CHAPTER 1

Why Go Public?

Before deciding how to go public, a company must decide *whether* to go public. As I often tell my clients, if you can benefit from being public, and can bear the costs of becoming so, you should seriously consider it, regardless of your company's stage of development.

Advantages of Being Public

In general, there are five major advantages to being public: easier access to capital, greater liquidity, ability to grow through acquisitions or strategic partnerships, ability to use stock options to attract and retain senior executives, and increased shareholder confidence in management.

Access to Capital

It is easier for public companies to raise money than it is for private companies. Regardless of the merits of any specific private company, public companies have five characteristics that make them more attractive to investors than private companies.

First, by law most public companies must disclose their financial results (good or bad) and other material developments to the SEC and the public regularly and in great detail. Disclosure requirements build investor confidence because it is harder for a public company to hide problems than it is for a private one to do so.

The second major benefit to investors is that there are more opportunities for a public company to create liquidity for their investment. This increases a public company's access to capital. Those who invest in private companies always worry about the "exit strategy" and look for companies that wish to be sold or to go public eventually. If a company is already public, it significantly enhances the investor's ability to exit.

The fact that one can trade a public company's stock creates liquidity because an investor can sell the stock in the public markets. Typically, public company investors obtain the ability to sell their shares publicly within three to five months after their investment. In an IPO, of course, investors usually can sell their shares immediately. At worst, they must wait six months after investing in a company (if it has not been a shell company for the past six months), or at most one year following most reverse mergers or if a company is not SEC reporting. This is significantly faster than the three to five years, or more, that a venture capitalist generally expects to wait for an investment to pay off.

The third major benefit to a company that completes a financing as a public company rather than a private one is that it is not bound by the restrictions and covenants that private equity or venture capital investors customarily require. Venture capitalists view themselves as management's partners, and require veto power on many different aspects of decision making in a company.

In general, once a company is public, investors stop demanding these powers. Thus, even if a private company is able to attract private equity investors, it still may want to consider going public, because IPO and private investment in public equity (PIPE) investors or others who finance public companies generally put fewer restrictions on the company's activities, decision making, and so on.

The fourth advantage of seeking financing after going public is valuation. The markets judge shares in a public company to be worth roughly twice as much as shares of similarly situated private companies. When a financing takes place as part of the going-public event itself, the value of the company before the investment (known as the "pre-money value") is almost always materially higher than the value a private equity investor would place on the same company. This makes perfect sense when one considers that investors place a premium on liquidity.

Even though it is easier for public companies to raise money than private ones, this is not a sufficient reason for going public, as many companies who go public solely to obtain one round of financing learn to their dismay. Companies that follow this path frequently regret the decision; many in fact end up going private again. Companies that make the most out of being public also make use of some or all of the following benefits.

Liquidity

Liquidity gives all investors the opportunity to enhance their exit strategy by being able to turn their investments into cash. New investors are not the only ones who want to be able to exit. Sometimes one of the main reasons for bringing a private company public is so company founders, former investors, and senior executives holding stock positions can take money out of the business without selling the company outright or losing practical control. There are as many reasons owners might want cash as there are owners.

The challenge in this situation is to avoid a great wave of share sales by company insiders. There are two reasons for this. First, if too many insiders sell out, those who built the company in the past will lose the incentives that would encourage them to continue building the company in the future. Second, Wall Street notices when insiders are selling out. Generally, a wave of insider sales discourages outsiders from investing in a company. Therefore, a company should consult its advisors and design an appropriate, rewarding, but measured selling plan.

For example, a former client took his company public through a reverse merger. Shortly thereafter, the company founder actively began to sell his stock. He sold nearly $5 million worth of stock before the price began to drop precipitously. This caused prospective investors to lose interest in the company. Today the company is out of business and in bankruptcy. This is also the type of situation that leads to SEC investigations of investors' activities.

