

Weighing exit strategies

Both initial public offerings and acquisitions have their advantages. **Interviewed by Leslie Stevens-Huffman**

Sarbanes-Oxley (SOX) compliance rigors have affected the exit strategy landscape for CEOs and investors of privately funded and venture-backed companies. While the initial public offering (IPO) is still the outcome desired by many who toil to build a company, an acquisition may well be the exit event of choice, given the current compliance requirements and IPO climate.

During the boom era in the late '90s, some venture-funded technology companies went public without posting significant sales dollars to their ledgers. Today, companies must generally post above-average performance results or have a very compelling story to garner interest from underwriters.

"If your company is doing reasonably well but not great, then chances are, as a CEO, you should think about how ready you are for an acquisition, because it's more likely an acquisition will be your exit strategy," says Paul Johnson, partner with Procopio, Cory, Hargreaves & Savitch LLP.

Smart Business spoke with Johnson about both exit strategies and what CEOs should consider when evaluating their options and preparing for the event.

What are the IPO advantages and disadvantages that CEOs should consider?

During the IPO, there's the chance that the stock held by the executive will increase in value, and holding the shares over time creates a residual incentive that engenders both a sense of accomplishment and a financial reward for the CEO. This can be especially gratifying for founders who have nurtured the company from conception. However, another consideration is that regulations usually only permit executives to sell their stock over the course of time, and there's no guarantee that the shares will appreciate. There's greater access to public equity markets after an IPO, so companies that require additional funding to reach the next level of development may find more readily available financial resources after going public.

What are the acquisition advantages and disadvantages?

Unlike the IPO, where executives may usually only sell their stock over time, depending upon how it's structured, an



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acquisition event can offer immediate cash gratification for investors and executives. Also because the executive's entire stock position is usually sold at the time of the event, without a new option or a stock grant from the acquiring company, there's no future upside or downside. While taking stock in the new entity rather than cash is sometimes an option, and doing so preserves some of the upside potential for the executive, the former company generally becomes a smaller part of a larger whole. Accepting the acquiring company's stock is a change in the risk proposition for executives since it's likely that the acquiring company will be run by others.

Are there other advantages driving the acquisition exit trend?

Perhaps one of the main attractions to the sale event is that, under most circumstances, the selling executive will not have to directly face the relatively new rigors of public company reporting in the post-SOX era. Examples of the burdens of being a public company include the pre-SOX obligations of filing 10-Qs every quarter and 10-Ks every year, preparing and filing annual proxy statements and filing 8-Ks. Sarbanes-Oxley has added to this list CEO and CFO certification of 10-Qs and 10-Ks, which comes with potential criminal liability for misstatements, a significantly accelerated time frame for 8-K filing, an expanded list

of 8-K-triggering events as well as SOX 404 attestation by auditors and management as to the company's internal controls. Few entrepreneurs really want to deal with all of the administrative headaches that public company executives must face.

What else should be considered when choosing between an acquisition and an IPO?

Certainly both processes are long and arduous, and the due diligence process is more thorough than many imagine, so executives should get professional advice and prepare for the event by cleaning up any intellectual property and stock ownership issues. Executives should also consider the tax consequences resulting from each event. Because an acquisition for cash is a liquidity event, it usually results in immediate tax consequences, whereas the IPO itself does not have tax consequences on the stockholder until he or she sells.

Should CEOs consider their future goals when selecting an exit strategy?

An important consideration in choosing an exit strategy is the CEO's future plans. In theory, founders and executives who choose to stay with the company should have more control following an IPO. Although they still must report to a board and please public shareholders every quarter, any retained executives won't have to report up through an additional layer of management, which becomes the most likely scenario if the company is acquired.

For certain execs, becoming part of a larger organization offers advantages. If they want to continue to be involved with the organization because they believe that it can truly benefit from being acquired, this is often an option. But, the acquisition will change their focus and their ability to control the outcome. Knowing yourself and your goals as well as contemplating the notion of reporting to others are important considerations when evaluating your options. I've observed that many entrepreneurs start another venture after they've cashed out. Launching a new company just seems to be in their blood, but dealing with SOX compliance isn't very appealing.

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