How to Prepare an Initial Public Offering

Considerations at the Planning Stage

Laird H. Simons III
Fenwick & West LLP

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Keep Organizational Structure Simple

- Usually a corporation, possibly with subsidiaries
  - Easy to describe
  - Easily understood by investors
  - Easier to identify any interested party relationships
  - Definition of "we," "our" and "us"
- Avoid brother/sister corporations, partnerships and other complicated structures
- To achieve structure, may need to merge, liquidate, make capital contributions or do exchange offering

Reincorporate to Delaware?

- More extensive anti-takeover protections
- Greater protections to officers/directors from personal liability
- Less stringent stockholder democracy rules
- Better known and more flexible laws
- But, time and expense to reincorporate and additional ongoing franchise taxes

Capital Structure – Convert Most Securities to Common Stock

- Do outstanding shares of preferred stock and debt securities convert to common stock upon IPO?
  - Want simple capital structure if possible
  - Check governing instruments for automatic conversion triggers
    - Firm commitment underwriting
    - Based on total proceeds and per share price
  - Redemption, negotiation, waiver or amendment to governing instruments, if necessary
- Evaluate for prospectus disclosure any securities that will not convert to common stock

Capital Structure – Consider Stock Split

- To get expected trading price into a typical range, based on estimated value of company and number of outstanding shares
  - Achieve minimum price required by institutional investors
  - Avoid perception of “penny stock”
  - Avoid making “round lot” too expensive
- Reverse or forward, depending on circumstances
- Forward split can also be used to increase float and improve aftermarket trading

Capital Structure – Comply With Registration Rights

- Be prepared to send out any registration rights notices or waivers
  - Obtain advice from underwriters about inclusion of selling stockholders
  - Check ability to eliminate selling stockholders altogether
- Evaluate timing of notification and coordination of interest in offering if selling stockholders are to be included
  - Do not want to announce offering too soon
  - But need to describe selling stockholders in prospectus
- Will want most other investors' rights to go away post-IPO

Capital Structure – Evaluate Authorized Shares

- Determine number of authorized shares of common stock and preferred stock after IPO
  - Make sure company will have enough common stock to cover employee plan issuances, stock splits and acquisition activity for a while
  - Usually several times current fully diluted shares
  - Blank check preferred stock for future flexibility

Capital Structure – Evaluate Overhang

- Underwriters generally want no other shares to be salable in market following IPO
- Evaluate restrictions on sale under federal securities laws
  - Rule 144
  - Rule 701
- Evaluate contractual restrictions in existing agreements
- Underwriters generally want their own form of lock-up to be signed
- Typical lock-up period is 180 days (with limited extensions)

Review Articles and Bylaws

- Will need revisions if not reincorporating
- Eliminate provisions not appropriate for public company
  - Preemptive rights
  - Restriction on share transfers
  - Cumulative voting (if possible)
  - Special voting requirements
- Consider anti-takeover provisions that are not typical for a private company
  - Restricting ability of stockholders to call special meeting or act by written consent
  - Staggered board
  - Poison pill

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Select IPO Advisors

- Evaluate advisors' experience in and capability of handling the company's IPO
  - Investment bankers
  - Lawyers
  - Accountants
- Independence of advisors, particularly accountants
- Knowledge of SEC rules and procedures
- Well-known names for prospectus

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Evaluate Management Team

- Are there any gaps in key positions?
- Is existing management team qualified to lead a public company?
  - Public company disclosure and reporting experience
  - Ability to win confidence of analysts and institutional investors
  - Has management considered “disclosure controls and procedures” and other procedures needed to comply with SEC reporting and Nasdaq/exchange notification and governance requirements?
- How does IPO affect existing employment agreements?