Another client took a more circumspect approach, with great success. He restricted when, in what amount, and how often insiders could sell their shares. He meticulously consulted with legal counsel before each such insider sale to determine whether there was a risk of insider trading. Today, the company is growing, its stock price is rising steadily, and the founders have been able to sell enough stock, slowly and deliberately, to begin to realize their exit strategies.

Growth Through Acquisitions or Strategic Partnerships

The second most popular reason for going public (after the need to raise capital) is to pursue a strategy of growth through acquisition, joint venture, or strategic partnership. As noted earlier, investors are more willing to provide financing to a public company, even when the purpose of the financing is to fund acquisitions. In addition, a public company often can use stock as currency or "scrip" in the package of consideration to be provided to a company it is acquiring or collaborating with. Indeed, sometimes the only consideration given is stock.

In general, the value of the stock provided exceeds the agreed-upon value of the transaction because there is some risk the stock will drop in value down the road. In other words, if a company is to be acquired for $20 million, including $10 million in cash, a seller may demand the balance to be equal to $12 million or $13 million in stock to offset the risk of stock price volatility. Public buyers generally are willing to be flexible in this regard, as purchasing with stock circumvents the need to raise cash for the purchase. It also allows a company to retain its cash for other purposes such as reserves or capital investments.

Stock Options for Executives

Many companies have difficulty attracting talented senior management. Public companies have an advantage over private ones in the competition for top people because they can offer stock options and other equity incentives—the "brass ring" of affiliation with a public company—as part of the compensation package. Frequently, compensation for top executives at public companies seems exorbitantly high. However, the fine print often reveals that the vast bulk of a multimillion-dollar compensation package comes not in the form of wages, but in the form of stock or stock options. (Stock options aren't just for high-ranking executives. Many stories have been written about the millionaire secretaries at Microsoft, Facebook, eBay, Google, and other companies.)

Private companies also have the option of setting up stock option plans; however, the problem, as with all investments involving private companies, is liquidity. Private company executives know that they cannot make money from owning stock unless there is some form of liquidity event. The company must go public, be sold, or initiate a major dividend distribution to turn shares into cash. Stock options in a public company are much more versatile and, therefore, more valuable.

Options are attractive to those who lead public companies because they align management's incentives with company performance as judged by the market. Option holders are highly motivated to build the company's success so that its stock price will go up. The vesting process, whereby options become available based on an executive's time with the company, encourages a long-term commitment. I know many senior executives who stay with a company longer than planned simply to ensure that their options vest.

Confidence in Management

Because of SEC disclosure requirements, shareholders of public companies feel more confident that the actions of management and the operation of the company will be transparent. The SEC requires reporting companies to reveal financial results regularly (providing explanations of period-to-period changes), including executive compensation, related-party transactions, material contracts, liquidity, capital resources, and the like. Public companies create this stream of information as required by SEC rules, and the result is to help shareholders feel knowledgeable about the company's operations and challenges. The scaled disclosure permitted by some companies after completing a Reg A+ IPO, as we will discuss, does not materially reduce the quality or quantity of the information available to investors.

On the other hand, state laws generally limit the type and quantity of information that a shareholder of a private company may obtain. Rarely can a shareholder legally obtain a financial statement and a list of shareholders more than once a year. Some states require a shareholder to show cause or even bring a court proceeding before obtaining this or other information. Investors in private companies typically negotiate broader and more frequent information delivery, but still find extracting pertinent information to be a constant challenge.

That being said, it must be remembered that even public company filings can be misleading or fraudulent. The lessons of Enron, WorldCom, and others are not terribly distant and will linger. Nonetheless, private companies still have greater incentives to play games than do public ones. After all, the public company that plays fast and loose with disclosure requirements faces a greater risk of SEC investigation, criminal prosecution, and class action lawsuits.

It is not unusual for a senior executive of a public company to ask my firm to figure out how *not* to disclose something, which is almost always something bad. Even when disclosure is not mandatory, when the decision is on or even near the borderline, we usually take the view that disclosure is recommended. (We don't recommend it in every case. For example, the departure of a CEO's longtime personal assistant generally would not need to be disclosed. However, the departure of a director certainly would.)

