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SWIGGART & AGIN, LLC

**Preparing your Company
to be Acquired or for an
Initial Public Offering**

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Presenter

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What is a Sale or IPO?

- **An Initial Public Offering is the**
 - Sale of ~20% of company stock to the public.
 - Underwriter scrutinizes the company as a single buyer would.
- **A Sale is the**
 - Transfer of all or most company stock or assets to a single buyer or buyer group.
 - Payment: Stock of Acquiror or cash, or both.

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Why Sell?

- **Reward Investors**
- **Succession Planning**
- **Fulfill an Exit Strategy**
- **Raise Growth Capital**



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Prerequisites to a Sale

- Good technology, effective employees, wide market acceptance, healthy revenues, and *also...*
- **Documentation of Key Corporate & Business Arrangements:**
 - Corporate books,
 - Financial records,
 - Contracts,
 - Ownership of intellectual property,
 - Grip on all liability situations.

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Due Diligence

- Defined:
- “[S]uch a measure of prudence, activity, or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent man under the particular circumstances; not measured by any absolute standard, but depending on the relative facts of the special case.”
Perry v. Cedar Falls, 87 Iowa 315, 54 N.W. 225

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Due Diligence Process

- Non-Disclosure Agreement
 - Disclaim representation/warranties re diligence information
- Letter of Intent with buyer (incl. breakup fee) (Sale), or
 - Nonbinding & No duty to negotiate
 - Structure of Deal
 - Asset, Stock Purchase or Merger
 - Tax Consequences for each structure
- Underwriting Agreement (IPO) leads to ...

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Due Diligence Process

- Due Diligence Requests from:
 - Accountants
 - (goodwill impairment)
 - Underwriters & their attorneys (IPO)
 - Buyer’s attorneys (Purchase)
 - Seller’s attorneys (don’t overlook)

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Due Diligence Process

- Weaknesses sought:
 - Documentation gaps
 - Key contracts
 - Royalty obligations
 - Ownership of IP
 - Lease obligations
 - Claims or lawsuits
 - Pension Obligations

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Surviving Due Diligence

- Corporate Structure
 - You kept it simple from the start.
 - Where there were multiple classes of preferred stock, etc. your company used down rounds to recapitalize them.
 - You tracked all stock options & warrants carefully.
 - You terminated underwater options if possible.

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Surviving Due Diligence

- Branch and Subsidiary Filings
 - Qualified in states where doing business.
 - Withdrew where inactive.
- Secured Financings
 - Obtained and filed termination statements promptly.

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Surviving Due Diligence

- Documented all contracts with
 - Customers,
 - Distributors,
 - Joint Venturers,
 - Developers,
 - Vendors, and
 - Landlords

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Surviving Due Diligence

- Intellectual Property
 - Exercised Trade Secret Vigilance
 - Employment Agreements
 - Contractor Agreements
 - NDA's with customers, vendors & joint venturers
 - Trademarks & Service Marks
 - Registered key marks
 - Displayed "TM" next to unregistered marks
 - Registered in Foreign jurisdictions
 - Defended your marks vigorously

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Surviving Due Diligence

- Intellectual Property cont'd
 - Domain Names
 - Registered product names, not just company name.
 - Policed cybersquatters.
 - Patents
 - Filed patents for key inventions within one year of public disclosure.
 - Involved engineers closely in the claims.
 - Copyrighted software
 - Negotiated favorable licenses
 - Paid special attention to renewal & termination clauses.

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Surviving Due Diligence

- Existing Claims or Lawsuits
 - Settle them promptly (if at all possible).
 - Secured insurance coverage for defense costs or, at worst.
 - When all else failed, you obtained an opinion from company litigation attorneys.
 - (They're always glad to do it!)

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Surviving Due Diligence

- **Considerations for IPO/Corporate Governance Reform**
 - U.S. Congress -- *Sarbanes Oxley Act of 2002*
 - Securities Exchange Commission (SEC)
 - Public Company Accounting Oversight Board (PCAOB)
 - Financial Accounting Standards Board (FASB)
 - NYSE, NASDAQ, etc.
 - Delaware Supreme Court -- *In re Walt Disney Co.*, 731 A .2d 342 (2003)
- *All have a say in putting things right*

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Surviving Due Diligence

- IPO/Corporate Governance Reform, cont'd
 - Financial Statement Requirements
 - 3 years' Audited Income Statement
 - 2 years' Balance Sheet
 - Selecting Audit Firm
 - Industry and technical expertise
 - “Big Four” -- yes or no?
 - Proposed SEC rules
 - Prohibition of Non-Audit Services
 - Rotation every five years
 - Hiring Restrictions -- audit firm not independent if a company's CEO, CFO or controller is former employee of the audit firm.

