon* in forming its conclusions.

The Court next considered whether, to the extent the SLC reviewed or relied upon Oracle's privileged documents in forming its conclusions, those documents must be produced. The plaintiff contended that it was entitled to Oracle's privileged documents under the so-called "*Garner* exception"<sup>2</sup> to attorney-client privilege, which, under narrow circumstances permits a stockholder to "invade the corporation's attorney-client privilege in order to prove fiduciary breaches by those in control of the corporation upon showing good cause."<sup>3</sup> The Court found *Garner* inapplicable, reasoning that it was unclear whether the plaintiff could establish the "narrow and exacting" conditions sufficient to vitiate the privilege under the doctrine as it is applied by our courts."

Still, the Court held that, based on a "balance of the harms" analysis, "privileged communications given by Oracle to the SLC, and relied upon by the SLC in concluding that litigation by the [plaintiff] is in the corporate interest, must be produced to the [plaintiff]." Here, the Court again relied heavily on the SLC's determination to hand control of the claims over to the plaintiff. Because Oracle determined it was in the Company's best interest to produce these privileged documents to the SLC, and because the SLC determined it was in the Company's best interest for the plaintiff to pursue the litigation, Oracle could not "advance[] a single reason why, in its business judgment, the corporate interest in non-disclosure of those same communications to the [plaintiff] outweighs its interest in vindication of the asset."

The Court did, however, distinguish the SLC's claims of privilege from Oracle's. The Court ruled that the SLC, a duly-created committee of the Board, was distinct from Oracle, the constituent corporation, and thus the plaintiff could not compel production of the SLC's privileged materials on the same basis as Oracle's. The Court rejected the plaintiff's argument that



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it may be “forced to replicate the SLC’s work at great expense” and noted that Delaware law does not recognize an “efficiency exception” to the attorney-client privilege or work-product doctrine, thus declining to compel production of the SLC’s privileged materials and work product.

## Implications and Practical Considerations

The ruling in *Oracle* appears to be the first time a Delaware court has required the production of undeniably privileged documents to derivative plaintiffs in the context of an SLC investigation, without finding that the “narrow” and “exact-ing” Garner exception to privilege applied. The fact that the ruling required the production of a potentially large volume of privileged documents—which the Company clearly intended *not* to be produced—amplifies its significance.

However, three factors should cabin the reach of this decision. First, the Court’s decision applies only in the exceedingly rare circumstance in which an SLC concludes that it is in the Company’s best interest to allow plaintiff’s counsel to pursue derivative litigation. That fact—which, the Court emphasized, made the case virtually unprecedented—gave the derivative plaintiff leeway to go beyond discovery into the reasonableness of the SLC investigation and obtain underlying materials relied upon by the SLC. In the far more common scenario in which the SLC moves to dismiss the claim, or decides to pursue some narrower claim on its own, discovery would be limited to documents and information reflecting the scope and reasonableness of the SLC investigation.

Second, the Court recognized that “the SLC and its counsel are in the best position to identify which documents and communications [it reviewed and relied upon]” in forming its conclusions, thus permitting the SLC in the first instance to determine the scope of the production.

Third, the Court was careful to distinguish the SLC’s privileged documents from Oracle’s

privileged documents and denied the request to compel production of the SLC’s privileged materials. As a result, the SLC would not have to turn over its attorney work product, which often includes compilations or summaries of the most sensitive documents. For these reasons, *Oracle* should not be read to apply broadly beyond these unusual facts or to signal some tectonic shift in Delaware’s SLC jurisprudence.

Although the underlying fact pattern is unlikely to be frequently repeated, this case presents an important reminder that companies must be thoughtful about the nature of the documents and communications provided to an SLC. Companies should review such materials carefully for relevance and privilege and be mindful that the same documents may be ultimately turned over to a derivative plaintiff. Additionally, companies should take care to clearly delineate privilege belonging to the company versus privilege belonging to the SLC. This is particularly important when an SLC shares communications and documents with management and the board, such as drafts of SLC meeting minutes, expert analysis, and any investigative report.

Finally, in the rare event, an SLC does decide to hand over a derivative claim to a plaintiff, or even in the more common scenario in which the SLC declines to pursue a claim and discovery is limited to the reasonableness of the investigation, plaintiffs are likely to make a strong push to gain access to documents relied on by the SLC in reaching its decision. Accordingly, SLCs should consider demarcating documents that they actually relied upon in forming their conclusions to create a clear record in the event such documents must later be produced.

