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INITIAL PUBLIC OFFERINGS - PERSPECTIVE OF COMPANY COUNSEL

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Companies are again going public in record numbers. In 1972, almost $2.7 Billion Dollars was raised through initial public offerings. During the next eight years, however, only an aggregate of $3.3 Billion Dollars was raised as the initial public market shrank severely. In 1981 ($3.2 billion dollars)[1], 1982 ($1.47 billion dollars)[2], and the first four months of 1983 ($2.9 billion dollars)[3], the initial public offering market has again become a robust financial vehicle for raising equity.

This resurgence has resulted in numerous lawyers acting for the first time as company counsel for a public offering. As counsel for the issuer, they have significant responsibilities dictated by the registration requirements of the Securities Act of 1933, as amended (the "Securities Act")[4] and the anti-fraud provisions of the Securities Exchange Act of 1934, as amended (the "Exchange Act")[5]. In addition to the specific statutory disclosure and due diligence requirements, counsel has the broader challenge of assisting a private company to conform its behavior to the more rigorous requirements of public companies[6].

This article addresses only two aspects of a public offering that may be useful to uninitiated company counsel: (1) the relationship between the company and the underwriters; and (2) the pre-offering period.

Underwriters

The company should select and evaluate prospective underwriters primarily based upon their ability to sell the initial offering, and secondarily from their record of remaining an active and stabilizing market maker in the secondary market and their talent at providing ongoing capital and financial services for the company. Where the company is exciting, and the proceeds required substantial, one or more national underwriters may be interested. If investor interest will be limited to the company's home community, a regional firm may make sense as the sole lead underwriter or at least as a co-dealer manager. The company's analysis of the investment appeal of its offering, and therefore the most appropriate underwriter, should reflect the views of its counsel, accountants, and several prospective underwriters.

During the selection process, the company should concentrate on three broad negotiating areas: (1) underwriter's compensation; (2) mechanics of the underwriting; and (3) initial public offering price.

Underwriter selection involves practical business questions. Who will pay the expenses of underwriter's counsel? What percentage of the gross proceeds of the offering will the underwriting syndicate receive as their "spread"? Will the company be required to obtain expensive underwriters' indemnification insurance? Contrary to what the underwriters may indicate, all of these are negotiable, and financially important, items. Even minimal differences in the "spread" or allocation of offering expenses can involve substantial sums. Counsel should confirm in writing the underwriters' proposals relative to fees, expenses, and minimum estimated price/earnings multiples. While underwriters will often resist reducing their proposals to a letter of intent, and though the actual underwriting agreement will not be executed until the night before the offering, written communications should firmly indicate to the underwriters what the company's expectations are.

Underwriting mechanics, the second principal area of concern to the issuer, involve a variety of issues. Where there are co-dealer managers, the company should select one underwriter who will control the books of the syndicate, and whom the company will regard as the lead underwriter. The company must decide how many shares will be available to the underwriters as an over-allotment option (referred to as the "Green Shoe"), the length of time such option may be exercised, and whether the over-allotment shares will be sold by the company, the selling shareholders, or both. In connection with a firm commitment public offering, the underwriting group may create a short position in the security by selling more shares than the maximum being offered. This is frequently done in anticipation of subsequent cancellation of orders by customers. The underwriter obtains the over-allotment option to be used to cover the syndicate short position.

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When all shares are sold by the company, the proceeds strengthen the balance sheet and financial position of the issuer. Founding shareholders, however, frequently sell a percentage of their shares to realize cash - a disposition which does not benefit the company. Where the shareholders sell only a fraction of their interests and retain the balance, the underwriters are normally comfortable. Although some cash is realized, the majority of the selling shareholders' profits will depend upon the performance of the stock after the offering. What does offer the underwriters some discomfort is the converse situation where the shareholders sell virtually all of their shares. Because this can appear to be a "bail-out" of the sellers at the expense of the public investors, underwriters are understandably resistant to wholesale disposition of founders' shares. In the final analysis, however, it is the company and its founders who are going public, and if they are insistent on this issue, they should prevail.

The allocation of offering expense between the company and selling shareholders is extremely important. Selling shareholders may pay a proportionate share of the aggregate expenses, with or without a maximum amount, or simply pay a fixed sum. State securities commissions are extremely sensitive on this point and may refuse to register new issues where selling shareholders pay less than their proportionate share of expenses, thereby apparently profiting at the expense of the company. This possibility militates strongly against making an allocation of expenses on other than a proportionate basis.

