Sprucing for the Sale

Planning for a corporate liquidity event can turn a board member's oak-paneled world upside down.

By Elizabeth Woyke

IN 1998, KETAN KOTHARI LOOKED AROUND at his neighbors in Silicon Valley and decided that it was an excellent time to dive into the booming IPO market by taking his education technology company, Intelligent Peripheral Devices (IPD), public. Six years earlier, he had launched IPD in the second bedroom of his apartment. His initial meetings with investment bankers, however, yielded a stern mandate: Nearly everything in the company needed tweaking, from the composition of its board to its complicated name.

At the time, IPD's board was a casual coalition of its three 30-something founders—Kothari, his brother, Manish, and his friend, Joe Barrus, who had worked with Kothari at Apple—and their fathers, who had provided the initial seed money for the venture. The bankers stressed the importance of adding seasoned directors with experience in negotiating IPOs and running public companies.

As the markets for public offerings and mergers and acquisitions show intermittent signs of life, those who serve on the boards of emerging growth companies should be prepared for change. A liquidity event can alter the board's needs, even when it is a formal board with decades of collective business savvy. Directors may find their positions at stake as founders prepare their companies for public scrutiny. The board itself is an important selling point, and new stakeholders will want to see an assemblage of individuals whose skills and affiliations complement each other.

It would take another six years for Kothari to reach his liquidity event. He had assumed—by his own admission, naively—that an IPO would boost his company from a $25 million business into a $100 million market-beater, based on the management skills he and the other cofounders had accrued, along with the product he had invented: a two-pound computer companion called the AlphaSmart, designed for use in classrooms. To prepare, he heeded his bankers' advice and began taking steps to make his company ready for prime time. Kothari's father and Barrus' father dropped off the highly informal board without any ill feelings, but Kothari soon found that the restructuring of the board was by no means the end of the changes he had to implement.

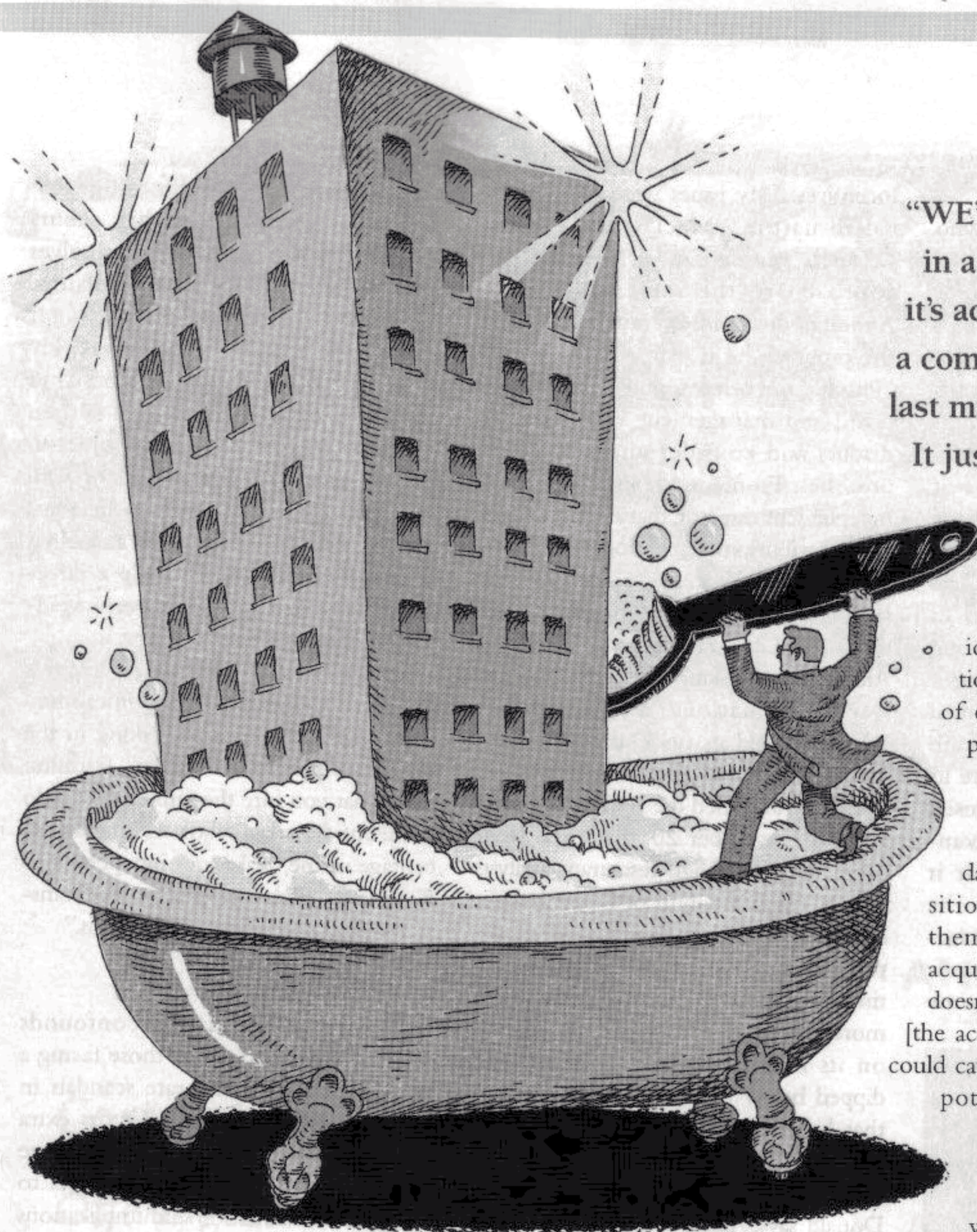
The real transition began with an infusion of late-stage venture financing and expertise from the private equity firm Summit Partners. "We were hoping they would bring expertise in all the stuff we'd been hearing we were deficient in," Kothari says. A $20 million influx of cash from Summit enabled the founders to postpone the IPO while they buttressed the company. Aided by the new investors, IPD made a number of strategic changes: It adopted the catchier name AlphaSmart, recruited a new CFO, cleaned up accounts by streamlining databases and diversified the board by adding ex-CEOs from other technology companies.