## Notes

1. 2017-0337 (Del. Ch. Dec. 4, 2019).
2. *Garner v. Wolfinbarger*, 430 F.2d 1093 (5th Cir. 1970), cert. denied, 401 U.S. 974 (1971).
3. *Wal-Mart Stores, Inc. v. Indiana Elec. Workers Pension Tr. Fund IBEW*, 95 A.3d 1264, 1276 (Del. 2014).

# The Rise of Direct Listings: Understanding the Trend, Separating Fact from Fiction

By *Ran Ben-Tzur and James D. Evans*

Spotify did it. Slack did it. Many other late-stage private technology companies are reported to be seriously considering doing it. Should yours?

If you are a board member of a late-stage, venture-backed company or part of its management team, you likely have heard the term “direct listing” in the news. Or you may have attended one or all of the slew of recent conferences being hosted by big-name investment banks and others, including tech investor guru Bill Gurley, who recently debated the pros and cons of choosing a direct listing over a traditional IPO.

Before you decide what’s right for your company, here are a few things you need to know about direct listings.

## Just What Is a Direct Listing?

For people not familiar with the term, a direct listing is an alternative way for a private company to “go public,” but without selling its shares directly to the public and without the traditional underwriting assistance of investment bankers.

In a traditional IPO, a company raises money and creates a public market for its shares by selling newly created stock to investors. In some instances, a select number of investors may also sell a portion of their holdings in the IPO, although in most instances this opportunity is reserved for very large stockholders or employees and is not made broadly available to other pre-IPO stockholders. In an IPO, the company

engages investment bankers to help promote, price and sell the stock to investors. The investment bankers are paid a commission for their work that is based on the size of the IPO—usually 7 percent in the case of a traditional technology company IPO. In a direct listing, a company does not sell stock directly to investors and does not receive any new capital. Instead, it facilitates the re-sale of shares held by company insiders such as employees, executives, and pre-IPO investors. Investors in a direct listing buy shares directly from these company insiders.

So now you ask: If my company does a direct listing, does this mean that we don’t need investment banks? Not quite. Companies still engage investment banks to assist with a direct listing, and those banks still get paid quite well (to the tune of \$35 million in Spotify and \$22 million in Slack). However, the investment banks play a very different role in a direct listing. Unlike in a traditional IPO, in a direct listing, investment banks are prohibited under current law from organizing or attending investor meetings, and they do not sell stock to investors. Instead, they act purely in an advisory capacity, helping a company to position its story to investors, draft its IPO disclosures, educate the company’s insiders on the process and strategize on investor outreach and liquidity.

## Why Have Companies Only Started Considering Direct Listings Recently?

The concept of a direct listing is actually not a new one. Companies in a variety of industries have used similar structures for years. However, the structure has only recently received a lot of investor and media attention because high-profile technology companies have started to use it to go public. But why have technology companies only recently started to consider direct

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listings? A few trends have emerged in recent years that have made direct listings a viable, and sometimes attractive, option relative to an IPO:

***The Rise of Massive Pre-IPO Fundraising Rounds:*** With an abundance of investor capital, especially from institutional investors that historically hadn't invested in private technology companies, massive pre-IPO fundraising rounds have become the norm. Slack raised over \$400 million in August 2018—just over a year prior to its direct listing. Because of this widespread availability of capital, some technology companies are now able to raise sufficient capital before their actual IPO either to become profitable or to put them on a path to profitability.

***The Insider Sentiment Against the Current IPO Process:*** There has been increasing negative sentiment, especially amongst well-known venture capitalists, about certain aspects of the traditional IPO process—namely IPO lock-up agreements and the pricing and allocation process.

***IPO Lock-Up Agreements.*** In a traditional IPO, investment bankers require pre-IPO investors, employees and the company to sign an agreement restricting them from selling or distributing shares for a specified period of time following the IPO—usually 180 days. This agreement is referred to as a “lock-up agreement.” The bankers argue that these agreements are necessary in order to stabilize the stock immediately after the IPO. While the merits of a lock-up agreement can certainly be debated, by the time VCs (and other insiders) are allowed to sell following an IPO, oftentimes the stock price has fallen significantly from its highs (sometimes to below the IPO price) or the post-lock-up flood of selling can have an immediate negative impact on the trading price.

Over time, VCs have gotten companies to chip away at the standard 180-day lock-up period. For example, on many recent IPOs, companies have been able to negotiate for

an early release of the 180-day lock-up if the company's stock price has traded above certain thresholds after the IPO or if the lock-up period expires during a blackout period under a company's insider trading policy. Despite this, lock-ups haven't gone away completely.

