

Acredula

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Bricker & Eckler LLP's Acredula is available to clients and friends of the firm, and highlights information of particular importance to boards and executives. The information contained in this newsletter is not to be construed as legal advice or opinion.

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Acredula is the Latin word for "owl," connoting wisdom. This newsletter is intended as wise counsel for boards and executives.

Raising Capital Is a Concern for All Businesses

In covering issues of importance to boards and executives, Acredula focuses on organizations in all stages of their life cycle – from those starting up, to those emerging into the capital markets, to those “going private” from the capital markets. This month’s issue concentrates on the emerging business.

Contrary to popular opinion, organizations with publicly traded securities markets may *not* have an easier time raising capital than organizations that have not emerged into the capital markets. Often, it is easier to convince commercial bankers, angel investors, and venture capitalists of closely held companies to invest in a new product or business line than it is to convince security analysts and market makers of publicly held companies. This is because the typical commercial banker, angel investor or venture capitalist focuses on the potential earnings and other fundamentals of the company. They are often supportive of a new product or business line if it looks like it will add to the company’s earnings. Security analysts and market makers, on the other hand, concentrate on the market and technical demand for the company’s securities. They are usually less supportive

Editor’s Note

of investing in a new product or business line because change often results in a decline in the market or technical demand for the company’s securities.

Frustrated with trying to win over security analysts and market makers, maturing companies contemplating substantial product or business line changes will consider “going private.” Usually, this is accomplished through an affiliation with a larger enterprise. By entering into such an affiliation, the company’s management is betting that support for their new venture will most likely come from the responsible parties of a larger enterprise, who will consider the resulting impact on earnings and other fundamentals.

In this month’s issue, Mark Pomeroy provides helpful guidelines for navigating the public offering process. Since raising capital is a concern for all businesses, Mr. Pomeroy’s article should be of interest not only to emerging businesses, but also to businesses in other life cycle stages.



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Guidelines Help Navigate the Public Offering Process

Emerging businesses contemplating becoming publicly held often face many hurdles in preparation for and during the public offering process. During this process, a company must disclose every material fact about its business and ensure that those facts are true. Before approaching the capital markets, emerging businesses should consider all aspects of the public offering process, including the necessary preparation, the potential disclosures required, and the consequences of and alternatives to going public.

The Public Offering Process

At first glance, the public offering process appears to be relatively simple. With an initial public offering, a company is required to file a registration statement with the Securities and Exchange Commission (SEC), triggering disclosure and due diligence requirements under the Securities Act of 1933. This act requires the issuer (emerging business) to disclose material facts about its business and operations. Under this act, certain directors, nominees for directors, and executive officers are obligated to satisfy the due diligence requirement by assuring that the disclosure is complete and not misleading. In order to meet these conditions, issuers can turn to counsel experienced in SEC filings to provide guidance in:

- Determining what needs to be disclosed, what does not need to be disclosed, and how to disclose it;
- Conducting the due diligence required of the issuer, its directors, nominees for directors, and executive officers; and
- Facilitating relationships with underwriters, market systems (NASDAQ), stock exchanges, stock transfer agents and others necessary for the process.

Because the 1933 act expressly makes the issuer's directors and executive officers responsible for the disclosure process on behalf of the issuer, the most important factors in an issuer's selection of SEC counsel are:

- Counsel's understanding of the issuer's business from the viewpoint of its executive officers and directors; and
- Counsel's familiarity with the industry in which the issuer is engaged.

SEC counsel will need to make "close" disclosure "calls" and will need to design relevant and meaningful due diligence investigations, which must take into account the viewpoint of management, and the current circumstances and future prospects of the issuer's business, all within the context of the prevailing conditions of the issuer's industry.



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Required Disclosure

The SEC requires that every material fact about a business, and about its management and principal security-holders, must be verified and disclosed.

The SEC rules determine what must be disclosed, but generally depend upon the size of the offering, in terms of dollars, and the method of

distribution. Nevertheless, required disclosures will include the following areas:

- **Description of business.** This should include a description of past development and a detailed, narrative description of the business currently done and the business intended to be done in the future. Principal products, services, industry segment, sources of raw materials and supplies, customers, and intellectual property rights, among others, should be included in these descriptions.
- **Description of property.** This should include a description of principal facilities and any major encumbrances.
- **Summary of financial information about industry segments.** Revenues, operating profit or loss, and identifiable assets should be included.
- **Audited financial statements.**
- **Management discussion and analysis of financial condition and results of operation.** This should include liquidity, capital resources, operating trends and uncertainties, and unusual or infrequent events or transitions that will enhance an investor's understanding of the financial condition, changes in financial condition, and results of operation of the issuer.
- **Changes in and disagreements with accountants on accounting and financial disclosure.**

