Snell & Wilmer L.L.P.

THE CORPORATE

HANDBOOK

SERIES

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contents

Going Public

The end of 2005 brought to a close a stable year for the U.S. capital markets. The Nasdaq Composite Index rose 1.4%, from 2,175.44 to 2,205.32, during 2005 and finished the year up 65.1% since December 31, 2002. Meanwhile, the S & P 500's increase of 2.9%, from 1,213.55 to 1,248.29, during 2005 allowed it to finish 42.8% above its close at December 31, 2002.

Companies seeking to go public also saw success. During 2005, 202 companies priced traditional initial public offerings (IPOs), a 13.3% decline from the 233 IPOs that priced during 2004, but well above the two prior years. Venture-backed companies accounted for 56 of these IPOs, again a decline from the 93 venture-backed IPOs in 2004, but also above the two previous years. In addition, many other companies became public as a result of Rule 144A equity placements or reverse mergers, with the latter being a particular attractive method of going public for smaller domestic companies and foreign companies seeking to access U.S. capital markets. With more than 130 companies in registration for IPOs as of mid-January 2006, many predict that 2006 will be another strong year. If you are a private company with the size and financial profile necessary to go public, now may be the time to consider doing so.

In this issue of the Snell & Wilmer *Corporate Handbook Series*, we provide an overview of the principal ways in which private companies go public, the mechanics and timing of each method and the key issues that private companies should focus upon as they prepare to go public. We believe that a company that understands and anticipates the business and legal issues it will face in its going public process may achieve significant time and cost savings and greatly increase its chances for a successful outcome.

Methods of Going Public

There are three principal ways in which a private company can go public:

- *Initial public offering.* In a traditional IPO, a company engages underwriters, drafts and files a registration statement with the Securities and Exchange Commission (the "SEC") in which it makes required disclosures about its business and finances, conducts a roadshow with its underwriters, generally targeting institutional investors, and prices and closes the offering following the SEC's declaration that the registration statement is effective. In addition, the company lists its securities on an exchange or Nasdaq in order to provide a liquid trading market for its stockholders.
- *Rule 144A equity placement.* Although historically used by public companies to issue debt or preferred stock, in recent periods domestic private companies have sold equity securities through Rule 144A equity placements. In this type of transaction, a company sells equity securities to large institutions known as *qualified institutional buyers*, or QIBs. Initially, the QIBs can trade the securities among themselves on an exchange-like market operated by Nasdaq and known as the PORTAL Market. As a condition to the QIBs' purchase of the securities, however, the company will agree to file with the SEC and seek effectiveness of a registration statement (typically within six to twelve months after the closing of the initial purchase) that registers the privately placed securities for resale to the public. Upon the effectiveness of the registration statement, the company will become a publicly reporting company under the Securities Exchange Act of 1934, as amended (the *"Exchange Act"*) and may, if it chooses, seek to list its securities on an exchange or Nasdaq. The initial phase of a Rule 144A equity placement follows a process that substantially resembles the process involved in an IPO, and the offering documents contain all of the information that would be required in a prospectus for a traditional IPO. Importantly, however, the offering documents in a Rule 144A equity placement are not filed with the SEC and, thus, the company obtains the proceeds of the offering more quickly.
- *Reverse merger.* In a reverse merger transaction, a private operating company merges with a public *shell company* (which is a term used to describe a company that files reports under the Exchange Act and whose stock may even be traded in the Pink Sheets or on the Over-The-Counter Bulletin Board, but that has no or nominal operations or operating assets). Upon the merger, the combined company is a reporting company under the Exchange Act, and, within four days of closing, must file a Current Report on Form 8-K containing information and disclosures, including financial information, similar to the information a company discloses in connection with a traditional IPO. As a result of the transaction, the combined company has access to the public capital markets and, if it meets the applicable listing standards, can seek to list its securities on an exchange or Nasdaq. In contrast to an IPO or Rule 144A equity placement, however, a reverse merger is only an *indirect* route to raising capital – unless the shell company already holds cash or the deal is done in conjunction with a

separate financing, the combined company, while public, will need to raise capital in a separate transaction in order to grow its business.

