Pre-IPO Planning: Significant Issues for Consideration

An IPO is the result of a great deal of effort, coordination of resources and resolution of myriad legal and business issues. These pre-offering issues are driven mainly by concerns raised by:

- *the legal and regulatory compliance obligations of public companies, including ongoing SEC disclosure requirements and the Nasdaq rules and standards;*
- *the investor relations demands of being a public company, including the need to build credibility with analysts, the financial press, regulators, institutional shareholders and other players in the capital markets;*
- *the complexities involved in changing a company's corporate and capital structure, or taking other actions that require shareholder approval, once the company is public; and*
- *marketing considerations related to the offering.*

Outlined below are some of the more significant issues that should be considered by companies in the process of contemplating an initial public offering.

Use of Proceeds

- Consider how the funds obtained will be used. The SEC requires a registrant to disclose in its IPO prospectus the principal purposes for which the net proceeds are intended to be used. Analysts and investors are particularly interested in how the Company intends to use the proceeds.
- Break down the estimated amount needed for each purpose.
- Anticipate the time period during which the funds are expected to last.

Selection of Managing Underwriter and Co-Managers

- There are many criteria to consider when selecting a managing underwriter and co-manager(s), including analyst coverage, industry expertise, level of interest in the Company, track record with similar IPOs, reputation, distribution capabilities and focus, aftermarket support, experience in other investment banking functions, references and offering price and underwriting discount.

Selection of Underwriters' Counsel

- Insist on input on selection of underwriters' counsel. Even though the underwriters are paying most of the costs, selection of certain underwriters' counsel may increase the Company's costs and the length of the process.

Shareholder Issues

- Determine whether the underwriters require minimum insider holdings.
- Determine whether any shareholders will be selling in the offering. This can be a sensitive issue. If the Company wants someone to be able to sell, it should reach an understanding with the underwriters and the non-selling shareholders early in the process.
- Note that the underwriters typically attempt to discourage selling shareholders. The market may view negatively an attempt by existing shareholders, particularly management shareholders, to "bail out" of the Company.
- Consider what kind of market standoff provisions (lock-ups) will be required, who will be required to sign lock-ups, and for how long. Underwriters typically require 180-day lock-ups for officers, directors and significant shareholders. Determine whether any exceptions (e.g., gifts, family transfers, etc.) will be allowed.
- Beneficial owners of 5% or more of the Company's common stock before the offering will have to answer detailed questions about their holdings and relationships with the Company, and much of this information will be disclosed in the prospectus.

Related-Person Transactions

- The Company will need to disclose certain transactions with entities or persons related to officers, directors and significant shareholders. This topic has received significant attention over the years, including a specific provision in the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act") and a Nasdaq rule requiring audit committee approval of related-person transactions. As a result, any such transactions may be heavily scrutinized.
- Once identified, related-person transactions should be evaluated to determine whether they are on terms equivalent to or better than those that could be obtained by the Company with an independent third party. Those that are not may receive significant scrutiny by the SEC, the underwriters and potential investors, and may need to be revised or terminated. Once the Company is public, related-person transactions will need to be approved by the audit committee.

Loans

- The Company should consider having any loans outstanding to directors or executive officers repaid or terminated prior to the public offering. The Sarbanes-Oxley Act prohibits extending any new loans or making material modifications to any existing loans to directors or executive officers once the Company is public. Split-dollar life insurance arrangements and other special credit arrangements may also be prohibited once the Company is public.

Option Issues

- Determine whether the Company will need to establish additional stock option plans or amend, replace or supplement its existing option plans, programs or agreements. New plans or changes to existing benefit plans often require a shareholder vote. Such approval should be obtained before the Company has public shareholders.
- Evaluate and possibly restructure cashless option exercise provisions to comply with the Sarbanes-Oxley Act loan and credit prohibitions for Section 16 reporting persons.

- Evaluate prior option grants for cheap stock issues.