Initial public offerings are traded in the over-the-counter market. The major stock exchanges all require listing companies to have a minimum number of round-lot shareholders and to satisfy a broad geographical shareholder distribution requirement. If management believes that exchange listing is a corporate goal, then the underwriting agreement should specify that after the offering, all such exchange requirements will have been satisfied.

Companies are concerned not only about the geographical distribution of their shareholders, but also about their characteristics as investors. Some companies prefer institutional investors who tend to trade infrequently but in block quantities. When a high percentage of shares is held institutionally, the active float in the secondary market diminishes. Issuers desiring an active secondary market will encourage the underwriter to emphasize sales to individuals and limit sales to institutional investors. Today's securities markets are dominated by institutions so that there are serious limitations to the underwriter's ability to restrict institutional sales. If the company persists, however, the underwriter can considerably increase the percentage of individual share ownership.

The final aspect of the underwriting/issuer relationship is probably the most critical - initial public offering price. The underwriter and company will explore the price-to-earnings ratios of comparable companies in similar industries, to try to establish a value that reflects the company's worth yet which will also be saleable to the public. Issuer and underwriter share a general concern - that the company realize value for its shares sold, and that the price of the shares perform well in the secondary market. An overpriced stock may create value initially for the company, but create a weak aftermarket with falling prices, negatively impacting the company, the underwriter, and the non-selling founding shareholders.

Because pricing depends upon exact stock market and economic conditions on the offering date, the actual offering price is not determined until the night before the offering. The underwriter frequently attempts to reduce the offering price to minimize risk that the underwriter can sell all of the securities. Lowering the price also increases the likelihood that the stock price will rise after the offering. Nothing is better for the underwriter than for the price of the stock to increase 5-15% in the aftermarket, thereby immediately benefiting the new investors. On the other hand, nothing is more painful for the company than to watch its stock rise 50% in the week following the offering and realize how much money was made by others and not the company. The company and its counsel should press for a fair price, but remember that the underwriter's business is selling securities, and their pricing decisions generally reflect a seasoned business judgment.

Preparation Period

Negotiating with the underwriter represents the external aspect of the offering process. Equally important are the internal changes prompted by the frequently traumatic transition from a private to a public company. Major corporate decisions for a public company may require shareholder approval from a diverse and independent group. Such approval involves compliance with the proxy requirements of the Exchange Act, including review by the Securities and Exchange Commission (SEC), rather than the casual shareholder and director approval common in a closely-held corporation. To minimize the inconvenience and attendant expense of obtaining shareholder approval after the public offering, the company and its counsel frequently use the pre-offering period to analyze existing policies and adopt all anticipated programs, agreements, or plans which require shareholder approval.

The "due diligence" obligations of the Securities Act[7] necessitate a thorough review by all underwriting participants to ascertain that the company has complied with all statutory and regulatory requirements affecting its business. Counsel frequently begins the review process by examining the company's corporate record book to ascertain whether all required meetings have been held and all transactions approved. Bank loans, leases, employment agreements, acquisitions, and relationships with insiders must be carefully scrutinized. This review frequently uncovers incomplete documents, undocumented transactions, or other "housekeeping" details which must be attended to. Depending on the transaction, counsel may sometimes feel like Hercules before the Augean stables.

Prior to going public, the company's Articles of Incorporation will usually be amended to increase the authorized number of shares. The company may diversify its capital stock by creating a class of preferred shares with indeterminate financial terms. This provision permits the Board of Directors to subsequently establish specific terms for such preferred shares without additional shareholder approval[8], thereby facilitating the use of such shares in future acquisitions.

As a public company, unwanted take-over bids[9] may be forthcoming. Common defensive measures to thwart such hostile attempts include amending the company's articles of incorporation to eliminate cumulative voting,[10] providing for staggering terms for election to the Board of Directors, or requiring supra-majority approval to remove directors or to amend articles of incorporation. It is easier to adopt such provisions before a public offering rather than in the midst of an unfriendly tender offer.