The following table summarizes certain key similarities and differences among the three methods of going public:

Method	Time to completion	Review by SEC?	Audited financial statements required?	Subject to listing requirements, including independent board/ committee requirements?	Subject to Exchange Act reporting obligations, and Sarbanes-Oxley, including Section 404?	When company receives capital	When offered securities are freely tradeable[1]
IPO	3-6 months	Yes, review of registration statement	Yes, as part of registration statement	Yes	Yes	At closing of IPO	Upon closing
Rule 144A equity placement	1-3 months to closing of private placement 6-12 months thereafter to effectiveness of registration statement	No review of initial private placement memorandum Likely review of subsequent registration statement	Yes, as part of offering memorandum	No. May subsequently choose to list in connection with completion of registration statement	Yes	At closing of private placement	Upon closing, securities tradeable on the PORTAL Market among QIBs Upon completion of post-closing registration process, securities become freely tradeable
Reverse merger	1-6 months	No review of merger documents Possible post-closing review of Form 8-K	Yes, as part of Form 8-K required to be filed immediately post-closing	No – typically will trade initially on OTC Bulletin Board or Pink Sheets. Can choose to move listing to exchange or Nasdaq later if qualified	Yes	No capital is raised unless shell company has cash or the transaction is combined with a financing	Securities issued in reverse merger are typically restricted securities subject to Rule 144

[1] *Directors, officers and other affiliates of the company will be subject to various restrictions on trading.*

Mechanics and Timing of Going Public

Choosing among the three methods of going public involves considerations of deal mechanics and timing. The discussion below presents an overview of the mechanics and timing of each method.

A. The traditional initial public offering. The traditional IPO process begins with the company's selection of professionals (lawyers and accountants) and underwriters. Following such selection, an initial organizational meeting will be held, attended by senior management of the company and its outside counsel and accountants and the underwriter and its counsel, at which the parties will discuss the timetable for the transaction and any legal and business issues that may affect the offering. An IPO generally takes 90 to 180 days from the date of the organizational meeting to the closing.
A typical timetable would be as follows:

Time Period Following Organizational Meeting	**Tasks**
Weeks 1 through 8	Draft the registration statement; conduct legal and business due diligence; review and finalize plans with respect to corporate structure and capitalization changes and draft applicable documents; review, finalize and draft equity plans, executive employment agreements, board committee charters, director indemnification agreements and other matters; file the registration statement with the SEC, the listing agreement with the selected exchange or Nasdaq and the underwriting agreement with the NASD
Week 12	Receive and review SEC comments; prepare and file amended registration statement; print preliminary prospectus; complete roadshow preparation
Weeks 13-15	Conduct roadshow; file any necessary amendments to the registration statement to respond to additional SEC comments or to update financial data; complete other matters, including the listing application, NASD underwriting approvals and other corporate matters
Week 16	Price and close offering

While the above chart and discussion generally describes the timing and process of an IPO, there are a number of issues that a given company will face that will need to be dealt with prior to completion of the transaction. With proper planning, some of the tasks noted above, particularly preparation of an initial draft of the registration statement, legal due diligence, and corporate planning, can be front-loaded and accomplished prior to the start of the formal process, thereby potentially shortening the timeline from initial meeting to closing. It is nearly always the case that careful planning and upfront investment by a company in ensuring that it is properly positioned to go public will save valuable time and money down the road.

The following summarizes some of the potential advantages and disadvantages of a traditional IPO:

Advantages:

- *Raise capital.* A company that completes a traditional IPO will raise a significant amount of capital that it can use in its business operations or for other disclosed purposes.
- *Provide liquidity to current stockholders.* The listing of the company's stock on an exchange or Nasdaq will create an active trading market and provide an avenue to liquidity for current stockholders, who may have been invested in the company for a substantial period of time.
- *Future access to capital markets.* Having an established market for its stock will provide a company with name recognition, as well as a readily ascertainable market value for its stock. This will often make it easier to raise additional capital in the future as needs arise.
- *Acquisition currency.* A liquid stock can also provide currency for making acquisitions, thereby saving the company's cash for other purposes.
- *Employee incentives.* Companies with a market for their stock have a greater ability to incentivize employees through equity grants.

Disadvantages:

- *Public company costs.* Upon completion of a traditional IPO, a company will incur all of the current and ongoing costs of being a publicly reporting company, including the costs of complying with its Exchange Act reporting obligations and with applicable provisions of Sarbanes-Oxley. It will also need to comply with the listing standards of its chosen exchange or Nasdaq.
- *Disclosure obligations.* As part of its Exchange Act reporting obligations, the company will be required to make extensive disclosures about its business and operations, and provide detailed information about the compensation of its directors and officers, related-party transactions, and other matters. In addition, a company's directors, officers and affiliates will become subject to complex filing obligations and trading restrictions under Sections 13 and 16 of the Exchange Act.
- *Increased risk of legal exposure.* The company and its directors and officers will be subject to potential liability under the federal securities laws for material misstatements or omissions in its SEC filings and other public disclosures. In addition, the duties and other obligations of the company's board of directors and officers, and their susceptibility to claims for breaches of such duties, will increase substantially.

