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Capitalizing on the Success of Entrepreneurship: IPOS, Private Sales, Tax Aspects, Residual Interest of Entrepreneurs after Sales of IPOS - United States Speaker, Canadian Speaker

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Anthony Penhale

UNITED STATES SPEAKER

*Elizabeth Dellinger**

&

CANADIAN SPEAKER

*Anthony Penhale**

MS. DELLINGER: Great. Well, my name is Betsy Dellinger. I am a partner at a law firm here in Cleveland by the name of Baker Hostetler. I chair our private capital practice. What that really means is my practice involves representing venture funds, representing startup businesses, representing what I often call emerging growth companies, privately held companies and basically working all sorts of capital formation. You look at a business, look at their capital needs, match up the two, do the legal work, do a lot of strategic counseling and let the companies grow but stay out of

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their way and then helping them exit and realize on to other potential businesses.

Anthony will introduce himself, and then we will give a presentation where we sort of lead off, go back and forth between us and feel free to jump in with questions as we go.

MR. PENHALE: My name is Anthony Penhale and I am a partner in the Montreal office of Stikeman and Elliott. I principally deal ultimately with the tail end process of what we are talking about, once the company has been taken public or bought or sold, typically bought by somebody bigger or private equity in this context.

Our offices are throughout Canada, mainly in Toronto, Montreal, Vancouver, Ottawa, Calgary; we deal with a number of different capital raising functions and obviously a lot of tax planning for which I must put a disclaimer right away – I am not capable of explaining anything correctly when it comes to taxes.

MS. DELLINGER: We have a number of slides here, and I will loosely follow them. I will start with this one, "*Capitalizing on Successful Entrepreneurship: When and How.*" On the "when," there are two times when you, as an entrepreneur, will not capitalize on your success. The first is when VC (venture capitalist) money comes in to fund the growth of the company.

Venture capitalists put a lot of money into the company, but they don't want to see it spent on the management. They want management and the founders of the company to be tied in closely with them as co-investors in the growth of the business.[1]

The second instance in which you will not be able to capitalize on the success of your entrepreneurship is when some form of cash compensation is being drawn from the company during the growth stages of the business. I think entrepreneurs are uniquely the hardest working people out there for the lowest relative compensation, because their opportunities to realize success come closer to the back end of their activities than at the front end during the course of the entrepreneurship.

That said, in this presentation we really want to address when an entrepreneur will experience success and how best to achieve it. There are three basic categories of exits from a company. A liquidity event is really the definition of how the entrepreneur realizes the success of the business. As I say this, bear in mind that there could be two types of entrepreneurs growing the business coming in to a liquidity event. One is the person who started the company, a family-owned business that is now looking for an exit. The other

[1] *See generally* DAVID GLADSTONE & LAURA GLADSTONE, VENTURE CAPITAL HANDBOOK: AN ENTREPRENEUR'S GUIDE TO RAISING VENTURE CAPITAL 103 (FT Press, rev. ed., 2001) (discussing how a venture capitalist evaluates management).

is a venture capital funded business. When venture money comes in, the control shifts in a variety of ways and timelines are sometimes more predetermined by the fund's particular commitments to its investors and when the fund plans to withdraw from its investment.[2] So these factors can have a bearing on what the exits are and how they happen.

Liquidity events can occur first in the form of a private sale. Such a sale could be to a strategic buyer, to someone else in the industry, or to a more mature equity fund or second state venture fund. Second, they can occur in the form of public sales, typically called "initial public offerings," or IPOs. A third type of liquidity event is a recapitalization event. We will drill down on each of these a bit, but recapitalizations are basically a way of selling part of the business and holding on to another part as the business continues to grow.