In a direct listing, there is no lock-up agreement. All of the company's insiders are free to sell their shares on the first day of trading, providing equal access to the offering to all of the company's pre-IPO investors, including rank-and-file employees and smaller pre-IPO stockholders.

***IPO Pricing and Allocation.*** In a traditional IPO, shares are often allocated directly by a company (with the assistance of its underwriters) to a small number of large, institutional investors. Traditional IPOs are often underpriced by design to provide large institutional investors the benefit of an immediate 10-15 percent “pop” in the stock price. Over the past few years, some of these “pops” have become more pronounced. For example, Beyond Meat's stock soared from \$25 to \$73 on its first day of trading, a 163 percent gain.

This has fueled a concern, particularly shared amongst the VC community, that investment banks improperly price and allocate shares in an IPO in order to benefit these institutional investors, which are also clients of the same investment banks that are underwriting the IPO. While the merits of this concern can also be debated, in instances where there is a large price discrepancy between the trading price of the stock following the IPO and the price of the IPO, there is often a sense that companies have left money on the table and that pre-IPO investors have suffered unnecessary dilution. If the IPO had been priced “correctly,” the company would have had to sell fewer shares to raise the same amount of proceeds.

Because a company is not selling stock in a direct listing, the trading price after listing

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is purely market driven and is not “set” by the company and its investment bankers. Moreover, since no new shares are issued in a direct listing, insiders do not suffer any dilution.

***The Spotify Effect:*** Before Spotify’s direct listing, technology companies hadn’t used the direct listing structure to go public. Spotify was, in many ways, the perfect test case for a direct listing. It was well known, didn’t need any additional capital and was cash-flow positive. In addition, prior to its direct listing, Spotify had entered into a debt instrument that penalized the company so long as it remained private. As a result, it just needed to go public. After clearing some regulatory hurdles, Spotify successfully executed its direct listing in April 2018. After Spotify’s direct listing, Slack (relatively) quickly followed suit. Slack’s direct listing was notable because it represented the first traditional Silicon Valley-based VC-backed company to use the structure. It was also an enterprise software company, albeit one with a consumer cult following.

Combine all of these trends and mix in some prominent VCs writing about the benefits of the structure, the media picking up the story and running with it, and even the big investment banks pushing the structure—and the rest is history: Direct listings have now become the hot topic for many late-stage private technology companies considering going public.

## Debunking Myths and Misconceptions

As advisors to many late-stage technology companies that are considering a direct listing, we keep hearing a number of common misconceptions. Here are the top three:

***“Direct listings are a capital-raising event for the company.”*** No! This is one big misconception that we are still continuing to hear. A direct listing is *not* a capital-raising event for the company. If your company needs additional capital at the

time of its IPO, a direct listing is likely not the right structure for your company. And although the U.S. Securities and Exchange Commission recently rejected an NYSE proposed rule change to allow for a company to raise capital and do a direct listing at the same time, we expect significant regulatory developments in the near future that will give companies more flexibility to pursue alternatives to a traditional IPO.

***“I want to do a direct listing because there is less due diligence required.”*** Also no! For companies considering a direct listing, limited investment banker due diligence should not be a reason to choose a direct listing over a traditional IPO. That’s because the investment banks and their legal counsel put companies through the exact same due diligence process as in a traditional IPO. They do this in order to protect themselves from liability if a court were to determine that they acted in the capacity of an underwriter. Moreover, a company and its directors and officers are subject to the same liability as in a traditional IPO, so companies are well served by going through the same stringent due diligence process, which serves to protect the company and its officers and directors from liability.

***“The direct listing process is totally different from an IPO.”*** (Mostly) No! Although there are certain aspects of a direct listing that differ significantly from a traditional IPO, the process for each of these transactions is actually quite similar. A company doing a direct listing still selects investment bankers (they are just called “advisors” instead of “underwriters”), holds an organizational meeting, prepares an S-1 registration statement, goes through the same lengthy SEC review and comment process, and has the same liability exposure.

## IPO vs. Direct Listing: What’s Right for Your Company?

The high-profile public market debuts of tech unicorns Spotify and Slack are encouraging many late-stage, venture-backed technology companies to consider whether a direct listing

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makes sense for them. Although a direct listing offers many benefits, the structure does not make sense for every company. In this article, we explore the pros and cons of direct listings relative to a traditional IPO and outline some key considerations before choosing this structure.