B. Rule 144A equity placement. Rule 144A facilitates the private placement and subsequent trading of equity securities, including common stock and securities that are convertible into or exercisable for common stock, so long as the security issued (or the underlying common stock) is not of the same class as a security of the issuer listed on a national exchange or quoted in a U.S. automated inter-deal quotation system. This rule generally prevents public companies from pursuing Rule 144A common equity placements because public companies typically have common equity that is listed or otherwise quoted. On the other hand, private companies – and companies that are publicly reporting companies solely because they have registered debt – can do Rule 144A equity placements because their common stock is not publicly listed or quoted.

To effectuate a Rule 144A equity placement, a private company first sells its securities in a private placement (through one or more investment banks) to QIBs. Some time thereafter (generally six to twelve months) and pursuant to a registration rights agreement between the QIBs and the company entered into at the closing of the private placement, the company will either file and go effective with an IPO registration statement that will include the QIBs' securities or file and go effective with a shelf registration statement from which the privately placed securities (or the common stock underlying them in the case of convertible securities) can be sold publicly from time to time. Between the closing of the private placement and the effective date of the applicable registration statement, the privately placed securities are eligible for trading among QIBs on the PORTAL Market.

The process of a Rule 144A equity placement mirrors the traditional IPO process in several important respects, including in the selection of investment banks, the drafting of the offering documents (which resemble, and include all of the information and disclosures required by, an IPO prospectus) and the use of a road show to market the deal to QIBs. The major difference, however, is that a Rule 144A equity placement does not require any filings with the SEC prior to the closing of the private placement and the company's receipt of the offering proceeds. Rather, upon completion of the offering documents, the company and the investment banks will conduct the road show and then price and close the deal. It is only after the company receives the proceeds of the transaction that it will become obligated to draft, file and seek effectiveness of a registration statement.

The following summarizes some of the potential advantages and disadvantages of a Rule 144A equity placement:

Advantages:

- *Quicker access to capital.* A company can complete a Rule 144A equity placement and receive the offering proceeds without having to go through an SEC review process.
- *Valuation.* The stock issued in a Rule 144A equity placement will be tradeable among QIBs on the PORTAL Market. Thus, a company may get a higher valuation for its stock than it would in a typical private placement.
- *More time to meet public company obligations.* Because it is still a private company at the time the private placement closes, a company that completes a Rule 144A equity placement will have up to a year to prepare itself for the costs and obligations of being a public company.

Disadvantages:

- *Only half way there.* Upon the closing of a Rule 144A equity placement, the company will still need to go through a registration and SEC review process that can be long and costly. In addition, the registration rights agreement with the QIBs will provide for financial penalties if the filing or effectiveness of the registration statement does not occur within stated time periods.

- *Valuation and liquidity.* Upon the closing of a Rule 144A equity placement, the company will not yet be public and its securities will not be publicly tradeable. Accordingly, its stock will not obtain the valuation or have the liquidity of a publicly traded stock.

C. Reverse merger. A reverse merger refers to a transaction in which a private operating company combines with a public shell company and, by doing so, becomes public. Reverse mergers as a method of going public are typically pursued by companies that desire access to the public capital markets, but that may not be big enough to attract the attention of underwriters who could take them through a traditional IPO. In recent years, reverse mergers have also been a method of choice for foreign private companies to go public in the United States.

To accomplish a reverse merger, the private operating company must first seek to identify a shell company. To avoid entangling itself in any hidden liabilities, the ideal shell company will be one that has never had an operating business, has been dormant for a long time, or has been through a bankruptcy and had its liabilities discharged. In a typical reverse merger, the public shell company acquires the private operating company in a stock-for-stock merger, with the stock issued to the private company owners often amounting to 90% or more of the combined company's outstanding stock after the transaction. Since the stock issued in the reverse merger is usually restricted stock, the sellers of the operating company may also negotiate for registration rights.

Upon the closing of the transaction, the combined company will be a publicly reporting company subject to the reporting requirements of the Exchange Act. Under SEC rules that became effective in 2005, the combined company will be required to file a Current Report on Form 8-K within four days of the closing of the transaction that must include information and disclosures relating to the combined company, including financial information, similar to that required in a registration statement filed in connection with a traditional IPO.