MR. PENHALE: All right. Just before you move on, there is perhaps a distinction we can make between what I think is a reality in the Canadian market in contrast to the U.S. market. In the Canadian market, at least in Quebec, if you look at the 50 largest companies, you would not be surprised to find that two thirds of them are either controlled by a group of shareholders – public and private – or controlled by the family that actually founded them.[3]

I remember a number of years ago we were involved in a cross-border IPO-related transaction. Our firm had been retained by counsel for the underwriters, and we had the U.S. counterpart. We were looking at a structure involving dual classes of shares, and you had half of the table literally scratching their heads trying to figure out why there would be one class of shares with more votes than the other class. How could you possibly take this to market and what had you been smoking to think that you could? And that's a reality. Increasing the market of people investing results in investors' recognition of all sorts of governance issues to do with a class. Still, even in an established public company in Canada, it would not be rare to find that there is a controlling shareholder, group of shareholders or family, who play a key role in decisions pertaining to liquidity.[4]

MS. DELLINGER: I will also add, and this ties into what Anthony said, that it seems to me after having practiced law for 20 years, that over that period of time, the exits for privately held companies, whether by private

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[2] *See generally* PAUL GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE 346-347 (MIT Press, 3d ed. 2006) (1999) (discussing the exiting of venture capital investments).

[3] *See generally* Andrea Jezovit, Marlene Rego, Zena Olijnik, Andy Holloway & Tom Watson, *The Big 50*, CAN. BUS., May 21, 2007, at 28 (describing the top fifty Canadian businesses).

[4] *See generally* John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 688 (1999) (discussing the potential for controlling shareholder threats of lost liquidity to public shareholders).

sale, public sale or otherwise, have almost become commoditized somewhat.[5] Nowadays, someone declares, "Well, I am thinking about selling my business," and all of a sudden someone else jumps out in front of them and says, "Here are the three ways you can do it. Here are the valuation models and the agreements you are going to need, and this is how you are going to sell your company, and we also have a list of the 50 best candidates to sell your company to, and we are going to narrow that list at auction."

There are virtues to that because, in some respects, that makes the market more efficient and some of the auction processes that have been created by investment banks, large or small, tend to increase valuation. On the other hand, when something is commoditized, there may be something lost in that process, too.

There is one thing that I always encourage an entrepreneur to do: look at the whole package of options, listen to what the professionals have to say, and pay close attention for the option that sounds prepackaged. They might be selling to the company you can compete with versus what is really, really important to your business that may look for the particular value proposition your business offers and really help promote that piece of it and actually got lost in the process.

The first method of exit that we will focus on is the private sale. There are two types of potential buyers out there when dealing in private sales. First, there are "strategic" buyers, who are people in the industry or companies looking to buy companies and equity funds.[6] Second, there are equity-fund buyers.[7]

It used to be that you had venture capital, and then you had traditional equity funds and it was somewhat uncommon to have an equity fund sell to an equity fund. The opposite is true today. Now this is one of the most common types of transactions being made.[8]

The other word you see flying around in the media is "hedge funds," but from the entrepreneurial company standpoint, an equity fund and a hedge fund are really the same thing. An equity fund is a pile of money that is

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[5] *See* A business broker directory: Connecting business buyers and sellers, http://www.businessbroker.net/ (last visited September 27, 2007).

[6] *See* Michael L. Sklar, *A Full-Court Press to Sell a Business*, MERGERS & ACQUISITIONS J., (2004); *see also*, ANDREW DOLBECK, COMPETITION FOR DEALS: THE RETURN OF THE STRATEGIC BUYER, WKLY. CORP. GROWTH REP., (2006).

[7] *See generally* Martin Sikora & Joan Harrison, *Gusher on the Sell Side: Massive liquidity is fueling selling ardor and high prices*, MERGERS & ACQUISITIONS J., (2005) (discussing business purchases by equity funds and others).

[8] *See generally* Press Release, PR Newswire, Private Equity Boom Over: Firms to Look to Smaller Deals, Distressed Opportunities, Say Keynotes of Today's Dow Jones Private Equity Analyst Conference (Sep. 19, 2007), *available at* http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=109&STORY=/www/story/09-19-2007/0004666114&EDATE= (noting a company's return to all-equity deals).

funded, either by individuals or institutions or pension funds, that is looking for a place to make money outside of the traditional public market series of private investments.[9] They are looking for businesses that can run themselves and make money on their money, versus the strategic buyer who is really looking to have innovative business with its current operations.[10]

MR. PENHALE: There can also be some confusion between strategic and financial buyers because they can strap onto one of their foreign acquisitions, causing a party that is seemingly a financial buyer to behave like a strategic buyer.