## The Positives

If your company is fresh off a big fundraising round, doesn't need additional capital and is generating cash flow, then a direct listing may just be right for you. Direct listings offer companies a number of key benefits:

**Equal access to all buyers and sellers:** In a direct listing, company insiders are not constrained from selling or distributing their pre-IPO shares by a lock-up agreement. They are free to sell their shares whenever and for whatever amount they want. Moreover, unlike in a traditional IPO, the shares in a direct listing are not allocated by the company to a small number of institutional investors. Instead, investors of all shapes and sizes (yes, even your grandfather and grandmother) can participate at the same time. As discussed below, the large investment banks have also not yet gotten comfortable with involving their research analysts in a direct listing process.

Accordingly, unlike in a traditional IPO, companies in a direct listing have been unable to share detailed forward-looking projections with these research analysts. Instead, in a direct listing, companies have issued public-company-style guidance that is available to all investors. Moreover, since the investment banks are not able to set-up and attend investor meetings, companies that have pursued a direct listing have opted out of the traditional IPO roadshow, which consists of a one-to-two-week series of one-on-one meetings between the company's management team and the large institutional investors buying in the IPO. Spotify and Slack, for example, chose to educate their potential investors by holding an "Investor Day" via live streaming, opening access to a broader base of investors.

**Market-based price discovery:** In a traditional IPO, the price for a company's stock is determined based on demand from a small number of large institutional investors for a limited supply of a company's shares (often only representing 10-20 percent of the entire company). This scarcity in supply results in a stock price following an IPO that isn't necessarily reflective of what a purchaser of the stock would pay for the shares if more shares were available in the open market. This explains the stock price decline that companies often experience in advance of the lock-up expiration. In theory, a direct listing allows for true market-based discovery since all of a company's shares are available for sale and purchase on the first day of trading.

**Lower investment banking fees:** Although there is still a bit of mystery around how investment bankers charge for their services in a direct listing, the fees are generally lower than if the company were to do a traditional IPO. To get a sense: Spotify did its direct listing at a \$29 billion market capitalization and paid \$35 million in advisory fees; Snap went public at a \$24 billion market capitalization and paid \$85 million in underwriting fees. Slack did its direct listing at a \$16 billion market capitalization and paid \$22 million in advisory fees, while Lyft went public at a \$24 billion market capitalization and paid \$64 million in underwriting fees. Due to the more limited role that investment banks play in a direct listing, there is no need to have a large group of banks advising on a direct listing. This results in smaller overall fees being split amongst a smaller group of investment banks.

**Similar to an IPO process with a bit less IPO-related documentation and process:** A company doing a direct listing still selects investment bankers, holds an organizational meeting, prepares an S-1 registration statement, goes through the same lengthy SEC review and comment process, and has the same liability exposure. Despite all these similarities in the process, there are a few things that are streamlined in a direct listing. For example, you do not need to negotiate and enter into lock-up agreements and an underwriting agreement, and you do not need to go through the FINRA review process.



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## The Downsides

Despite all the positives, a direct listing is not for every company. Here are \*some\* of the downsides to consider if your company is thinking about doing a direct listing:

***A direct listing is NOT (currently) a capital-raising event:*** One big misconception is that a direct listing is a capital-raising event for the company—like a traditional IPO. It is not. Companies doing a direct listing aren't currently raising capital. Even with massive pre-IPO fundraising rounds, many technology companies still need to raise additional capital in their IPO. There have been many instances of high-profile technology companies that have raised a lot of money prior to an IPO and still opted for a traditional IPO structure over a direct listing, including Uber, Lyft and Pinterest. Not being able to raise capital in a direct listing probably forecloses this structure for many technology companies, especially those that are not yet profitable or that do not have a clear path to profitability.

Companies that do direct listings can raise capital in a follow-on offering afterward but if the company's stock price trades down following the direct listing, it may be unable to execute a transaction or have to do so under non-ideal terms. And although the SEC recently rejected an NYSE proposed rule change to allow for a company to raise capital and do a direct listing at the same time, we expect significant regulatory developments in the near future that will give companies more flexibility to pursue alternatives to a traditional IPO.

***No ability for the company and its board of directors to set the price for the shares or control investor allocations:*** If your company or board of directors wants to set the price of the shares sold and choose the investors that will buy shares in the offering, then a direct listing isn't for you. The trading price of the stock following the direct listing is completely beholden to the whims of the market. Moreover, companies can't pick and choose which investors they want to allocate the shares to. Unlike a traditional

IPO, where companies have a say in the allocation of shares, and are able to place the shares with long-term, high-quality institutional investors, companies in a direct listing will have a stockholder base composed of any investor that decides to buy the shares on the open market.