The key point to remember about a reverse merger is that, unless the shell company has cash left over from a prior business or there is a planned financing that occurs concurrently with or shortly after the closing, no capital is raised in connection with the transaction. Thus, while the combined company may have its securities traded on the OTC Bulletin Board, the Pink Sheets or another trading market, at least initially the market for its securities will be limited and illiquid, and the company will have incurred the current and ongoing costs of being a public company without having raised any capital. On the other hand, the fact that the company now has access to the public markets should make it easier to raise capital in the future through a public or private offering.

The following summarizes some of the potential advantages and disadvantages of a reverse merger:

Advantages:

- *Public trading status.* As a publicly reporting company with securities included on a recognized market, the securities of the combined company will be relatively more liquid, and the company will have greater access to the public capital markets.
- *Use of stock.* The combined company's stock may have greater value as a currency for acquisitions or for employee incentives.

- *Time and cost.* The time and cost to achieve public company status may be less than that required in a traditional IPO or Rule 144A equity placement.
- *Availability.* Companies seeking to go public that cannot attract an underwriter for a traditional IPO may still utilize this method.

Disadvantages:

- *No capital raised.* Unless the shell company has cash left over from a prior business or there is a planned financing that occurs concurrently with or shortly after the closing of the reverse merger, no capital is raised in connection with the transaction.
- *Illiquidity.* Since the substantial majority of its outstanding shares post-closing will be restricted, the combined company's stock, while traded, will still be fairly illiquid, especially if there are no "sponsors" in the brokerage community ready and willing to make a market in it.
- *Public company costs.* Even though the combined company may not have raised any capital, it will have incurred all of the current and become subject to all of the ongoing costs of being a publicly reporting company, including the costs of complying with its Exchange Act reporting obligations and with applicable provisions of Sarbanes-Oxley.
- *Successor liability risk.* In combining with a shell company, a private company may succeed to unexpected and hidden liabilities.

Preparing to Go Public

A private company that wants to go public must consider and understand several key legal requirements and business issues before it begins the process. While some of these items may seem daunting at first, with careful planning and proper upfront investments of time and resources, a company can tackle these issues in a considered fashion and save itself valuable time and money down the road.[2]

A. Selecting Professionals and Underwriters. A company typically begins the going public process by selecting attorneys, accountants and underwriters with the experience and reputations to effect a successful transaction.

- *Attorneys.* The process of going public is subject to a complex legal and quasi-legal framework that includes the federal securities laws, stock exchange and Nasdaq listing requirements, accounting practices, and, to a lesser extent, state corporate law, federal and state tax laws and the corporate governance and voting policies of Institutional Shareholder Services ("ISS") and other corporate watchdog groups. Each of the foregoing can directly affect the timing of any going public transaction, as well as the costs involved. They also can impact the choice a company makes regarding the structure of its going public transaction. Thus, a company should select counsel experienced in SEC matters and going public transactions that can guide it through the going public processes, provide crucial recommendations concerning corporate structures and policies, conduct the offering

[2] *This discussion focuses on the Nasdaq listing requirements. If a company seeks to list on the New York Stock Exchange (the "NYSE") or another exchange the listing issues will be similar, although not identical.*

document drafting process and manage the company's interactions with the working group and the SEC. Ideally, counsel selected by the company to complete the going public transaction will continue to serve and advise the company following the transaction when it is subject to the myriad legal responsibilities of a public company.

- *Accountants.* A company should pick a well-known, national pubic accounting firm as its auditor and, at a minimum, must utilize one that is registered with the Public Company Accounting Oversight Board (the "PCAOB") and otherwise admitted to practice before the SEC. In addition, a public company's accounting firm must be independent of the company, as defined under applicable rules of the SEC and the PCAOB. An accounting firm will not be independent if, among other things, (i) it previously provided certain services to the company, such as bookkeeping, financial information systems design, valuation services, actuarial services, management functions, human resource functions, legal services and/or internal audit outsourcing services, (ii) any person in a financial oversight role for the company was employed by the accounting firm in a professional capacity during the one-year period preceding the date of the initiation of the audit, or (iii) the lead audit partner has performed audit services for the company for more than five consecutive fiscal years.
- *Underwriters.* A company should consider a potential underwriter's reputation in the company's industry and its ability to complete the transaction in a timely manner, as well as its views on, among other things, the company's valuation, the timing and size of an offering and relevant corporate governance issues. A company may also weigh the reputation of the investment bank's analyst in the company's industry. A company should also be aware of any relationships that it may have had with a potential investment bank prior to the offering process (such as the bank's or an affiliate's involvement in a financing) so that it can determine whether the potential underwriter has received compensation from the company that would raise issues concerning improper underwriter compensation or conflicts of interest.