Disadvantages of Being Public

There are five well-recognized disadvantages of being public: pressure to please Wall Street by emphasizing short-term results; mandatory public disclosure of company information, which makes "warts" hard to hide; vulnerability to fraud (even after Sarbanes-Oxley); higher annual expenses, because of the costs of fulfilling SEC reporting and auditing requirements; and vulnerability to lawsuits.

Emphasis on Short-Term Results

If a public company is lucky enough to have its stock covered by Wall Street analysts, the pressure to please "the Street" is intense and constant. Every quarter, the question on analysts' minds is whether the company will meet or beat expectations in the market. There is a healthy aspect to this because management must keep its eye on stated goals. The negative, of course, is that short-term results become more important than the long-term goals every company must pursue in order to build shareholder value.

A public company must concentrate both on making wise decisions and on how those decisions will be perceived by analysts. This can cause problems. Say a company with a strong cash position decides to spend a portion on long-term capital expenditures. Some Wall Streeters will see the long-term benefit—but some will simply see the erosion of cash reserves. Another example: If the underwriters in an initial public offering (IPO) did not insist that the company shed an early-stage or R&D opportunity and that opportunity continues to drain cash, Wall Street may not respond kindly. Additionally, investments in systems, real estate, or overhead in anticipation of future business may be negatively received.

Conflicts also arise when companies "do the right thing." When I ran my own law firms, I made financial decisions based on my business philosophy of doing right by my vendors, my clients, and my staff. This may mean, for example, keeping problem employees on if I feel they are working diligently to correct their deficiencies. It may mean a larger raise for an employee who is going through tough times, or experiencing unusual personal circumstances. Or it may mean cutting a client's fee, even when he does not request it, if I feel that we may have spent too much time on something. If my firm were public, I would feel more pressure to base my decisions on the smartest financial strategy, regardless of whether I was doing the right thing.

Some recently have proposed changing the quarterly reporting standard for U.S. public companies. The leader of one of the most profitable corporate law firms in the United States suggested several years ago that reporting twice a year would allow companies to think and plan on a more strategic and long-term basis. Former Vice President Al Gore has expressed similar sentiments. In addition, the European Union eliminated mandatory quarterly reporting for listed companies in 2013.

Quarterly reporting was not always the rule in the United States. Through the 1950s the SEC required only annual reports. They then went to twice a year. It was not until 1970 that quarterly reporting was mandated. As we will see, under the new Regulation A+ rules, a post-IPO company trading its stock in the over-the-counter markets can choose a "light" reporting option where filings are made twice a year instead of quarterly.

Public Disclosure

Earlier I described some of the advantages of the public disclosure of financial results, executive compensation, and the like. However, public disclosure is not always beneficial. All of a company's significant problems have to be revealed without delay. If its financial statements are being restated, or the company loses a major customer, or an executive has strong personal or family ties to a major vendor, or a board member resigns, the public will find out immediately.

Disclosure requirements also make it more difficult to keep important information away from competitors. I had a public client, since sold, whose business primarily involved obtaining military contracts. SEC rules require that major new contracts must be filed and disclosed. Unfortunately, one contract included a copy of the company's original bid, which was very specific and detailed regarding pricing and other terms.

The company challenged the filing requirements on the grounds that the original bid was confidential. Unfortunately, the SEC ruled that the contract must be disclosed, confidential bid and all—and the company's competitors were easily able to obtain this information on the SEC's website. Granted, the information was also obtainable with a Freedom of Information Act (FOIA) request (which was the reason the SEC deemed it not confidential). However, the process of obtaining information through FOIA is more cumbersome, and our client's competitors generally do not seek information in that manner.

The other side of public disclosure is that good news travels fast. When positive things are happening at a company, press releases and SEC filings help promote the company's success.

