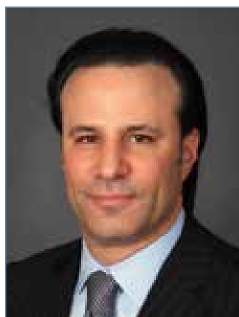
The Board's Role in Avoiding Common Post-financing Mistakes

By Adam J. Epstein



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Nearly one out of every two exchange-listed companies in the United States has a market capitalization lower than $300 million. For these micro-cap companies, frequent financings are a fact of life.

Given how important financings are to these companies, their officers and directors must be focused on the relevant matters at hand from the beginning of a financing to the end. The mistake often made, though, is that many officers and directors consider the signing of definitive deal documents to be the end of the financing, while in fact there are additional post-financing steps that can be critical to its success—for example, publicly announcing the financing and complying with material terms.

Announcing the Financing

Those people more familiar with governance at larger public companies would likely scratch their heads wondering why directors would need to be engaged in active dialogue with management about a press release that simply announces a financing. There are three reasons why micro-cap directors should consider being actively involved in management's public explanation of financings: 1) there are scores of micro-cap management teams with little experience in operating a public company and communicating with the Street; 2) the quality of advice from micro-cap investor relations firms is highly disparate; and 3) since many micro-cap companies are inactively traded, it takes a minimal amount of shareholder confusion to cause rapid share price erosion. The following are the most common mistakes that micro-cap directors should address with management:

1. **Audience.** Unlike larger public companies, many micro-cap companies have predominantly retail shareholder bases; that is, institutional investors may provide financing, but the majority of investors that buy and sell stock in the open market are often individuals. Despite the statistically significant retail shareholder base, micro-cap companies routinely craft press releases announcing complex financings for an audience they don't have. Press releases are often replete with sophisticated financial nomenclature and legalese, to such an extent that even mutual fund managers might give pause. Nothing good ever comes from speaking over the heads of shareholders: it builds distrust; it creates more work for companies in answering scores of investor inquiries; and uncertainty in the capital markets historically breeds a predictable result—selling. The key point here is for directors to remind officers about the importance of clearly communicating the terms of the financing to the company's core audience and to make sure that the message is appropriately crafted for that audience.

2. **Form 8-K vs. press release.** Unless directed otherwise by regulators or an exchange, public companies typically have the choice of disclosing a financing through a Form 8-K filing or a press release (or both). Since many micro-cap financings are highly dilutive to shareholders, companies sometimes opt to announce financings via Form 8-K instead of a press release. The thinking here is that a Form 8-K filing is less likely to garner attention than a press release—put bad news in a Form 8-K, and reserve press releases for better information. But investors understand the difference—it is uniformly understood in the investing community that when a company announces a financing via Form 8-K instead of a press release, the company knows it's not a great result for shareholders, and it's attempting the capital markets version of "hiding." While there are times when announcing a financing via Form 8-K is clearly appropriate, management would do well to consider issuing press releases for financings on a case-by-case basis,

dilution notwithstanding, so that the company can take ownership of the financing, clearly explain the terms, and move forward. The key point here is that announcing financings via Form 8-K is tantamount to deemphasizing material information. Investors are expressly cognizant of this, so micro-cap directors should assist management with determining whether that's ultimately in the shareholders' interest.

3. Lost opportunities. It's common in the micro-cap ecosystem for companies to substantially defer to counsel for drafting financing-related press releases. The results, predictably, are dry, one-dimensional excerpts of the legalese contained in the financing documents. This is a lost opportunity to communicate effectively with shareholders. More specifically, there are often "facts" that are just as important as the financial terms that shareholders might not focus on but for highlighting them. For example, perhaps the same investors that previously financed the company have expressed confidence in the company by investing again; perhaps the financing is less dilutive than recent peer financings; or perhaps some of the more onerous terms of a financing might be expunged if the company reaches certain milestones. The key point here is that micro-cap directors should make sure that management, together with the company's professional service providers, is seeking to include relevant material facts in financing press releases so as not to waste an opportunity to communicate effectively with shareholders.

Administering the Financing

It is a dramatically underappreciated fact of micro-cap life that many financings have austere penalties for companies that fail to strictly abide by the provisions set forth in the definitive deal documentation—penalties that under some circumstances can be business-ending. Consequently, micro-cap directors have no choice but to understand any and all penalties contained in financing documents, and they need to take steps to ensure that officers understand the penalties and are administratively prepared to abide by the financing's provisions. Here are a couple of examples that deserve boardroom attention.

1. Common stock PIPEs. Private investments in public equity (or PIPEs) are commonplace in the micro-cap ecosystem. In a typical PIPE, a company transacts an equity financing by privately selling unregistered common stock to a group of investors (versus a public offering), which is only eligible for resale on a stock exchange after the stock is subsequently registered by the company with the Securities and Exchange Commission (SEC). Most such financings have registration-rights agreements that require companies to file registration statements by a particular deadline, to respond to regulator requests within a certain period, and ultimately to have the registration statement declared effective by the SEC by a certain date. Especially for companies without meaningful experience in public company corporate finance, filing registration statements can be challenging, time-consuming exercises.

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Moreover, common stock PIPEs typically contain provisions that require companies to remove restrictive legends from stock certificates once the registration statement is declared effective. Unprepared companies can quickly run afoul of these provisions and begin to accumulate substantive penalties. The key point here for directors is that it's a good idea to have counsel summarize any material requirements placed on the company by financings immediately upon closing them, and also to clarify (with hypothetical examples) what situations could give rise to penalties.

2. Convertible PIPEs. For most micro-cap companies, there is no such thing as a simple convertible financing (i.e., financial instruments that are convertible under specific circumstances into unregistered common stock). Pricing periods, voluntary conversions, involuntary conversions, amortizations, and so on create a blizzard of company deliverables for typically overworked, understaffed finance departments. Micro-cap companies routinely fail to take the necessary steps to prepare for administering these complex financings, resulting in rampant penalties.

More specifically, directors need to ensure that after the close of a convertible financing, there is a series of internal process meetings at which management, financing staff, counsel, and the company's transfer agent (if necessary) run through mock pricing, conversion, and amortization scenarios so that not only does each constituency understand its role, but also all parties coalesce to produce deliverables within the time frames set forth in the financing documents. The key point here for directors is that the likelihood of incurring material penalties and liquidated damages after undertaking convertible financings can be high if proper preparations aren't made.

Eyes on the Ball

The moral of this story is that, convention notwithstanding, financings often aren't over even when the money is in the bank. When micro-cap officers and directors take their eyes off of the ball too soon after a financing, bad things routinely happen.