B. Preparing the Required Financial Statements. A threshold issue in any going public transaction is whether a company has, or can obtain on a timely basis, the audited and unaudited financial statements, and related auditor consents, required to be included in the offering documents. A company's offering documents will generally need to contain three years of audited financial information and up to five years of unaudited financial data,[3] and the company's accountants will need to consent to the use of such audited statements in the offering documents. In addition, if a company has acquired or is in the process of acquiring a material business, it may need to include in its offering documents up to three years of audited financial statements (and related auditors' consents) of the acquired, or soon-to-be-acquired, entity.

C. Assembling the Board of Directors. Subject to limited exceptions, the exchanges and Nasdaq currently require

[3] *If the company qualifies as a "small business issuer" (generally, a company with revenues and a public float of less than $25 million each), then it will only need to provide two years of audited financial statements.*

listed companies to have majority independent boards of directors and wholly independent audit committees. Many private companies, however, have boards of directors and committees that do not meet current independence requirements. While current exchange and Nasdaq rules permit listing companies to comply with the board independence rules over specified phase-in periods, a company should, nevertheless, begin to consider and plan its independent director search process at the very beginning of its going public process.

- *Phase-In Periods.* A company listing on an exchange or Nasdaq generally has twelve months from the date of listing to comply with the majority independent board requirement. With respect to its audit committee, a company generally must have (i) at least one independent member at the time of listing; (ii) a majority of independent members within 90 days of listing; and (iii) all independent members within one year of listing. Notwithstanding the phase-in rules, because of the high profile of corporate governance in today's market, a company may desire, and its underwriters may require, a fully compliant board and committee structure prior to completion of the public offering.[4]
- *Director Independence - Generally.* For Nasdaq purposes, an independent director is a person who (i) is not an officer or employee of the company or its subsidiaries, (ii) has not been an officer or employee of the company or its subsidiaries during the past three years, and (iii) does not have any relationship which, in the opinion of the company's board of directors, would interfere with the exercise of independent judgment by such person.[5] Once public, the board of directors of a Nasdaq-listed company must make annual determinations, and disclose such determinations in its annual report or proxy statement, as to which of its directors are independent.
- *Director Independence – Audit Committee Members.* A Nasdaq-listed company must have an audit committee composed of at least three directors, all of whom (subject to limited exceptions) are independent and can read and understand fundamental financial statements, and none of whom (i) have accepted, directly or indirectly, any consulting, advisory or other compensatory fee from the company or its subsidiaries, (ii) have an affiliate relationship with the company (other than in such member's capacity as a director), or (iii) have participated in the preparation of the company's financial statements during the past three years. Thus, for example, while a person

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[4] *Other governance standards will also impact board composition. For example, ISS, which advises many institutional investors on corporate voting issues, has several policies on director qualifications that govern its voting recommendations to its clients. It should also be noted that the majority independent board requirement is not applicable to "controlled companies," which are companies with a stockholder who holds more than a 50% stake, although controlled companies are subject to the audit committee requirements discussed below.*

[5] *Under Nasdaq rules, the following relationships, among others, preclude a finding of independence:*
- *receipt by a director of more than $60,000 per year from a company (other than fees for board service);*
- *payments by a company in excess of specified amounts to a business in which the director is involved;*
- *payments by a company to charitable organizations in which the director serves as an executive officer; and*
- *interlocking compensation committee arrangements.*

A director's (or an affiliate's) ownership of stock, by itself, does not generally impair independence, so that a director with a significant investment in the company, or one associated with a private equity or venture capital investor in the company, can be counted as independent for purposes of meeting the test.

who received less than $60,000 of consulting fees from a company could qualify as independent for purposes of the majority independent board requirement if the board so determined, he or she could not serve as a member of the audit committee.

- *Other Requirements of Audit Committees.* For SEC and Nasdaq purposes, one member of the audit committee must have past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities. In addition, a company must also disclose whether one of the members of its audit committee has been determined by the board to be an audit committee financial expert. If no member qualifies as an audit committee financial expert, the company must disclose why it does not have such a person on its audit committee.[6]

- *Nominating and Compensation Committees.* Nasdaq does not require listed companies to have compensation or nominating and governance committees. If a company chooses not to have such committees, then Nasdaq requires that the compensation of the CEO and other executive officers, and the nomination of directors, be determined by a majority of the independent members of the board of directors. If a company does choose to have such committees, then they must be composed solely of independent members (subject to limited exceptions). Since these committees are required of NYSE-listed companies and have become more prevalent in recent years, underwriters and counsel may recommend that they be created in order to establish a company's corporate governance credentials as it goes public.