Board, Board Committees and Officer Issues

- Nasdaq rules require that a majority of the Company's directors be "independent" within a relatively short-period of time following the proposed initial public offering of the Company. However, if possible, it is preferable to have a board with a majority of independent directors at the time of the initial public offering as investors are tending to focus on this aspect, among others, of a Company's governance at the time of the offering. The Company should determine whether current outside Board members meet the definition of "independent" under the Nasdaq rules. We will advise you as to the technical definition of "independent" and assist you in determining the independence of Board members.
- Identify any new needs regarding board composition and begin the process of adding new board members several months in advance, or as soon as practicable. Any agreement with a new director may need to be disclosed in the IPO prospectus.
- Determine whether the Company's chief executive officer, chief financial officer, chief accounting officer or controller was employed by the Company's outside auditors in the year prior to the last audit. Prior relationships with auditors may disqualify the auditors from being independent.
- Form an audit committee, if the Company does not already have one, and consider its composition. A public company's audit committee generally must be composed entirely of "independent" directors who may not receive any consulting, advisory, or other compensation from the Company other than board or committee fees or be an "affiliated person" of the company or its subsidiaries. In addition, audit committee members must be able to read and understand financial statements, and the public company must disclose in its annual reports whether at least one member is an "audit committee financial expert" (and if not, why not).
- Establish an audit committee charter that complies with Nasdaq rules.
- Form an independent compensation committee and an independent nominating and corporate governance committee and establish charters for these committees.
- Consider the extent to which the Company will be hiring new officers. Depending on certain timing and other issues, such officers may need to be listed in the IPO prospectus.
- Determine whether the Company needs D&O insurance. Companies often obtain coverage before the offering.
- Consider whether key employees should be offered employment agreements. If so, any golden, silver or tin parachutes will be easier to implement before the offering. These devices, however, may be unpopular with institutional investors. Also, such agreements may need to be disclosed in the IPO prospectus.
- Determine the sensitivity among the Company's top officers to disclosure of their compensation. Plan to begin any education efforts among management early.
- Discuss with directors and officers their responsibilities and liabilities with respect to disclosure in the IPO prospectus.

Disclosure Practices and CEO/CFO Certifications

- Form a disclosure practices committee, which will be responsible for considering the materiality of information and determining disclosure obligations in publicly filed reports on a timely basis. A disclosure practices committee generally consists of the principal accounting officer or controller, the general counsel or other senior legal official responsible for disclosure matters, the principal risk management officer, the chief investor relations officer, and other officers or employees that senior management deems appropriate.
- Once the Company is public, the CEO and CFO will be required to certify as to compliance with disclosure requirements and the effectiveness of the Company's disclosure controls and procedures on a quarterly basis, and that they have disclosed to the Company's outside auditors and audit committee all significant deficiencies in the design or operation of internal controls, any material weaknesses in internal controls, and any fraud that involves management or other employees who have a significant role in the Company's internal controls. Establish an annual reporting time and responsibility schedule and adopt disclosure controls and procedures guidelines, which should assist in the certification process.

Codes and Procedures

- Adopt a "code of conduct," as required by Nasdaq rules, for the Company addressing conflicts of interest and compliance with applicable laws, which will need to be publicly available once the Company is public.
- Adopt a "code of ethics," as required by the Sarbanes-Oxley Act, for the Company's senior financial officers and chief executive officer to promote ethical conduct, accurate disclosure and compliance with laws. This code may be integrated into the Nasdaq "code of conduct."
- Establish "whistleblower procedures," required by the Sarbanes-Oxley Act, for the handling of complaints and concerns regarding auditing matters.

Publicity and "Gun-Jumping"

- The SEC may regard certain kinds of publicity as constituting an illegal offer of securities when done in connection with the preparation of an offering. Management should meet with counsel to review publicity plans and proposed press releases, and agree on guidelines for responding to press inquiries.

Employees

- Determine whether the Company will want to direct shares to employees, suppliers or customers. Coordinate any directed share (or "friends and family") program early with the underwriting team to identify and resolve any potential NASD issues.

Accounting

- Generally, the Company needs to include audited financial statements for each of the last three fiscal years (or the life of the Company, if less) and selected financial data for each of the last five fiscal years (or the life of the Company, if less) in the IPO prospectus. Review with the audit committee the

financial statements, critical accounting policies, adjustments or pro forma financial statements that will be presented in the IPO prospectus, and identify potential accounting issues:

- Consider whether the Company and its outside auditors have disagreed about any accounting issues. Option accounting and revenue recognition, as well as potential state tax liability, are often problem areas.
- Ensure that the auditors are comfortable with the accounting of any recent acquisitions.
- Consider any lingering presentation issues arising from any predecessor entities.
- Consider whether any "management letters" were issued by the auditors. Ensure that any issues identified by these letters have been addressed and resolved.
- The SEC will particularly focus on the MD&A section of the IPO prospectus. Identify the Company's critical accounting policies, which the Company will need to disclose in MD&A.
- Discuss with outside auditors all material correcting adjustments identified by the auditors, and any material off-balance sheet transactions. The Company and its outside auditors must also ensure that pro forma financial information is reconciled with the Company's financial condition and results of operations under GAAP.
- Determine whether any financial statements need to be restated.
- Determine whether any reserves should be increased or decreased.
- Discuss with the auditors any need to change accounting procedures (e.g., reporting directly to the audit committee) after the offering.
- Review any non-audit services provided by the auditors and consider whether to discontinue such services. A public company's audit committee must pre-approve nearly all audit services and permitted non-audit services.
- Because of the important role they play, the Company's outside auditors should be involved in the offering process early on.