MS. DELLINGER: Certainly, and I have another slide that will address that very issue. At this point, I would like to discuss the valuation of a business. It used to that a strategic buyer would almost invariably pay more than an equity fund in a private sale because there were synergies of the strategic buyer coming into the transaction.

They had more ways to reduce the costs of the business so they would be able to pay more upfront because of these cost savings. By contrast, what you find now is that there is so much money in these equity funds that they are forced to put out that money. If they don't, then they have commitments from investors that they are not rolling into investments. Those investments then aren't getting a return on capital, and so that impacts the total rate of return that the equity fund is producing.

So the equity funds are really motivated to put money out there, and they are paying multiples for businesses that would have been unheard of a decade ago. Was that your experience?

MR. PENHALE: It was. We had a phenomenon that sort of mimicked that in Canada, and you may have heard of it. It was called "income trust" or "income fund."[11] This was an absolutely efficient flow-through mechanism that a company would buy based on a multiple of the cash flows, thereafter distributing all of its available cash from operations.[12] In return, it would get, instead of the traditional, let's say, seven times or six and-a-half times, that might be rigid and might turn on a sale, they would get closer to seven, nine, and sometimes 12 times, depending on the business that they were in.

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[9] *See generally* CLIFFORD E. KIRSCH, FINANCIAL PRODUCT FUNDAMENTALS §15:2.1 (Practicing Law Institute 2004) (defining equity funds).

[10] *See generally* JOHN LELSLIE LIVINGSTONE & THEODORE GROSSMAN, THE PORTABLE MBA IN FINANCE AND ACCOUNTING 595 (John Wiley and Sons 3d ed. 2001) (1992) (discussing how a strategic buyer seeks to integrate its operations with the purchased business); *see also* DUNCAN HUGHES, ASSET MANAGEMENT IN THEORY AND PRACTICE 70 (Lessons Professional Publishing 2002) (stating that an equity fund manager seeks to provide an element of income for investors).

[11] *See* JILL BOOKER, WEALTH MANAGEMENT AND ESTATE PLANNING 16-77 (CCH Canadian Limited 2d ed. 2006).

[12] *Id.*

But if you take seven and nine on a $10 million business, there is an automatic pickup of $20 million in value. So this was very, very lucrative. It disappeared, or at least it is going to be disappearing because the Government changed the tax scheme with regard to these entities last fall by announcing that they will essentially tax them as corporations, much as they started to do with partnerships a number of years ago.[13]

This was such an efficient vehicle to buy and raise money and it also offered the ability, which was uncommon in Canada until then, to basically sell 100 percent of the business to the public. Normally, you would have a retained interest or concern of flash-in-the-pan and dealers telling you, "Oh, you got to have some skin in the game, or we won't buy."

With the income trust, you could buy 100 percent of the business and ultimately have no retained interest. At least with the equity buyers that we were seeing in Canada, you also had to up their valuation because, to be effective and competitive, they would offer more than the seven times, closer to the nine, which upped some of the funds.

MS. DELLINGER: Before we spend another minute talking about valuation, it is important to remember that you are getting this from two lawyers, not investment bankers. The valuations in private sales hinge on two timely factors that influence what I see.

One is the nature of the business, the industry, and the uniqueness and value of its technology. The second is the size of the business. In a smaller company that makes sort of commodity widgets, if they are going to sell the business, they may be talking about a multiple of four or four and-a-half times EBITDA, which is earnings adding back in tax and depreciation amortization, so sort of real net earnings of the company.[14] With a really tiny company, you start talking about a one-time revenue, but that pertains to companies that are coming in at $100,000 or $200,000, and EBITDA. This isn't a relevant number for that, but for a company that has an operative history, EBITDA is sort of the commodity measure of valuation with a multiple attached to that.