- *Insurance and Indemnification.* A director can be personally sued for actions that are deemed to breach the director's duties to a corporation or its stockholders, and commonly are sued in class actions alleging inadequate disclosure in public filings (including IPO offering documents). Thus, to attract qualified board candidates, a company should have in place a satisfactory director and officer (D&O) insurance policy, comprehensive director indemnification agreements or bylaw provisions, and up-to-date exculpation provisions in its corporate charter.

D. Analyzing Stock Issuances in the Pre-Public Period. A key incentive that private companies offer their officers and employees is the opportunity to build wealth through the receipt of private company equity that can later gain substantial value when the company goes public. Some companies, however, fail to comply with applicable securities laws governing the issuance of private company stock. Missteps in this area can, and often do, lead to SEC issues that can slow down the going public process.

- *Cheap Stock.* Cheap stock issues arise when the SEC questions the low valuation a company may have placed on its stock when making stock or option grants to employees in the period (usually

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[6] Members who have been, or who have supervised, a principal financial officer of a company in connection with preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues comparable to those of the applicable company will generally be able to qualify as an "audit committee financial expert" for such company.

up to 12 months) prior to going public. This may result in an increase in the compensation charge related to the grants. A consistent record of careful deliberation by the board of directors or compensation committee, together with contemporaneous documentation of the valuation methodology utilized in determining fair value, will likely help a company avoid a cheap stock issue. Accordingly, the boards of directors or compensation committees of private companies planning to go public should take great care to design and contemporaneously document the process they use to determine the fair value of the company's stock when making equity grants. The most persuasive indicator of fair value likely will be a recent third party acquisition or investment, but, in the absence of such a transaction, many private companies today obtain stock valuations from third party appraisal firms to support their fair value determinations. At a minimum, a company should prepare an internal valuation utilizing market- and industry-accepted valuation metrics when making its equity grants.[7]

- *Limits on Private Company Stock Grants.* To satisfy a key SEC safe harbor relating to employee stock grants, a private company must limit the amount of securities it issues for compensatory purposes during a given 12-month period to the greater of (i) $1,000,000; (ii) 15% of total assets of the issuer measured at the issuer's most recent balance sheet date; and (iii) 15% of the outstanding amount of the class of securities being sold, measured at the issuer's most recent balance sheet date. A company must also make various disclosures if the amount of securities it issues for compensatory purposes exceeds $5 million during any consecutive 12-month period. The SEC can levy sanctions against a company for failure to comply with these rules, including requiring rescission offers to be made to the affected employees, seeking a cease and desist order against the company, or seeking personal sanctions against the individuals, such as the chief financial officer or general counsel, responsible for managing the employee equity program. In addition to federal securities law considerations, applicable state laws (generally, of the states in which employees reside) must also be considered.

E. Preparing for Legal Due Diligence. In addition to analyzing prior stock issuances, a private company should consider, as part of the planning process, performing a legal audit of its material operations and contracts in order to prepare for underwriter due diligence, to understand and resolve any legal issues that could impact the timing and completion of the offering and, generally, to prepare for its offering document disclosures. The scope of such an audit will vary by company. For example, a regulated company may retain special counsel or a qualified consultant to conduct a regulatory compliance audit. Similarly, a technology company with a significant intellectual property portfolio may seek a thorough review by IP counsel. Other items that a company's counsel should review are its material contracts, including registration rights or other rights granted to stockholders in the past that may impact the offering, related-party transactions, legal proceedings involving the company or its directors and officers and

[7] The adoption by the Financial Accounting Standards Board of its Statement of Financial Accounting Standards No. 123 (revised 2004), or FAS 123R, which is effective for periods ending after June 15, 2005, as well as the adoption of Section 409A of the Internal Revenue Code, have added great complexity in the area of accounting for options and other share-based payments and in the rules affecting option pricing. Accordingly, companies should also consult with their accountants and tax advisors when making equity grants.

past compliance with relevant corporate, securities and other laws. As part of this process, the company may also determine whether any contracts that would be required to be filed with the SEC as exhibits to a registration statement contain confidential or sensitive provisions with respect to which the company should seek confidential treatment.