Make Necessary Board Changes

- Majority must be independent
  - Phase-ins available for compliance with independence requirements
- Evaluate qualifications, willingness to serve, experience and benefits to company
- Evaluate committee needs

Establish Audit Committee

- Nasdaq, exchange and SEC requirements
- Three or more “independent” directors
- Need to be able to read financials
- One must have prior financial management experience
- SEC rules will require disclosure unless one member is a “financial expert”

Establish Compensation Committee

- Nasdaq and exchange requirements
- Section 16 and Section 162(m) benefits
- At least two “independent,” “non-employee” directors; generally no members who are not independent

Address Nominating Committee Functions

- Nasdaq, exchange and SEC requirements
- Solely “independent” directors
- Formal documentation of nomination process

Make Other Corporate Governance Changes

- Adopt Board committee charters
- Establish disclosure committee?
- Adopt corporate policies
  - Code of conduct and ethics
  - Insider trading policy
  - Whistleblower policy
  - Compliance and ethics program?
  - Corporate governance principles?
  - Communications policy?
- Consider purchasing D&O insurance and entering into indemnification agreements

Consider Other Accounting and Internal Control Issues

- Evaluate early on any potentially significant issues
  - Revenue recognition
  - Accounting for acquisitions
  - Pro forma disclosures
  - Cheap stock
  - Prior periods for which audited financials are not currently available (need at least 3 years)
  - Unqualified opinion
  - Significant subsidiaries
- Be prepared to establish adequate systems of "internal control over financial reporting" under SOX Section 404
- Review management letters and any material weaknesses
- Consider audit committee pre-approval policy for non-audit services

Assess Nasdaq or Exchange Requirements

- Does company's existing financial position allow it to qualify for Nasdaq or one of exchanges?
- Example -- For the NASDAQ Global Market, will want to consider whether meet one of the three sets of criteria, which may require:
  - ≥ $1 million pre-tax annual income last year or in two of three years
  - ≥ $15 million/$30 million stockholders' equity
  - ≥ 2-year operating history
  - ≥ $75 million market value of listed securities
  - ≥ $75 million total assets and total revenue last year or in two of three years
  - ≥ $8 million/$18 million/$20 million market value of publicly held shares

Update Employee Benefit Plans

- Evaluate existing option plan terms
- Revise or adopt new plan
- Increase share reserve by amending existing plan or adopting new plan
- Consider Section 423 employee stock purchase plan
- Assess granting additional employee options prior to IPO
- Confirm Rule 701 compliance
- Schedule meetings with employees to explain securities laws (Rules 144 and 701 and Form S-8) and enrollment in employee stock purchase plan

Address Stock Certificate Issues

- Design new certificates
- Reserve trading symbol
- Obtain CUSIP number
- Hire transfer agent and bank note company

Consider Insider Transactions

- Assess what transactions have occurred in past three (or four) years for disclosure purposes
- Under SOX, assess need to eliminate outstanding loans to management before filing registration statement
- Assess what transactions are ongoing
  - Eliminate as possible and desirable
  - Make “fair” if not so now
- Establish procedures for future
  - Code of conduct/ethics
  - Approval by audit committee

Review Tax Issues and Business Qualifications

- Has company properly filed income and sales tax returns with federal and state governments?
- Has it qualified to do business where necessary?
- Assess impact of IPO on ability to use tax loss carryforwards

Review Past, Present and Future Litigation

- If possible, resolve material litigation before first filing
- Existing and potential litigation will be key due diligence focus
- Filing of registration statement may prompt adverse parties to file new suits

Address Other Due Diligence Matters

- Prepare director, officer and 5% stockholder questionnaires
- Assess other legal and business issues that could create disclosure issues
  - Collect diligence materials
  - Prepare to file material agreements
  - Consider notice or consent issues
  - Begin confidential treatment process
  - Begin EDGARizing exhibit documents

Limit Prefiling Publicity

- Evaluate recent and expected <u>publicity</u>
- Set up procedures to <u>minimize risk</u> of “gun jumping”
- Review <u>website</u>
  - Press releases
  - Hyperlinks
  - Other content
- Be careful about communications with potential purchasers through <u>directed share</u> program

Consider Use of Proceeds

- Evaluate need for future funds, including IPO proceeds
- Evaluate how IPO proceeds will be used
- Have a reserve, so can handle IPO cancellation or postponement if necessary

Refine Financial Projections

- Be careful about financial projections
  - Can the company realistically achieve them?
  - Need to avoid surprises in first public quarters
- Does the company have a predictable and profitable business model?