- **Information on directors and executive officers.** This should include names, ages, positions held, terms of office, management background, business experience, family relationships, and security holdings, as well as involvement in certain legal proceedings and other similar events which may adversely reflect on or affect management ability and experience, or character and reputation.
- **Executive compensation.** Executive officers' and directors' salary, bonuses, and perquisites, whether cash or non-cash (such as stock options and appreciation rights) or current or deferred (such as pensions and profit sharings), should be included.
- **Security ownership of large beneficial owners and management.** Any arrangements that maintain control or that could result in a change of control should be included.
- **Possible conflict relationships and transactions among related parties.** This should include relationships and transactions in which any director, executive officer, nominee for director, principal security-holder, or any family member of the foregoing has a personal or financial interest, as well as certain business relationships, including indebtedness.
- **Use of proceeds, determination of offering price, plan of distribution, expenses of the issuance and distribution, resulting dilution to investors, and other information regarding the offering.**

In addition, the 1933 act generally requires disclosure of all material facts necessary to make any statements made in the disclosure not misleading.

Steps in the Process

Completing an initial public offering involves many steps. Emerging businesses should be aware that the public offering process begins before and continues after the filing of the registration statement. Some important phases of this process include:

- Interviewing and selecting an underwriter.
- Identifying the participants in the offering process.
- Determining internal limitations on communications.
- Identifying preliminary due diligence on behalf of the issuer and underwriter.
- Preparing the disclosures and due diligence on those disclosures.
- Preparing the financial statements and due diligence on those statements.

- Auditing the financial statements.
- Filing the registration statement with the SEC.
- Filing in the various states and other jurisdictions in which the offering will be made.
- Having the SEC and other agencies review the registration statement.
- Responding to comments from the government review.

Preparation for an Initial Public Offering

A business that decides to proceed with an initial public offering should begin planning as early as possible. To prepare itself for undertaking an initial public offering, a prospective issuer can take a number of steps, including:

- Retaining an independent accountant.
- Having all due diligence documents organized and accessible to counsel.
- Performing any material corporate cleanup.
- Resolving any material accounting issues in accordance with generally accepted accounting principles and Regulation S-X of the SEC.
- Negotiating any necessary reduction of control of outside security-holders requested to be reduced or eliminated by the underwriters.
- Negotiating any agreements with key personnel on the terms of employment, noncompetition, and confidentiality required by the underwriters.
- Taking adequate steps to protect intellectual property that may be required by the underwriters.
- Considering forming an advisory board.

Alternatives to Public Offering

The public offering process requires a marshaling of resources to prepare the issuer for the process; to draft the necessary disclosures; and to conduct the necessary due diligence. Even with careful completion of all of these steps, the public offering will likely bring with it certain consequences. Some consequences include those typically imposed by the

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underwriter of the public offering, such as employment contracts and noncompetition agreements for management and key employees; compliance with corporate proceedings, such as due exercise of corporate authority by the board of directors; and appointment of independent directors. Other consequences include those resulting from becoming a public reporting company under the Securities Exchange Act of 1934. However, the most significant consequence is that the issuer must please either its market makers, stock analysts (if it is widely traded on a national market), or public investors (when considering the possibilities of raising additional capital). An emerging business thinking of going public should consider the alternatives and, at some point, do a cost-benefit analysis.

A public offering of securities is just one of several ways to:

- Raise capital for the issuer’s business, and
- Create a market for the principals’ securities (including, at times, cashing out principal security-holders).

The initial public offering is often just one stage in the life cycle of a thriving business. A prosperous business will go through many stages, and may do so rapidly, depending upon its industry, market conditions, and the general economy. After successfully maneuvering through its early development stages, a business often looks for a larger source of capital to finance growth. One such source may be a public offering. Other available sources include:

- Entering into an affiliation with a larger business that has greater capital resources, such as becoming a subsidiary of a larger corporation.

- Entering into a joint venture with a company that has needed resources, such as a manufacturer of a consumer product joint venturing with an online fulfillment firm for the sale and distribution of the manufacturer’s products.
- Obtaining traditional financing in the form of loans from lending institutions, such as banks, insurance companies, pension funds, and other similar institutions.
- Obtaining venture capital from a venture capital firm.

Businesses generally choose their source based on the desire of the controlling shareholders to remain independent and the ability of management to meet the requirements of being a public company. As businesses mature, public companies may “go private” to avoid the hassles of being a public company or may become so attractive to larger businesses that the shareholders cannot refuse an offer to merge.

Conclusion

Raising capital through a public offering with the SEC can bring an emerging business many benefits, such as increased access to capital and more public recognition. It will also bring new obligations, including the responsibility to keep shareholders informed and the loss of flexibility in managing the company’s affairs. By following these guidelines, up-and-coming businesses can navigate the public offering process more successfully.

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A Bricker & Eckler Initiative

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