TRANSCRIPT

LegalMindsTV Exclusive Interview:

"Challenges & Opportunities Accessing Capital Markets"

December 7, 2009

Steven Khadavi
Partner
Dorsey & Whitney LLP
khadavi.steven@dorsey.com
212-415-9376

To view the video of this interview, visit:
http://legalminds.tv/index.php/2009/12/16/challenges-opportunities-accessing-capital-markets/

Before we get started, Steven, please tell us a little bit about the focus of your practice at Dorsey Whitney.

My practice is a broad-based corporate practice, primarily capital markets, which would encompass high-yield debt offerings, convertible debt, initial public offerings, secondary offerings, and then some PIPEs transactions. I also do a fair amount of M&A and private equity work, and also dabble a little bit in venture capital and early-stage investing.

What do you see some of the major issues or obstacles for companies that are looking to access the capital markets?

Companies that are looking to access the capital markets for the first time are often surprised by the level of disclosure that they need to provide. Running a privately held company is, essentially that -- a privately held company -- where you don't really report to outsiders other than your investors.

As a public company, you've got to provide all sorts of disclosure, and this is regardless of whether you are doing a full-fledged initial public offering or a Rule 144A private offering, where the disclosure documents are meant to mirror essentially what you would see in a full-fledged public offering.

So, any company that is raising money in a capital markets transaction would have to provide specific disclosure regarding their business, which may include disclosure regarding important customers or suppliers, risks related to the company, executive compensation disclosure, and then full-blown financial information, which would include audited balance sheet, income statement, statement of cash flows, and then footnotes to financial statements as well.

What are some of the major issues that are impacting the decision to commence a capital markets transaction?

A company that's considering accessing the capital markets would need to carefully weigh the costs and benefits of the transaction -- and costs would refer to actual cost dollars out, as well as diversion of management's time and additional resources that would go towards becoming a public company or accessing the capital markets.

So, to the extent that there are alternatives in terms of other types of transactions that would not require capital markets transaction -- private offerings to investors or private equity, which wouldn't necessarily include accessing the capital markets and the different disclosure requirements -- those are the types of things that a company would want to weigh before deciding whether to go public or not.

What about the time factors involved in going public?

Accessing the capital markets is a long process. I would say that the lead-time to actually commencing a transaction is probably a year or so. In that first year, you want to get your house in order essentially. You want to start thinking about acting like a public company. You would want to think about engaging auditors that are PCAOB (Public Company Accounting Oversight Board) certified, so that their audit opinions could be filed with the SEC. A lot of companies are using smaller accounting firms that are not necessarily qualified and would have to go out and hire, not necessarily a "Big Four" accounting firm, but someone in the Top 20 or so that's familiar with SEC reporting and would be able to go through the capital markets process.

You mentioned several times the potential impediment of disclosure requirements. What are some of the regulatory issues which either impact the process or decision to go public?

In addition to disclosure obligations, any company that's considering accessing the capital markets would need to consider the impact of Sarbanes-Oxley Act and the testing of internal controls and procedures. It's a time consuming process. There is a large upfront cost to doing testing for internal controls and procedures -- particularly the first time around.

I would say when Sarbanes-Oxley first came about it was a more daunting task than it is today. I think now accounting firms are better suited to do the proper internal testing over the controls. So, although it's still a daunting issue for companies that are considering going public, it's not as bad as before.

There was a fear when Sarbanes-Oxley first came out that you would see a wave of companies going private to avoid the requirements of Sarbanes-Oxley. There may have been some companies that did go private initially, but again I don't think that Sarbanes has been as difficult as people may have originally thought, so that wave of going private transactions doesn't really seem to be there any longer.

With congressional consideration of easing the requirements as it relates to Sarbanes-Oxley, how do you see that affecting the types of companies going public?

There is a proposal out there by Congress to exempt smaller companies, companies with a market capital of $75 million or more from the internal controls testing of Sarbanes-Oxley. If that were to be the case, then I think companies that are on the fringe of going public and are below that market cap may give additional consideration to accessing the capital markets. I don't know what the likelihood of that is. The accounting bar is obviously opposed to any sort of exemption because they are the ones that are doing the testing. So, it will be interesting to see whether or not this exemption for these smaller companies will actually take hold or not.