In a company that employs a little bit more groundbreaking technology, that is in a little bit of a sexier industry, and that is a little larger, you are going to find multiples going up six, seven, eight, nine times. With a company that happens to be the jewel of the marketplace, like an aerospace company, an industry that is hot right now, you will see larger aerospace

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[13] *See* Press Release, Canadian Department of Finance, Canada's New Government Announces Tax Fairness Plan (Oct. 31, 2006), *available at* http://www.fin.gc.ca/news06/06-061e.html.

[14] GUY LYNN, A DICTIONARY OF ACCOUNTING AND AUDITING 342 (Xlibris Corporation 2005); *see also* Ben McClure, *A Clear Look at EBITDA*, INVESTOPEDIA, A FORBES COMPANY, April 24, 2006, http://www.investopedia.com/articles/06/ebitda.asp.

deals being priced at nine and-a-half, ten, 11 and 11 and-a-half times EBITDA.

Two years from now aerospace won't be in the limelight. It will be something else, but that's what we are talking about in terms of valuation. You want to talk about big companies versus little companies. If a company has $100 million in revenue, for the purposes of this presentation, that is what I consider a bigger company. With something smaller than that, you don't usually get even a little ding on the valuation in my experience.

MR. PENHALE: Except we have a lot of media stock right now.

MS. DELLINGER: The agency I am working with has an aerospace company, and that is why they are so popular. I would like to toss this out. In a private sale to a strategic buyer that is in the industry and will fold the business into the company, oftentimes there is just no room for the seller's management. This is when you are talking about entrepreneurial companies, usually the founders of the business going into the new company. Or, it may be that the target company's management is so much better than the management of the existing company that they will displace them. But there is certainly no assurance that the founders, the founders' family members, or the founders' management will find a home, necessarily, going forward in the long-term with the strategic buyer. With the equity fund, the equity fund is a bunch of people who went to Wharton and Stanford Business School, Harvard Business School and are good at crunching numbers and investing money. They are not operating people, so they are going to need the management and the founders, if that's the case, to have the company run. At times, we find that they have high growth plans for the company that they simply can't achieve. The entrepreneurs have taken the company as far as they can, so they may bring in, and this would usually be negotiated, a new CEO or some other skilled management to help the company hit the next level.

Lastly, if it is done right and done well, it will benefit everybody.

MR. PENHALE: One of the issues you often hear about in public and private companies is that, under Canadian law, if your venture fund investors or fund investors have, in fact, negotiated that condition at the board level in any context, private sales will occur, and your board will be asked to look at things and try to disassociate themselves from those who put them on the board to do what is best for the corporation or the entity. [15]

And when dealing with management and management's role, let's say in the sales end, you are selling to strategic, and in fact, your best negotiator is a

[15] *See* MEL GILL, GOVERNING FOR RESULTS: A DIRECTOR'S GUIDE TO GOOD GOVERNANCE 103 (Trafford Publishing 2005)

member of management, you are going to have a possible conflict with their own interest.

Whether they have a deal or not, they can get a deal or look at the world and think, "You know what, some equity is not a big deal. I will get paid now, some of the business now, get a three to seven percent stake and make money as a salary, and make money down the road if they stay as well," and that's their decision process and how they view a transaction.

In conflicts of board members, at least under Canadian law, you must do everything that you can to act in the best interests of the corporation.[16] That's a big generalization, but it assumes that the interest of the corporation does not necessarily at all times equate to the interests of the shareholders or the majority shareholders.

MR. GROETZINGER: I wonder if you could comment on the appropriate time or an ideal time to be thinking about sales as opposed to looking for more money to grow the business, and let me give you variables.

One is a group of entrepreneurs who come up and finally arrive at a valuable patent issue but don't have the money to move it forward any more versus a company that is up and running and has a positive cash flow for the last three or four years. What is your counsel on what is a good time to sell out?

MR. PENHALE: I am glad I am just a lawyer. That's what the bankers do. You pay them the fees to make those calls. And you'll notice that the bankers have to do ten deals just to get paid on one of them. So they are probably wrong more than half of the time. I don't think you can say that there is an objective "best time to sell."