A few years later, the company restructured its board again to better comply with Sarbanes-Oxley rules for independent directors. Barrus and one of two Summit representatives dropped off to make room for another Silicon Valley CEO and a well-known educational consultant. By then, however, external forces were conspiring against them. The dot-com bust and 9/11 thwarted AlphaSmart's plans to go public in 2001, but the company continued to expand and diversify until it finally took the big leap in February 2004. Kothari says that the six years of preparatory work made for a smooth metamorphosis into a public company. "We had been operating like we were already public for quite a few quarters, so the heart-wrenching changes happened way before the actual public offering," he explains.

THE LONG ROAD

Such long-term planning is crucial. Hal Shear, president of the consulting firm Board Assets, has led director education seminars in conjunction with the National Association of Corporate Directors (NACD) for more than 20 years. He advises directors approaching an IPO or M&A event to begin planning well in advance and to build up corporate infrastructure. "Research shows that merely having good corporate governance doesn't make for a smooth liquidity exit," Shear says. "But the companies

TOP VIEW | Board members of emerging growth companies should prepare for a high-profile liquidity event as far in advance as possible. Such planning requires putting governance principals in place, scrutinizing valuation and compensation plans and making certain the board has just the right blend of skills—even if that means stepping down.



WESLEY BEDROSIAN

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that tend to have real problems tend not to have good corporate governance, so it's a protection device."

Even Google, a company that had the advantage of being the most anticipated IPO of 2004, ran afoul of U.S. Securities Exchange Commission regulations before going public weeks behind schedule and at an offering price well below its original expectations. Although Google's choice to sell its shares via a Dutch auction—and the ensuing hype around this unorthodox method—made it something of a unique case, the search engine avatar made a number of bush-league mistakes, Shear contends. "From a corporate governance standpoint, Google was a relative disaster. It didn't do much of this kind of preparation—such as creating an independent board—just enough to meet standards."

Shear recommends that six to nine months before the company starts considering underwriters, "you should already be on your way to having independent directors identified, audit and compensation committees formed and code of ethics and conflict of interest policies drawn up." Even private companies anticipating acquisitions would do well to comply with public compliance standards as a way of easing the transition, adding value and making themselves more attractive to the acquiring company. "If a company doesn't have those controls in place, [the acquirer] may see it as a risk that could cause it to restate its earnings and potentially face federal or civil penalties," notes Jon Karis, a partner at the law firm Nixon Peabody, who regularly advises directors on their duties.

Jay Lorsch, the Louis Kirstein Professor of Human Relations at the Harvard Business School, has written widely on corporate board issues. He takes an even longer view, recommending that companies put their boards in order three to five years before an IPO. "We're no longer in a situation where it's acceptable to build a company board at the last minute to go public," Lorsch says. "It just doesn't work."