In addition to disclosure and accounting requirements, what are some other issues that should be considered as companies approach a capital markets transaction?

One of the issues that companies that are thinking of accessing the capital markets face now is identification of independent directors. Every public company needs a majority of independent directors within a year of going public and that also includes independent committees. So your audit committee, corporate governance committee, and compensation committee, to the extent that you have one, will also be required to be composed of fully independent directors with a couple of exceptions.

What are some of the obstacles that companies face in finding independent directors?

A company needs to think about identifying independent directors, as I said, there are some impediments to doing so -- the big one being liability. Independent directors are going to carefully look at Director and Officer coverage that a company has, but even that may not be sufficient to overcome the hurdles of identifying independent directors.

There was a WorldCom decision last year where the directors of WorldCom had to go out of pocket to satisfy fines that were imposed because the regulators were unwilling to have the D&O coverage cover the directors for their liability. So, even with adequate D&O coverage there may be situations where independent directors would be hesitant to sit on the Board of a public company.

What are some of the other issues releated to identifying and attracting independent directors?

Other issues regarding identifying and attracting potential independent directors would deal with disclosure again.

The SEC has come out and stated that in this coming year's proxy season they will be imposing additional disclosure on public companies regarding qualifications of directors, specifically and as well as composition of committees.

So, companies are going to need to start think about what sort of additional disclosure they need to provide in their proxy statement regarding the qualifications of their directors, specifically why they are qualified to sit on the Boards of particular companies and what makes them qualified to sit on committees.

What kind of activity do you foresee in the capital markets in near future and how is the affecting the advice you give your clients?

2009 was obviously a difficult year for the capital markets. They were extremely choppy. There was really no flow to them, at least for the first nine months of the year.

We think that 2010 could potentially be a much better year. There are signs that the capital markets are loosening up. In particular, if the IPO market does open up, we expect that there will be a good portfolio of companies that will be accessing the capital markets in 2010, particularly portfolio companies of private equity companies that have essentially been on the sidelines for the last year or so. Private equity firms will be looking for exits, and other than a sale, IPO is obviously the best exit for a portfolio company of a private equity firm.

What are some of the alternatives you see to an IPO?

As an alternative to an IPO and we saw this during 2009, PIPEs (private investments in public equity), as well as registered direct offerings, are always a potential alternative. A lot of the bank deals that were done when the financial institutions needed to enhance their capital were done through PIPE transactions and there was a lot of publicity around Warren Buffet's investments in GE and in Goldman Sachs, both of which were done as PIPE transactions.

What are some of the risks and downsides to these alternative financing vehicles?

The downside to some of these alternative vehicles to raise capital would be that there is generally a limited market for PIPE deals and for registered direct offerings. You've got to be S-3 eligible for either type of transaction because the investors need registered securities either at the time of the sale or in short order after that sale. So, not every company has access to a PIPE or a registered direct.

And then from the company's perspective, there is generally a significant discount to the current market price for doing a transaction of that type. A lot of companies don't want to leave that kind of money on the table. So, what we saw is that companies that really needed to access capital and didn't have access to the true capital markets accessing those vehicles. But otherwise, like I said, it's a very limited group of companies that would generally do a PIPE or a registered direct.

What are some of the other concerns for companies considering going public?

Another area of concern for companies that are thinking of going public would have to do with risk assessment. The SEC has come out on numerous occasions and has said that they are going to take a hard look at how companies are assessing risk and in particular how Boards of Directors of companies are assessing risk. Whether companies have an actual risk committee. Whether a Board of Directors is involved in risk related to strategy decisions. And obviously the most prevalent one now is risk related to executive compensation.

We're seeing that now with the Pay Czar, and we saw that with AIG (NYSE:AIG) and some of the other big banks in terms of whether the risks that employees and management took with respect to the companies was meant to maximize their income or it was really meant to do what was in the best interest of the company.

So, I don't think we'll see it this year, but probably by next year's annual reports there will be extensive requirements regarding disclosure risk and the role that public company Boards play in overseeing risk.

Hopefully, we'll have you back again next year to see how these factors have played out in the market. In the meantime, I want to thank you for taking the time to share your thoughts with LegalMindsTV.