I think if you were to come into my office and ask me what I ought to do in those two scenarios, we would look realistically at what your needs are, what the cost to get to that capital is, and how realistic it is for you to get that capital at a cost that makes sense for your business.

It is surely the reason for equity in the public market versus no guarantee that you are going to get the valuation you want or that you are actually going to get a deal. I know that way too many companies file a prospectus, and somewhere through the process they allege that this is not going to happen. And maybe you have an aggregate, a big banner for sale in your company, and you are not in the driver's seat any more. So you don't have guarantees.

You don't have chances for success. You can't equate automatically the perceived cheaper cost of capital or cheaper cost to get the capital at a public offering versus, let's say, another round of financing, or an alternative round of financing. And maybe, if you are looking to get VC financing, your

[16] *See id.* at 39.

advisor probably ought to tell you that you may not be in the market or look at aims and alternatives but not as one of the conditions to it.

I am sorry if my answer is sort of "everything under the sun," but I think it is the best answer that I can provide under the fact patterns that you have suggested.

MS. DELLINGER: I would say that it is not uncommon for me to have someone in my office ask me, "Should I sell my company, and what's it worth?" – the two weightiest questions in any business. The entrepreneur knows more about what their company is worth than really anybody else out there. You need to help me as a counselor to put some structure around that, to help determine that answer. The way I usually answer that question is, "Let's talk about what your company is worth." Then we would talk a little bit about common methods of valuation, a multiple, and what multiples might be out there for their industry.

What do you think it is worth? If the multiple of EBITDA comes out and the company is worth $10 million and you say to me, "I thought it was worth at least $25 million," we know the answer. You think it is a $25 million company. You simply haven't gotten the operations up to support that number yet.

Hold on to it. Keep running it, and find some additional investment capital. If you say "You know what, I am 63 years old, I have two good years left, I have a house in Florida that is screaming my name, and I think the company is probably worth $25 to $30 million; traditional analyses can support $18 to $20 million." Maybe, with some good massaging and a decent investment banker in there to help fair market it, you can get there.

But you don't want to say I need to sell it in the next day. You want to give yourself a meaningful period of time for whatever weaknesses there are in the business, and then you can key it up for a possible sale. The other thing you can say is that "I think it is worth $25 million; let's go test the market and see what I can sell the thing for, but if I don't get the money, I don't want to sell it."

That's a very dangerous proposition because once your company is on the market, all sorts of things happen that are completely outside of your control. Your customers may say "I was happy dealing with John Smith, but I will not necessarily be so happy dealing with someone else." Your employees may get nervous, and competitors may see it as a sign of weakness. Your competitors may come in and say, "I want to buy it," and walk away with information on the company, notwithstanding disclosure agreements that they won't do it.

So once a company is for sale, I think, the commitment to sell it really has to be there. So that is sort of how I look at entrepreneurial companies.

Are there any other questions at this point before we continue on? What's next?

Public sales and IPOs. These are sales on to the public market. In my experience, and Anthony's up in Canada, setting aside 1998 to about the first half of 2000 during the internet boom when reality was set aside for a period of time, my experience is that entrepreneurial companies much, much, more often through a series of new investments, partial sales and ultimately private sales, didn't ever really go to do public offerings.[17]

The number of registration rights agreements probably number in the hundreds. The number I have ever seen exercised is zero. So this is an exit that you've got to plan for, and as you are negotiating a sale exit from your business, you are always negotiating against the alternative. This is one of those alternatives that you are considering pursuing or negotiating against so it is always out there. But they are talked about much more than they are used in my experience.

MR. PENHALE: That would be true in Canada as well and as I mentioned the income trust earlier on, but as a fallout of the burst of that tech bubble in early 2000, investors were shell-shocked, and they were not looking for growth any more on the price of the stock but for a monthly return in cold cash every month.[18]

The tax lawyers and bankers came up with a structure, which was really efficient for taxes, and that's the only time we ever saw people really looking at it as a viable alternative to build a public market as a new liquidity event.