***No research analyst education process:*** In a traditional IPO, companies spend significant time with their investment bank research analysts that will cover the company and its stock following the IPO. Ensuring that these research analysts have a clear understanding of a company's business is critical as the research that these analysts publish can have a significant impact on a company's stock price. By all accounts, the process of spending time with the research analysts and building a forward financial model that has been vetted with the research analysts is very useful for companies and allows analysts to build deep familiarity with the companies they are covering. Unfortunately, due to regulatory restrictions that limit what can be shared with research analysts that are not a part of your underwriting syndicate, the investment banks have not yet gotten comfortable with allowing their research analysts to participate in a direct listing.

Instead, both Spotify and Slack issued public-company-style financial guidance shortly before their IPO. As a result of the research analyst limitations, companies that do a direct listing are deprived of the valuable exercise of spending time educating the analysts as they would in a traditional IPO process. Moreover, while a company that is very well known may draw research analyst coverage regardless of whether their investment bank was engaged in a direct listing, companies that are less well known that try to do a direct listing may not get research coverage.

***Need to create a liquid market for your shares on the first day of trading:*** There is a lot of uncertainty in a direct listing because it is unclear who will sell and buy shares on the first day of trading. In a traditional IPO, you know who the buyers are and the bankers have a good sense of the trading patterns of your IPO

<b>Table 1: How is a Direct Listing Different From a Traditional IPO. Click image to enlarge</b>		
	<b>Direct Listing</b>	<b>Traditional IPO</b>
Financial Advisors Role & Underwriting Process	Company registers for resale existing outstanding shares without an investment bank underwriting the stock	Company sells shares to an investment bank who then sells the shares to investors
	Financial advisors do not plan and participate in investor meeting	Underwriters plan and participate in investor meetings
	Company pays flat fee to Financial Advisor	Company pays underwriters a commission on sale of shares (typically 7% in an IPO)
Share Registration & Plan of Distribution	No new shares are created and no capital is raised	New shares issued by company and/or sold by existing investors
	Gap between effectiveness of registration statement and trading of stock due to regulatory and logistical issues	Stock begins trading on day immediately following effectiveness of registration statement
Stock Pricing & Trading Activity	Prospective purchasers of shares place orders with their broker of choice at whatever price they believe is appropriate	Purchases by initial investors made at IPO price set by company
	Market-driven price discovery	Book-building during IPO roadshow
	Existing stockholders have access to immediate liquidity (no lock-up)	Existing stockholders subject to underwriter lock-up (usually 180 days)
Investor Education & Guidance	Publicly streamed “Investor Day”	Meetings with institutional investors during IPO roadshow
	Ability to provide public-company style financial guidance	Limited in ability to provide financial guidance due to liability concerns
	No information sharing with research analyst	Research analysts assist with investor education

investors in the after-market. In a direct listing, that certainty goes out the door and the market for your shares will be limited by the number of shares that your insiders choose to sell on the open market. An illiquid market on the first day of trading could result in negative consequences for the stock price. Accordingly, companies need to spend a lot more time educating their insiders, including employees, about the direct listing process and how to sell shares, if they so choose, immediately after the stock begins trading. Also, some of the company’s founders and venture capitalists will likely need to sell on the first day of trading to create an active and liquid market for the shares.

Finally, the employee education process needs to occur much earlier than it otherwise would in a traditional IPO. Since employees can trade

on the first day of trading, the shares need to be prepared for sale, and employees need to be educated about issues like insider trading prior to the first day of trading.

***Lots of heavy lifting by management to educate investors:*** Because the investment bankers in a direct listing are not involved in setting up and attending investor meetings and with no traditional roadshow and research analyst modeling process, the onus falls on the company’s management team to take control of, and run, the investor education process. Companies that do not have a management team that is experienced with navigating the complex public offering landscape may be better served by a traditional IPO, in which the investment bankers are able to assist with the investor education process.

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## How to Prepare for a Direct Listing— Best Practices

Assuming you've already weighed the pros and cons and decided that a direct listing is right for your company, we've put together a list of a few must-do items to ensure everything goes as planned prior to listing your stock directly.