F. Developing the Internal Audit and Disclosure Functions. A public company has significant responsibilities, and potential liabilities, in connection with the preparation and filing of its public reports, including its financial statements. Therefore, a key element of going public is the planning and development of a company's internal controls over financial reporting and disclosure controls and procedures, for purposes of both the going public transaction and ongoing Exchange Act reporting.

- *Internal Control Over Financial Reporting.* Among the financial reporting obligations that a public company faces is the requirement imposed by Section 404 of the Sarbanes-Ox1ey Act of 2002 that a public company's management evaluate the effectiveness of the company's internal controls over financial reporting, which refers to the processess that a company follows in preparing its financial statements to ensure that such statements are reliable and prepared in accordance with GAAP. Management must then certify this evaluation in the company's public filings, and its auditors must attest in the company's annual report to the adequacy of the company's internal controls. Companies that go public are not required to submit Section 404 auditor certifications until their first annual report filed after they go public or, if later, their annual report for their first fiscal year ending on or after July 15, 2007. Underwriters, however, may require, and investors may expect, the controls to be substantially in place when the company goes public. Accordingly, planning for Section 404 is an important consideration in the going public process.[8]

- *Disclosure Controls and Procedures.* Upon going public, a company must have in place immediately a system of disclosure controls and procedures designed to ensure that the information required to be disclosed in its SEC reports is recorded, processed, summarized and reported accurately and within the time periods specified by the SEC. As with the internal controls over financial reporting, a public company must report on the design and effectiveness of these disclosure controls and procedures in its public filings. In addition, in each quarterly and annual report, both the CEO and the CFO of a public company must file certifications stating that they are responsible for developing and evaluating the disclosure controls and procedures and disclosing the results of their evaluation. The development of a company's offering documents provides a good opportunity for a company's core team of management, counsel and accountants to design and develop good disclosure practices. Once public, many companies establish formal disclosure review committees, typically including the CFO, controller, unit heads, investor relations director

[8] *Due to auditor independence rules, a company's regular accounting firm, which will be required to attest to the controls, is not permitted to design the company's control processes. Accordingly, many private and small public companies, who typically do not have sufficient staff to design and implement the controls on their own, engage different accounting firms or outside consulting firms to help design and develop the controls.*

and counsel, to prepare and review their SEC filings and other important communications prior to filing or publication.

- <u>*Internal Staffing Levels.*</u> A company seeking to go public must ensure that it has a finance team capable of handling the financial reporting responsibilities that come with being a public company. Not only does a public company need to have in place and certify both its internal controls over financial reporting and its disclosure controls and procedures, but, among other things, it must file annual reports with audited financial statements and quarterly reports with reviewed interim financial statements within specified time periods following period end.[9] Members of the finance team are also typically involved in the preparation and filing of Current Reports on Form 8-K,[10] the preparation of earnings releases and conference call scripts and numerous other matters, including dealings with the company's stock exchange or Nasdaq. Having a finance team with inadequate public company experience or one that is simply understaffed can greatly complicate and impede a company's ability to go public and/or to satisfy its subsequent reporting and disclosure obligations.

G. Other Issues That Impact the Going Public Process. The following issues, while typically fairly straightforward to analyze and resolve, often arise as a company prepares to go public.

- <u>*Executive Stock and Bonus Plans.*</u> Stock and cash bonus plans may require stockholder approval to satisfy various corporate, stock exchange and tax provisions. Accordingly, a private company should consider and adopt equity and cash incentive arrangements prior to becoming public that will serve its purposes for at least the first few years after going public. In this regard, it is far easier for a private company to obtain stockholder approval than it is for a public company, which must satisfy the disclosure rules of the exchanges, Nasdaq and the SEC and the voting policies of ISS and other corporate watchdog organizations.[11]

- <u>*Capitalization; Charter and Bylaw Matters.*</u> In consultation with its counsel and underwriters, a company should consider whether, prior to going public, it needs to increase its authorized capital stock or effect any stock splits or reverse stock splits, establish blank check preferred stock for use in future financings, or adopt other charter or bylaw amendments, including those relating to its board of directors or the conduct of board and stockholder meetings. Any such changes that may be viewed as having an anti-takeover impact, such as a staggered board or the creation of blank