MS. DELLINGER: I will add a couple other tidbits. In the United States, I mentioned before how much money is sort of sitting in equity funds looking for a home and for private sales and businesses. There used to be a gap, and maybe you could sell your company in an eight times or six times multiple in private sale and 20 times sale on public markets. You had to really look at that meaningfully, but as multiples for private sales have gone up and as public markets have come down a little bit, that gap really isn't there anymore to the same extent that it was. So you have the private money out there really looking for good deals, on the one hand.

Secondly, in the United States, you have Sarbanes-Oxley, and depending who you talk to, I believe the New York Times has a negative story and The Plain Dealer has it as a positive story, but that Sarbanes-Oxley has done a great job of giving investors confidence.[19] And companies are thrilled about it versus it being an extremely burdensome level of responsibility to comply

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[17] *See generally* JILL ANDRESKY FRASER, THE BUSINESS OWNER'S GUIDE TO PERSONAL FINANCE: WHEN YOUR BUSINESS IS YOUR PAYCHECK 286 (Bloomberg Press 2002) (noting that public offerings are an option for only a select group of entrepreneurial companies).

[18] *See generally* Raymond Fazzi, *Investors Get Down To Earth*, FIN. ADVISOR MAG., June 2002, (discussing investor interests after the technology boom).

[19] Jonathan D. Glater, *Here It Comes: The Sarbanes-Oxley Backlash*, N.Y. TIMES, Apr. 17, 2005, at 5; Alison Grant & Mary Vanac, *The Hefty Costs of Compliance; Small, Midsize Public Companies Hit Hardest by Sarbanes-Oxley*, PLAIN DEALER, Mar. 15, 2005, at C1.

with the greater corporate governance and the corporate oversight rules that have come around in the United States since Enron.[20] So that's an impact.

MR. PENHALE: I was just going to say we are lucky in Canada; we have the benefit of having you as a neighbor, you being the U.S. capital markets. So we can take a look at legislation like Sarbanes-Oxley and see how things go and how people react and tailor it in our own environment, which is predominantly control companies smaller market cap.

So Sarbanes-Oxley, or the equivalent in Canada, surely is a pain but probably is a good thing in terms of disclosure and enhancement of corporate governance without the cost of annual million-dollar fees to do it. But it is nonetheless an issue, and you have got to really keep in mind, even absent Sarbanes-Oxley, that it is a million-dollar extra cost per year just to be public.[21]

So when you are talking valuations, if you factor in the cost of compliance and the cost of reporting transference requirements, suddenly it may not be worth it to do it, and the private bar may have a strong incentive to convince you to settle in.

MS. DELLINGER: One other thing I wanted to talk about is that there are opportunities out there presented to privately held companies, and usually technology based companies, faster growth companies that are looking for, particularly, extra capital, and that is to merge the company into a shell public company.

If someone calls our firm and says, "We have a company doing a merger, we are going to become public, we are going to represent the public companies and would love Baker and Hostetler to work with us," those transactions are just fraught with issues. They are usually some type of sham because if you don't have a company that could really get an underwriter to support and do a traditional public offering, it is never going to have the benefits of being public on the public market. There is not going to be a market maker. There is not going to be anybody who really wants that stock. The investors are not going to find liquidity. Usually on the public markets, if there is not a buyer, you can't be a seller. So, I'm sure there are one or two out there that have been great successes, but there is usually something in there that we run away from screaming.

Do you have something to add to that?

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[20] *See generally* Alwyn Scott, *Board Members Debate Whether Reforms Have Cleaned Up or Glossed Over Problems*, KNIGHT RIDDER TRIB. BUS. NEWS, Oct. 3, 2004, at 1 (noting that executives were glad to have everything out in the open).

[21] *See generally* Mary Crane, *Are You Ready To Go Public?*, FORBES.COM, Nov. 16, 2006 http://www.forbes.com/entrepreneurs/2006/11/13/goldman-sachs-morgan-stanley-ipo-ent-fin-cx_mc_1113goingpublic.html (noting the costs of going public)

MR. PENHALE: We do. Some are good; some are bad. We have the TSX Stock Exchange, and if you compare it to your large American counterparts, TSX venture is really a junior exchange, but you have a lot of shell companies in there.[22]

And it is really amazing, sometimes, when you are doing due diligence for a tech company to try and raise capital, and you find out they have all sorts of environmental issues because at one point in their life, they were digging for oil. They really don't know what they did for the last ten years because they did nothing because it had a liability, potentially. If there is a nice way of making a dollar quickly with little risk, they will probably find it. These deals are more often than not too capital and too costly to market. They are there. Still, sometimes this is quite a legitimate way to become a public company.

