Noteworthy Legal Issues for Pre-IPO and Small-Cap Directors

Interview by Adam J. Epstein

Peter M. Astiz, partner and co-head of the Global Technology Sector Practice of DLA Piper in its Palo Alto, Calif., office, focuses on general counsel services for high-technology companies, private and public financing transactions, and mergers and acquisitions. He represents both issuers and underwriters in initial public offerings and follow-on offerings as well as convertible debt offerings under Rule 144A. Among his many IPOs, Astiz represented Salesforce.com in the first SaaS IPO, and the underwriters in connection with the Groupon IPO. He also represents buyers and sellers in public and private merger and acquisition transactions, and issuers and venture capitalists in venture capital and other private placement financings. *NACD Directorship* interviewed Astiz about the legal implications for directors of pre-IPO and small-cap companies arising out of various issues making news of late.

The JOBS Act and related IPO on-ramp provisions have brought a renewed focus on IPOs and their importance to the U.S. economy. That said, the decision by a private company board to undertake an IPO is complex, especially inasmuch as the lengthy, distracting and expensive process doesn't result in an offering for so many companies. What are the least understood fiduciary obligations associated with a board's IPO deliberations?

Even with an improved IPO market, a substantial percentage of the companies filing for IPOs in the last couple of years have not been able to successfully complete their transactions. The recently enacted JOBS Act will reduce certain of the costs and burdens for "emerging growth companies" pursuing IPOs. However, at least for the near term, there is no indication that it will result in increased investor demand, and therefore is not likely to increase the percentage of IPO filings that lead to a successful offering. Even for those companies that have completed their IPOs, many have been priced below original expectations, and post-IPO stock performance has been very mixed. Many, if not most, companies considering an IPO are balancing pursuing the IPO against an M&A exit. In assessing a potential M&A exit, boards need to factor in how achievable is the "IPO premium": Will the deal actually get done, and will it price at the level originally anticipated? Will the company be able to sustain the aftermarket trading price? In addition, boards considering an IPO must factor in the risks of a delayed or unsuccessful IPO in the company's financing plans. If the company will need the IPO proceeds to fund operations, it is critical to have an alternative financing plan. IPOs are expensive, and the distraction of the offering can adversely impact company performance. Companies with the need to obtain financing following a failed IPO attempt face substantial challenges, and boards need to balance the cost versus the benefits of arranging for additional financing as security prior to the IPO process. As in all matters, in making these decisions independent directors must focus on the interests of all stockholders, not just the desires of management or key investors, particularly if existing investors are likely the source of any needed financing.

The SEC recently has brought a number of actions arising out of the increasingly vibrant secondary market for shares of privately held companies. What legal issues should directors be aware of if shares in their company trade in these secondary markets?

There are two significant legal

Peter M. Astiz is partner and co-head of the Global Technology Sector Practice at DLA Piper.

issues for boards to focus on in connection with secondary sales. The first is that companies face a risk of claims based upon the information provided in secondary transactions, particularly if the sellers include any company insiders. Buyers may claim fraud based upon inaccurate or incomplete information. Sellers may also make claims if they sell at too low a price as a result of incomplete information from the company. Boards should be actively engaged in the process of determining what information the company provides (or allows to be provided) to third parties to minimize the risk of claims. The second issue relates to differential treatment of different stockholders. The board has a fiduciary duty to all stockholders and needs to be sensitive to taking actions that facilitate sales by some stockholders (particularly insiders) without providing the same opportunities to other stockholders. Separate from the legal issues, the board should be cognizant of the changing dynamics and shift in priorities that can happen when founders, key employees or major investors gain liquidity prior to a liquidity event for all stockholders.

Facebook's IPO has inspired extensive commentary with respect to the controlled-company exemptions implemented by various stock exchanges. What are some legal issues that independent directors on controlled-company boards should be particularly cognizant of?

"Controlled companies" are companies with respect to which more than 50 percent of the voting power is controlled by one person or a group. Traditionally, the controlled-company exceptions most commonly arose in connection with private equity-backed IPOs. However, many of the more recent high-profile venture-backed IPOs have included dual class voting structures, with founders retaining control as a result of super-voting shares. Exchange rules exempt controlled companies from the general requirements to have a majority of the board be independent, as well as the requirements for fully independent compensation and nominating committees. Independent directors need to be mindful that the exchange exemptions do not change the fundamental fiduciary duty of the directors to represent the interests of all stockholders, and that best practices should still include steps to facilitate the most effective participation of the independent directors, such as executive sessions without management and active engagement in the development of board agendas and board processes and procedures. Separate from the controlled-company issues, all boards considering an IPO should thoroughly review and consider the proposed corporate governance structure. For example, substantially all venture-backed IPO companies adopt structures that are in conflict with what are generally viewed as best corporate governance practices. These include staggered boards, lack of independent chair or lead independent director, plurality voting, and restrictions regarding calling stockholder meetings, board nominations and raising stockholder proposals.

Now that we're approaching the 10th anniversary of the Sarbanes-Oxley Act, have you witnessed material changes in board conduct, or have you mostly seen lip service in the small-cap environment?

As a result of the Sarbanes-Oxley Act, companies pursuing an IPO must now adopt a variety of specific policies and procedures that historically were not required. For the most part, these policies and procedures represent what otherwise might have been considered to be best practices. For those matters, with respect to which there are specific requirements, most boards seek to carefully comply with the requirements. In particular, the emphasis on board independence and audit committee qualifications has had an impact on the composition of boards. That said, there is substantial question as to whether the manner in which boards conduct their routine business has materially changed as a result of Sarbanes-Oxley and the related regulations. As with all matters, boards must focus on performing their duties consistent with the spirit of best corporate governance principles, and not by just checking off compliance with a list of specific requirements. D