Fraud and Greed (Even After Sarbanes-Oxley)

Congress passed the sweeping Sarbanes-Oxley Act of 2002 (SOX) in reaction to the scandals at Enron, WorldCom, and other corporations. SOX instituted the most wide-ranging changes in securities laws since 1934.

Yet fraud and greed are still alive and well in corporate America. In some ways, public companies have more incentives to engage in deceptive practices than private companies do. This is because, as we described earlier, public companies are under so much pressure to meet or exceed Wall Street's expectations for their performance. Here are some of the tricks companies still use.

Unscrupulous management may engage in "Enronomics," which wordspy.com defined as "a fiscal policy or business strategy that relies on dubious accounting practices, overly optimistic economic forecasts, and unsustainably high levels of spending."

Then there is the euphemistic term, *earnings management*, which works like this: A product has been ordered and produced and is sitting on the shipping dock of the company-owned warehouse. On March 31, a customer informs the company that a truck is on the way to pick up the product within a couple of days. Is this a sale under accrual-based accounting rules on March 31? Absolutely not. A sale does not occur until the customer's truck arrives and picks up the product; however, some companies will record this as a sale anyway. That's earnings management: improving sales in the current quarter. Earnings management is a risky business. I had at least one public client whose earnings management, in the form of questionable inventory auditing techniques, caused it ultimately to lose its key lender and therefore its nearly $100 million business, leading to bankruptcy.

Companies also "manage" expenses. In this scenario, a bill arrives on March 31 for work done by a consultant. The CEO places the bill in his bottom drawer until the next day. Is this an expense on an accrual basis? Absolutely. Do some companies pretend not to incur this expense until the next day? Absolutely. This, too, is earnings management, because it reduces expenses in the current quarter.

Other tricks include complex off-balance-sheet transactions and multitiered corporate structures designed to hide underperforming assets or the involvement of a questionable player. In the late 2000s, as we will discuss, several dozen Chinese companies that had gone public in the United States through reverse mergers were accused of fraud and other securities law violations. Alleged tricks included bribing local bank branch employees to create phony bank statements and filing different financial statements with the SEC than those filed with the Chinese tax authorities.

It's Expensive!

A company that is considering going public needs to prepare for significant additional costs—both hard and soft—in connection with this change in status. Even the smallest private company could see annual expenses rise anywhere from $500,000 to $1 million when it goes public. For some companies, these additional expenses are the difference between positive and negative net income.

Additional costs include:

- Retaining attorneys to deal with the SEC
- Instituting internal financial controls that comply with SOX Section 404
- Hiring auditors to perform the annual audit and review each quarterly financial statement
- Adding additional company staff, in particular finance and shareholder relations staff, to deal with additional requirements
- Engaging a public relations and investor relations firm
- Paying travel and entertainment costs in connection with Wall Street activities

As we will see, one of the goals of the new Reg A+ rules is to help smaller companies reduce these offering and compliance costs. Between speedier SEC review of the IPO disclosure and the light reporting option following the IPO, companies can access public capital markets in a more cost-efficient manner. Some Reg A issuers, as we will see in Reg A Tier 1 offerings, can choose to be non-reporting companies even while their stock is able to trade.

Public Companies Attract Lawsuits

Twitter, Google, Instagram, Wells Fargo, PayPal, Hyundai, and Halliburton are just some of the companies that settled class action lawsuits in 2017. Not all were securities related, but there is no question that public companies face a greater risk of lawsuits, in particular from shareholders and in particular when a stock price takes a dive.

In 2016, according to NERA Economic Consulting, 300 securities class action lawsuits were filed, a one-third increase over the prior year. The average settlement: $72 million. A majority of the cases were against finance industry companies. About a quarter of the filings were related to alleged misdeeds connected to merger transactions.

The law firms that bring these cases on behalf of plaintiffs generally do so on a contingency basis and seek to earn millions. In some of these law firms, attorneys take turns sitting in front of a Bloomberg stock quote machine, watching to see if any particular stock takes a precipitous drop. When that occurs, the firm files a lawsuit, even if there are no facts whatsoever to suggest any wrongdoing. In many of these cases, companies settle quickly to avoid the negative publicity and the costs of defending even a frivolous suit.