You may have a private company that is the object. We call that a "reverse takeover," or "reverse merger," and there is a real operating entity in both companies.[23] It is not just a shell.

MS. DELLINGER: Right.

MR. PENHALE: And you are buying an asset and paying with your securities, and control changes as a result of that transaction. That's one thing. If there is just a shell to use the listing, you probably have more than half a chance that it is not workable.

MS. DELLINGER: I wanted to –

MR. PENHALE: Do you want to talk about auctions before you continue?

MS. DELLINGER: Yes, let's do that. We sort of talked about valuation, and I am going to hit on a couple of things. Valuations in public markets have traditionally been much higher than in private markets, but that's really worn away in the last couple of years.

Management's role, if you do a public company, you have your value – you are selling your shares. You are not selling to another company that has management keyed up. So to the extent you have a management team, the entrepreneur who still likes to work and wants to work just keeps you in that position with more liquidity and then lock it.

In an underwritten public offering, what you find is that the underwriter will say, "Great, you want to take the company public, and in the long run

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22 *See* Angel Capital Education: Toronto Stock Exchange Group Offers Options for Growth, http://www.angelcapitaleducation.org/dir_resources/news_detail.aspx?id=136 (last visited September 27, 2007).

23 DAVID N. FELDMAN, REVERSE MERGERS: TAKING A COMPANY PUBLIC WITHOUT AN IPO 20, 252 (Bloomberg Press 2006); *see also* GUY LYNN, A DICTIONARY OF ACCOUNTING AND AUDITING 342 (Xlibris Corporation 2005).

not only do you have better capital for the company, but you also will be able to sell shares in the public market. But don't do it on our watch."

So you see these companies that go out, and the IPO says that its stock is worth $50 a share and the stock jumps to $75 a share on the first day and stays up there for a little while. Then it hunkers down, and six months later the stock may be at $49 a share and seems to be pretty stabilized.

Well, 180 days is sort of the standard management lockup so management didn't experience any of that initial hype. And when I say management, I really mean the entrepreneur in the business. Instead, once the company has come out, they will have an opportunity to sell their shares, and I won't bore you with the methods into the public markets to get personal liquidity that way. But the underwriters will look so that often investors are coming in, knowing that the people who founded the business, who are running the business are tied up and committed to the business for that initial period of time.

MR. PENHALE: Right. And to that very same comment, this is very rare, at least from what I have seen. As I said before, they sell a 100 percent stake. You do a public transaction unless it was a buy, but if you are going to stock exchange markets or listing, you can pop at 45 or 60 percent depending what the underwriters told you the market could bear.

While there is some liquidity of selling, in fact, originally by your stake, the company raised the capital that you didn't really get as the entrepreneur. You have a new currency that you show your banker that you can value daily, but you don't have a dollar more in your bank yet.

And as Betsy was saying, you have 180 days before you actually get a dollar more, and then there are a bunch of rules that preclude you from getting that dollar when you want it. One of the things that I find entrepreneur managers don't do when they think they are taking their company public, is put themselves in the shoes of someone who invented something, actually went through the VC analyst, still has a stake in it, is still happy about the business, has done relatively well, and has got all the financial metrics aligned so that you can come and get your brokers to call you to invest in it.

And then you have a bunch of bankers and lawyers and people doing due diligence of everything under the sun again and again and again. We describe these individuals as crazies and, while creative, they are not patient, I can tell you that.

More importantly, don't underestimate their ability to manage the business. The toughest part I think for members of the management team, senior officers in the context of an IPO, is how unlikely it is that they are going to be able to manage the business as they systematically underestimate needs, wants, the timing issues and the requests that people will make.