Corporate Matters

- The Company's articles of incorporation, bylaws and material contracts should be reviewed for possible revisions prior to the initial filing. Consider whether to add antitakeover devices, including a staggered board and supermajority voting requirements. These devices are difficult to add once a company is public. However, these provisions have come under increased scrutiny from institutional investors and their advisors (such as Risk Metrics/ISS) and may adversely impact a company's public company corporate governance rating.
- Consider whether to increase the overall number of authorized shares, particularly common stock.
- Board meetings will, and shareholder meetings may, be required during the offering process. Obtain the travel schedules of management and Board members (particularly for foreign travel).
- Consider having the Board appoint a pricing committee to approve the IPO terms.
- Consider whether the Company's name should be changed prior to the offering.

Nasdaq

- Assuming the Company will seek initial listing on the Nasdaq Stock Market, determine whether the Company will meet Nasdaq's initial listing requirements. See the accompanying summary of Nasdaq's initial listing requirements.
- Consider the costs of an initial (and continued) listing. When an issuer submits an application, there is a one-time company non-refundable application fee of $5,000 plus a fee per share outstanding:

  Nasdaq Global Select Market or Nasdaq Global Market:

  Up to 30 million shares - $100,000
  30 to 50 million shares - $125,000
  Over 50 million shares - $150,000

  Nasdaq Capital Market:

  Up to 15 million shares - $50,000
  Over 15 million shares - $75,000

- In connection with the issuance of additional shares of each class of a listed security, the fee is: $5,000 or $.01 per share, whichever is higher, for additional shares of 50,000 or more total shares per quarter, up to an annual maximum of $65,000 per issuer. There is no fee, however, for issuances of up to 49,999 additional shares per quarter.
- Nasdaq will also assess issuers an annual fee calculated on total shares outstanding. The annual fee for listing on the Nasdaq Global Select Market or Nasdaq Global Market ranges from $30,000 - $95,000. The Annual fee for listing on the Nasdaq Capital Market is $27,500.
- Determine whether the Company will be able to adhere to the corporate governance requirements for continued listing, which vary based on whether the Company lists on the Nasdaq Global Select Market, the Nasdaq Global Market or the Nasdaq Capital Market. These requirements include board independence standards, periodic reporting, audit committees, annual shareholder meetings, quorums, solicitation of proxies, related-person transaction disclosure and shareholder approval of certain matters.
- Consider any blue sky issues. These are largely irrelevant now if listing on the Nasdaq National Market, which preempts state blue sky registration requirements.

Vendor Issues

- The Company will need to appoint a transfer agent.
- The Company will need to select a banknote printer and may want to develop a design for new stock certificates.
- The Company will need to select a financial printer. Company counsel can assist in the selection process.

The Registration Process

- The Company should identify to its counsel and the underwriters its competitors. A review of competitors' publicly available information will facilitate drafting of the IPO prospectus and shape diligence. The Company should collect industry statistics and trends to provide back up for information that will be in the prospectus.

- Begin organizing and reviewing the Company's significant documents and agreements early in the process. Some may need to be filed as exhibits to the registration statement. These will need to be scanned or retyped if electronic versions are unavailable so that they can be filed electronically with the SEC.
- Consider whether the Company will need to seek confidential treatment for any documents or agreements. Consider also the effect on the Company should confidential treatment be denied. Some documents or agreements may require consent of counterparties prior to disclosure, even to underwriters in the due diligence process, or may require that the Company provide notice of, and obtain consent to, the offering.
- The Company should identify one person (often the general counsel, controller or chief financial officer) to be the due diligence point person.
- The Company and the underwriters will need to consider artwork for the IPO prospectus. Artwork requires lead time and increases printing costs but is often encouraged by the underwriters.
- The Company eventually will need an investor relations representative capable of handling analysts and financial press communications as well as familiarity with reporting obligations.
- The Company's web site will need to be reviewed for consistency with statements in the prospectus.