Ohio corporations can also take advantage of recent changes in the Ohio General Corporation Law and Ohio Securities law.[11] These changes regulate bids for large blocks of stock of a public company. Section 1701.831 requires a favorable shareholder vote (excluding certain "interested shares") before a "control share acquisition" may be implemented, unless a corporation's articles of incorporation or code of regulations specifically provide that this section does not apply. These statutory provisions elongate the acquisition period for an unwanted raider, and give the target the maximum time to thwart the attempt. Where the principal shareholders and the company contemplate selling substantial amounts of stock, they may want to amend the charter documents to explicitly reject the provisions of the statute. If the shareholders contemplate that control share acquisitions would only occur under unfriendly circumstances, then counsel should accept the benefit of the statutory protection.

Prior to becoming a public company, shareholders and management (usually the same individuals) are often informal with respect to compensation. As the sole owners of the business, distinctions between salaries, bonuses, dividends, and loans may have been blurred. The correct time to eliminate ambiguities is prior to the public offering. The company should consider written employment agreements for its key executives, with or without the now infamous "golden parachute" provisions. All loan relationships should be evidenced by appropriate instruments and security agreements if any.

Stock option plans may be adopted during this period which should be approved by shareholders. Such plans should provide that no option shares may be issued until registered with the SEC. Registration of option shares is usually accomplished by filing a Registration Statement on Form S-8 with the SEC approximately six months after the initial public offering. Counsel should consider the relative tax consequences arid merits of incentive stock option or non-qualified plans, and such sensitive issues as the availability of options to major shareholders, directors, or non-employee advisors to the company.

Finally, management should examine purchase, lease, or service transactions between the company and its shareholders, officers, and directors to determine if such relationships should be maintained following the public offering. If management concludes that such transactions are beneficial to the company, then written agreements should be entered into, sensitively reflecting the inherent conflict in such situations.

It is important to note the philosophical difference between federal and state securities regulations. The federal system is predicated upon the prophylactic effect of public disclosure. A registration statement fully disclosing conflicts, no matter how severe, will be acceptable to the SEC and the shares may be registered for sale thereunder. Most state securities divisions, by contrast, review offerings on their merits and consider fundamental fairness of transactions.[12] The "blue sky" review of insider relationships may result in a denial of the issuer's right to sell its securities in one or more states, which can seriously undermine marketing efforts. Where possible, the relationships should be terminated, or management should prepare itself to defend the propriety of the transactions. Appraisals or independent valuations of worth may assist this procedure.

There is no magic answer as to how to resolve any of the foregoing issues. After the company is public, changes must be examined with a critical eye to potential reactions from financial analysts, impact on share prices, and relationships with, and approval from, public shareholders. The value of a diligent pre-offering review process, however, is that while the company is private, changes may be effected after consultation with only a few people, all deeply involved with the company.

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[1] See, Farrell Going Public, VENTURE, April-May, 1982, p. 30.

[2] Going Public – The Initial Public Reporter, January 2, 1983.

[3] Going Public - The Initial Public Reporter, April 28, 1983.

[4] 15 U.S.C. Section 77a et seq.

[5] 15 U.S.C. Section 78a et seq.

[6] For an excellent discussion of the broad range of securities issues faced by company management after the initial public offering, See Schneider and Shargel, "Now that you are publicly owned ..." 36 Bus. Law. 1631 (1981).

[7] The investigation mechanics required to satisfy the "reasonable examination" standards of Section 11 of the Securities Act are explored in, Soderquist, "Due Diligence Examinations" 24 Prac. Law. 33 (1978). Also, see, Comment, The Expanding Liability of Securities Underwriters; From BarChris to Globus, 1969 Duke L. J. 1191.

[8] Ohio Rev. Code Section 1701.06(A)(12).

[9] A thorough analysis of the numerous methods of deterring unwanted takeovers is contained in Hochman and Folger, Deflecting Takeovers: Charter and By-Law Techniques, 34 Bus. Law. 537 (1979). See, also. Steinbrink, Management's Response to the Takeover Attempt, 28 Case W. Res. L. Rev. 882 (1978).

[10] Ohio corporations cannot eliminate the rights of shareholders to cumulative voting. Section 1701.55 of the Ohio Rev. Code provides that cumulative voting must be permitted if requested by any shareholder not less than 48 hours prior to the date of any meeting of shareholders.

[11] Effective as of November 18, 1982, Sections 1701 and 1701.48 Ohio Rev. Code were amended, and new sections 1701.831 and 1701.48 were added.

[12] See generally Long, State Securities Regulation - An Overview, 32 Okla. L. Rev. 541 (1979).