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[9] *Companies with non-affiliated public floats of less than $75 million must file their annual reports within 90 days of year end and their quarterly reports within 45 days of quarter end. Companies with non-affiliated public floats of greater than $75 million must file their annual reports within 75 days of year end and their quarterly reports within 40 days of quarter end. With respect to fiscal years ending on or after December 15, 2006, companies with non-affiliated public floats of $700 million or more will be required to file their annual reports within 60 days of year end.*

[10] *Form 8-K has been significantly amended recently to require disclosure of new and broader categories of items and to shorten the time periods for making such disclosure. Persons with reporting reponsibility must understand these disclosure requirements and be adept at recognizing when they are triggered.*

[11] *For example, under Section 162(m) of the Internal Revenue Code, a company may not deduct annual compensation in excess of $1 million paid to certain employees, generally its chief executive officer and its four other most highly compensated executive officers, unless that compensation qualifies as performance-based compensation and is approved by stockholders. In addition, plans that permit the grant of "incentive" stock options, which provide favorable tax treatment to employee grantees, also require stockholder approval.*

check preferred stock, should be done with an eye towards how such measures may impact valuation and how they will be viewed by ISS and other corporate watchdog groups once a company is public.

- *Reincorporation.* With a view to its increased potential liability, a private company should consider whether its current state of incorporation is the best jurisdiction for it once public. In this regard, many private companies incorporated in states with undeveloped corporate laws consider reincorporating to states, such as Delaware or Nevada, that are established jurisdictions for public companies.
- *Publicity During an Offering.* Historically, a company in registration in connection with a planned public offering (typically considered to be the period following the selection of underwriters) was restricted from publicly disseminating any information that could be construed as being an offer in order to prevent the company from inappropriately promoting the sale of its securities. These unwritten rules impacted the ability of private companies to engage in ordinary business communications, attend industry conferences and participate in similar activities that could later be viewed by the SEC as gun jumping. Under new SEC rules that became effective in December 2005, the SEC provided safe harbors for communications that make it much easier for companies to avoid gun jumping issues. Now, a private company seeking to go public can make a public statement without fear of gun jumping so long as the statement (i) contains *regularly released factual business information* that is intended for use by persons *other than in their capacity as investors or potential investors;* or (ii) is made more than 30 days prior to the filing of a registration statement and does not refer to a securities offering that is or will be the subject of a registration statement, and so long as the company takes reasonable steps within its control to prevent further distribution or publication of such communication during the 30-day period immediately prior to filing the registration statement. Thus, for example, if a private company wants to attend an industry conference sponsored by an investment bank, it can now do so as long as the conference occurs more than 30 days before the company files its registration statement, the company does not mention the upcoming offering and the company takes steps to ensure that its presentation is not re-published within 30 days of its filing of a registration statement. Similarly, a private company that anticipates going public could establish a system of regular business communications to the public regarding product launches and other ordinary course business news in order to ensure that it can take full advantage of the safe harbor for communicating factual business information.
- *Related Party Transactions.* In its offering documents and periodic reports, a company will be required to make detailed disclosures regarding direct and indirect transactions between the company and its directors and officers and/or their immediate family members or its substantial stockholders. While many private companies engage in such transactions in the ordinary course of business

with the knowledge and approval of their boards and stockholders, such arrangements may be viewed very differently by public stockholders and corporate watchdog groups. Accordingly, each company preparing to go public should review any transaction or arrangement that could be classified as a related party transaction under current SEC rules, review the ramifications that may arise from the need to disclose such transaction or arrangement and determine whether the transaction or arrangement ought to be continued because of its benefit to the company or discontinued as part of the preparation for going public.

- *Loans to Officers.* The Sarbanes-Oxley Act of 2002 prohibits personal loans from public companies to their directors and executive officers.[12] This prohibition takes effect upon a company's filing of its initial registration statement with the SEC. The rules prohibiting such loans are vague and can be interpreted to prohibit other transactions that would not ordinarily be thought of as loans, including deferred compensation arrangements, split-dollar life insurance policies and, according to some commentators, the cashless exercise of options. A private company should carefully analyze, and preferably avoid, any transactions between the company and its directors or officers that may be characterized as a personal loan. If any such loans or other arrangements do exist, they should be paid off or otherwise restructured early in the process and, in any event, prior to the filing of the registration statement.

There are many legal, business and other considerations that may be relevant in determining a specific course of action for your company. This memorandum attempts to provide only a general overview of some of these issues. You should consult with securities counsel with respect to specific issues facing your company in connection with your going public transaction and ongoing public company reporting obligations.

[12] *Loans made prior to July 2002 are grandfathered, provided they are not amended in any respect or extended.*