The choice of director is crucial, and in the current post-Sarbanes-Oxley climate, independence is prized. Directors need to be more than independent, however; they should also have sound decision-making capabilities and financial savvy. "You want to make sure directors bring competencies that collectively give the board strategic value," Shear argues. "There should be people who understand the industry that they're in, who have diverse points of view and at least one who's a burr under the saddle, who can ask hard questions in a nice way."

THE DEVIL'S FIDUCIARY

The board should have directors who are willing to pose tough questions to senior management, preparing them for the rigors of a liquidity event. Robert MacDonald, a life insurance executive and three-time CEO who currently sits on the board of Buffalo Wild Wings Grill & Bar, says he has grown accustomed to playing devil's advocate at meetings. "To me, the most value a director can add to a board is to be candid, honest and straightforward," he adds. "If you've been brought in as an independent, you have a duty to bring a fresh, questioning approach to things."

When MacDonald joined the board of the sports-themed restaurant chain in September 2003, two months before its planned IPO, he soon found himself objecting to a proposed executive compensation plan be-cause he felt it favored those who were already the most highly paid in the company. MacDonald is a believer in giving the entire organization a "stake" in the same incentives. "My issues were philosophical in nature," MacDonald recalls. "Honest people can disagree on the approach to the same objective." Although the board eventually approved the proposal, he is happy he spoke up. "Possibly the best lesson is that both the board and management were open to discuss and consider alternative approaches. From my perspective as an independent director, that is the value of my contribution to the process."

MacDonald's previous experience leading two companies through acquisitions (LifeUSA Holdings in 1999 and Allianz Life Insurance in 2003) left him wary of valuations. When Buffalo's bankers priced its stock at $14 to $16, MacDonald protested the range was too low. They increased the IPO terms once, and on November 20, the stock went out at $17. Although restaurant analysts such as Michael Smith of Oppenheimer & Co. say they too would have set the price in the mid-teens, MacDonald continues to contend the stock was worth more, noting that it gained 35 percent on its first trading day and has not dipped below $21 since. "Managements that haven't been through the process before get caught up in the romance of doing an IPO and a road show," MacDonald says. Along with Shear, he recommends approaching all advisors with cautious skepticism. "Investment bankers could have a potential conflict of interest in terms of pricing, and a director's responsibility is to get the best price possible for the company and for the shareholders," MacDonald adds.

Maximizing value is not merely a worthy goal; it is a fundamental goal, and failure to secure it raises liability issues for directors, Karis says. "The fundamental question when you're selling a privately held business is: Did you sell it at a price and on terms which represent fair value to all stockholders and not just the insiders?" More than ever before, directors are all too aware that they can be sued for failing to act in the best interests of their company based on their knowledge and due diligence. Those involved in liquidity events should proactively protect themselves from possible fiduciary duty claims. Karis advises employing investment bankers to conduct research, actively seeking offers to get the highest bid possible and paying extra for a fairness opinion. The opinion, which comes in the form of a letter from a banking firm that declares a buyer's offer a fair deal based on the financial climate and other deals in the industry, can help a director's defense should a court ever investigate the propriety of a transaction.

Separating underwriting activities from writing a fairness opinion can further ensure bankers are working in the best interests of the company. "Tradition holds that you hire the same bank to do both, but a banker who's making a percentage of the deal is not independent," Karis says. "He's interested in the transaction, and courts are realizing this."

LOGIC OF LARGESSE

Executive compensation confounds many boards, particularly those facing a liquidity exit, as corporate scandals in recent years have made directors extra mindful of avoiding past excesses. One way directors can minimize risk is to study the construction and implications of all the various parts (base pay, incentives and bonuses) of the compensation packages, Shear says. In addition, consultants charged with crafting the compensation packages should be outsiders, so the compensation committee has freedom to manage—or even fire—them.

Scott Collins, a general partner at Summit Partners' London office, who has eight years of experience providing board-level guidance to later-stage companies, recommends keeping compensation plans as simple as possible. "Pick three or four goals or measurements and focus on those," he advises. "Those plans tend to work out better and are easier to administrate than the ones that are based on 7.5 percent of this or the rolling average of that."

Cover Your Tail

A LIQUIDITY EVENT presents an opportunity to review and, if necessary, amend directors' and officers' (D&O) liability insurance. If planned carefully, D&O insurance will serve to protect directors if disgruntled minority stockholders decide to take action after the event.

Board Assets president Hal Shear cites a case in which an acquiring company sued the directors after the acquisition in a dispute involving collection of receivables. The lawsuit forced the directors to pay the legal costs out of their own pockets.

To avoid this type of dilemma, directors can buy "tail coverage" to protect them from lawsuits for a select "tail period" after the sale. "Make sure your coverage has no exclusions," Shear warns.