In the United States, the threat of such a case is enough to send a stock price reeling. Most of the time, such cases eventually are dropped. Occasionally one is successful, and the lawyers get to defend the purported "rights of shareholders." I have received several notices that I was part of various classes in these cases. When, for example, a major alleged case of overbilling involving my cell phone provider reached settlement, each of us received a $10 phone card as our settlement. The lawyers received a $2.5 million fee.

Unfortunately, most cases are no more than legalized extortion. It is no surprise that the partners of one major plaintiff's firm became subjects of a criminal investigation, and the firm and several of its partners were indicted for alleged illegal payments to so-called lead plaintiffs in dozens of cases in the late 2000s.

A class action bill signed into law in early 2005 has helped reduce the number of truly egregious cases. In the meantime, however, there is no question that private companies considering going public sometimes choose not to do so primarily because of the concern over potential litigation.

Weighing the Pros and Cons

Each company must evaluate the pros and cons in light of its specific circumstances. Let's look at how one potential client did the math. This company, which is in the industrial equipment business, had generated about $25 million in revenues annually for each of the past five years. It expected to stay at this revenue level for the foreseeable future. From this revenue, the company derived earnings of about $2 million, all of which went to the founder, who was enjoying his success and working hard. The company wished to purchase a large warehouse as well as a significant piece of equipment. However, the conservative elderly founder abhorred debt and did not want to make the purchases with a mortgage or equipment financing.

His CFO suggested he meet with a hedge fund investor, who seemed willing to provide $15 million in equity financing for the purchases, if the company was willing to go public. The investor would provide everything necessary to get the job done—what amounted to a turnkey solution. The result would be a much stronger balance sheet, the elimination of certain warehousing and other outsourcing costs, no debt, and a fair equity position for the investor. It sounded logical.

I advised the potential client that he should think very seriously before going forward with the transaction, and ultimately the client decided not to. On one hand, going public would neatly provide the capital he wanted to pursue his business goals. On the other, raising this single round of capital was his only reason for going public. He did not want to make acquisitions, did not need stock options, and had no plans for future financings. Critically, he had no plans to pursue a growth strategy—something investors practically demand from public companies.

If he went ahead, he would incur the extra costs of being public, possibly eliminating a meaningful portion of the company's earnings (offset only in part by cost savings from the new warehouse and equipment). In addition, he would expose his company to the risks of lawsuits and scrutiny of quarterly results, and the burden of hiring additional financial staff. In sum, after this one round of financing, the company would see no other benefit from being public but would bear all of its costs and burdens.

Ultimately, the company found a private investor, who did not require the company to go public, to put up money to buy the building and equipment. The structure of the transaction allowed the company to buy out the investor at a future date. This occurred five years later, providing a healthy return to the investor and giving the company the continued benefit of using the assets it had acquired.

And so . . .

Going public is not for every business. At least a third of the companies that come to me and are ready to go public ultimately realize it is not in their best long-term interest. The manager for a recently deceased mega–rock star had come to me a few years ago with a plan to take a company public that had the star's financial backing and was involved in the Internet space.

When I told the manager that the star's 12% ownership in the company would have to be disclosed, he called me the next day and said that the star had abandoned the going-public plan. These disclosure issues often become the reason companies choose to remain private.

Going public can be, however, a valuable and lucrative path to growth for many emerging companies. As we will cover, recent legislation and SEC rulemakings have expanded the number of arrows in the quiver of companies seeking to grow and raise capital by going public.

Some companies choose the traditional initial public offering (IPO) approach, and many guides and texts can help them through that process. As indicated in the introduction, we are here to cover a very exciting new tool to complete a streamlined, cost-efficient, and speedy IPO through Regulation A+, as well as a number of other alternatives to traditional IPOs such as reverse mergers and self-filings. Let's get started!