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Surviving Due Diligence

- IPO/Corporate Governance Reform, cont'd
 - Prohibition on Personal Loans
 - Stockholder Approval for Stock Plans
 - Proposed NYSE rule may require direct s/h consent:
Vote your plan in *before* going public
 - Board of Directors and Board Committees
 - Independent Directors (Proposed rules)
 - **Majority of Board**
 - **All of compensation committee**
 - **All of director nominating committee**
 - **All of Audit committee**
 - Keep careful minutes to avoid appearance of self-dealing
 - (courts will now more likely reverse presumption of independence)

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Surviving Due Diligence

- IPO/Corporate Governance Reform, cont'd
 - Audit Committees
 - Must have at least one “Financial Expert”
 - SEC defines as: Experience as an accountant or as CFO or controller of a public company
 - Must keep detailed minutes
 - Must adopt and implement procedures for receiving and handling complaints regarding accounting matters, including
 - anonymous submission of employee concerns

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Surviving Due Diligence

- IPO/Corporate Governance Reform, cont'd
- Board Minutes
 - No defined standard. However, now, gaps are more likely to be construed to indicate a failure of fiduciary duty. Therefore, more is better, if done carefully.
 - **“The house counsel is often the best person to keep minutes of the meetings of management and the board of directors.... Well-documented minutes, including the steps taken by the members of the board to inform themselves about the potential transaction, will help to create a record of the deliberation process to be used should lawsuits arise questioning the directors’ exercise of their fiduciary duties.” Goldblatt & Cefalli, *Does M&A Mean Manage & Adjust?*, Business Law Today, 12:16 (July/August 2003).**

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Surviving Due Diligence

- Considerations for IPO, cont'd
 - Understand critical accounting policies
 - Revenue Recognition
 - Goodwill
 - Debt vs. Equity in the balance sheet
 - Use of Proceeds -- problems re SEC asset disclosure requirements
 - Deferred Taxes

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Surviving Due Diligence

- **Accounting re Sale or Acquisition**
 - Equity compensation considerations
 - FASB 148 - stock options expense
 - Audit or not to audit? It is a big question
 - Rule 3-05 of Reg. S-X for public company acquirer

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Surviving Due Diligence

- Accounting re Sale or Acquisition, cont'd
 - Purchase price methodology
 - What is the right cost formula?
 - Multiple (what multiple?) of:
 - EBITDA?
 - Free Cash Flow?
 - Revenues?
 - Identify owners' compensation and other nonrecurring expenses to add back into P&L
 - Know your numbers & develop key indicators.

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Surviving Due Diligence

- Accounting re Sale or Acquisition, cont'd
 - Understand revenue recognition criteria
 - Try to avoid extended projections
 - Perpetual accountability
 - Directly through an earnout or indirectly through Management expectations.

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Surviving Due Diligence

- Accounting re Sale or Acquisition cont'd
 - Definitive Agreement
 - Certainty of Closing
 - Signing Date / Closing Date transaction
 - Disparate Signing Date / Closing Date transaction
 - Negotiate hard on reps and warranties
 - Basket to cover unrecorded liabilities
 - Limit survivability
 - Knowledge qualifiers
 - Materiality qualifiers
 - Scope of indemnity

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The object of the Game

- **A CFO's Concerns**

- Is your house in order? Do you have:

- A clean and reconciled balance sheet,
 - 401(k) plan requirements met,
 - Benefit plan documents,
 - Customer contracts in order,
 - Tax filings up to date,
 - Debt agreements complete,
 - Noncompete agreements in place?

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The object of the Game

- Head off problems early.
- Document & protect property.
- Avoid costly last minute scrambles by M&A accountants and attorneys.
- Avoid overpaying to settle lawsuits.
- Avoid delaying your sale or IPO.
- Avoid preventing your sale or IPO.

• **Preparing your Company to be Acquired or for an Initial Public Offering**

- A Never-Ending Process...
- Vigilance
+ Documentation
= A more likely
(and more profitable) Sale

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