- **Review your financing and organizational documents:** This is an easy first step. In order to facilitate a direct listing, your financing and organizational documents should provide for the preferred stock to convert to common stock and for other preferred stock terms to terminate upon a direct listing. Unfortunately, most financing and organizational documents for venture-backed companies provide for the preferred stock to only convert, and for other preferred stock terms to terminate, upon an underwritten IPO. In addition, sometimes the conversion of the preferred stock is conditioned upon the company achieving a minimum IPO price.

Since a direct listing would not meet the definition of an underwritten IPO, companies should consider amending their financing and organizational documents in order to preserve flexibility for a direct listing. We have started to work with many of our clients to review and, oftentimes in connection with a financing round, modify their financing and organizational documents to preserve flexibility to do a direct listing.

- **Consider a fundraising round before your direct listing:** Because your company will not be raising capital in a direct listing (at least not yet), if it still needs additional capital, you should consider doing an equity financing between six and 12 months ahead of the direct listing. The financing should be sufficient in size to carry the company through profitability. Ideally, the financing would include traditional IPO investors, which will help to both create liquidity for the company's shares on the first day of trading as a public company and allow those investors, who will also likely be purchasers

of shares in the direct listing, to familiarize themselves with the company.

- **Facilitate price discovery by removing transfer restrictions (\*don't do this without consulting with counsel and your investment bankers):** In order to create liquidity on the first day of trading and facilitate price discovery, especially if you anticipate issues with liquidity, it may help to create an active secondary market for your company's shares in advance of the direct listing. One way to do this is to remove the transfer restrictions that typically exist in a venture-backed company's existing financing, organizational and equity documents. This is one of the tools that Slack considered in order to create a liquid market in the stock prior to its direct listing. Spotify had an active trading market for its shares prior to the direct listing.
- **Investor and research analyst education:** With no underwriting support from investment bankers and no formal research analyst education and modeling process, it is critical for management to be heavily involved in investor and analyst education and to own the process. We would encourage companies to design an extensive marketing plan six-to-12-months ahead of the direct listing. You don't want to start your direct listing without having spent significant time with the investors and research analysts that are active in your company's space. While most of our clients that are doing a traditional IPO outsource their investor relations (IR) function to an external IR firm, we would strongly encourage companies considering a direct listing to hire a strong internal IR person to assist in positioning and with investor introductions and education.
- **Educate your existing investors and employees:** As discussed above, it is very important to facilitate a liquid market for the stock on the first day of trading. In order to do so, it is critical for a company to educate existing investors and employees about the direct listing process, including how shares may be sold on the first day of trading. As part of this process, the company should seek to gain a good understanding of selling interest from

**Table 2: The Pros and Cons of a Direct Listing. Click image to enlarge**

<b>Pros</b>	<b>Cons</b>
Greater liquidity for existing stockholders and option/RSU holders	Opening stock price will be completely subject to market demand and potential market swings; No ability of company and board to set price for shares
Equal access for all buyers and sellers	Less control over investors buying shares
Greater transparency	No additional capital raised by company
Ability to provide public-company style guidance	More comprehensive investor education needed—no traditional IPO roadshow to tell story to investors and no research analyst information sharing
No dilution to existing stockholders	May end up paying more to financial advisors than would have in standard IPO underwriting fees
No lock-up restrictions	Limited by the number of shares company employees and existing investors choose to sell on the open market
Reduced IPO-related documentation (e.g., no underwriting agreement)	Potential to miss out on participation by long-term or large investors as would be typical in an IPO process
No FINRA review process	Financial advisors do not plan and participate in investor meetings
“Well-trodden” path from an SEC and stock exchange perspective due to Spotify and Slack	Logistical and communication hurdles in getting shares ready for trading upon listing
Cost of capital cheaper in subsequent offerings	D&O insurance more expensive

existing investors. Founders and VCs also must be willing to sell on the first day of trading in order to create an active market for the shares. This education should come early in the direct listing process—much earlier than what you would see in a traditional IPO.

### **I Want the Benefits of Both a Traditional IPO and a Direct Listing: Are There Any Other Options?**

Based on discussions we have had with prominent investment bankers that work on

technology IPOs and direct listings, we think there’s a lot more innovation to come. There have been many discussions about alternative IPO mechanisms and changing the SEC’s current rules to allow for a non-traditional IPO. And although the SEC recently rejected the NYSE’s proposed rule change to allow companies doing a direct listing to raise capital at the same time, the NYSE has stated it remains committed to evolving direct listings options. We expect significant regulatory developments in the near future that will give companies more flexibility to pursue alternatives to a traditional IPO.

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