We talked earlier about how extensive due diligence on the intellectual property might have been throughout the different phases of the life of the company. But, when you get to the time to become an IPO, suddenly, especially with biotech companies that I looked at in Canada, you need to have good answers to everything that was perfectly fine not to have answers to until then.

So thinking of a biotech company that may have a product that is ready to be commercialized or has been commercialized, has some sales somewhere in the world – and let's say was ten years in the making from the time, the two days for ten years, nobody bothered me more than half the time, and you guys are in my office for two weeks and are still not convinced, that is the biggest thing of management.

MS. DELLINGER: We sort of touched on this, and my first point up on the slide was, "issue or sale versus secondary sale." I feel I would call it an issue or sale. Basically a company sells its shares to a capitalist so that the company then has more money to do whatever the company does. Usually a good portion is used to pay down debt to the bank because the public market is more flexible and cheaper money.

MR. PENHALE: Which in Canada typically happened to be the parent of the underwriter doing the offering.

MS. DELLINGER: I read that, yeah, the relationship. Secondary sales occur when you have a public offering, but the company isn't selling a single share.[24] Rather, usually it would be a venture fund because the person is management, and everything is locked up as the venture fund sells its interest in the public market, so the company doesn't necessarily walk away with a penny. But the venture fund investor has now gotten significant liquidity by doing an IPO.

That decision to do an IPO is going to be driven on to the venture-funded company and in that example by the venture funds.

MR. PENHALE: As well as timing.

MS. DELLINGER: And timing, right. In the public market, it is a pickle. There are also many situations where there is a hybrid, there is primary sale of companies getting money to restructure the balance sheet and at the same time some type of institutional investor selling shares to the IPO.

MR. PENHALE: Just a little anecdote in passing: the decision to become public is also one where you have to advise the managers, the entrepreneur, and the seller of the business that they are now subject to a fair amount of scrutiny and transparency.

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[24] *See generally* University of Denver Sturm College of Law: Dialogue with Professor on Capitalization, http://www.law.du.edu/wduong/Capitalization.htm (last visited on Sept. 27, 2007).

By way of example, there was an interesting issue concerning a biotech company that I was involved with. You can imagine you had people working in labs all wearing white coats and the doctors and what not. Because it involved farm hands, farm hands won't typically command the same kind of salary as your researchers or work on the same range of your projects.

As in any good business, there were discussions among employees about how the researchers wanted more, and then the farm hands wanted more, and I am not trying to berate what they did, but it was classic. Of course, there was a good management reason for allocating more money to one individual over another, especially if one is doing research and is going to create a product while the other is taking care of goats. We prepared the prospectus with a nice glossy cover, and it has a stapled back, not a glue back but stapled, and the prospectuses are commercial copies that the dealer used to market, and there is a certain amount of pride involved.

So when it comes off the press – and this is a preliminary prospectus in Canada equivalent to your reds – boxes of it are delivered to the company and management, including the president and chief executive officer, who is a founder and is very proud to distribute this to all the employees to show how good it was to have stuck around, to be part of a public company, and all the pride that goes with the sense of success of your transaction.

Take that prospectus and sort of put it on your table, and let it open on where it naturally opens. Guess what page it is? Compensation of the five senior highest paid officers of which the one guy has been saying, "Oh, you know, guys, I can't pay you more," and suddenly – he is not drawing millions of dollars by any stretch but substantially more than the people he was convincing that they shouldn't take another hike in salary despite what he was making.

Now, my point on that, and that happens and it is not law, but you have to drop that point on to the person. Suddenly there is more transparency. Another example would be a company doing perfectly well. They have a process, have nice news, and they are in an environment that is competitive, and suddenly they have to put out their financial statements. And lo and behold, their customers are capable of basically figuring out what kind of margins this company is making and what kind of product they are buying from them. You look at what the competitor is selling them for, they realize it is all profit and start to tell you, "I want a better deal."

So yesterday your business was making, let's say, $100 million dollars of revenues and not particularly hard to do because you had good customers buying from you, and today you have a hard time making $60 because all of them retaliated, because they know how much you are making.

So that is to demonstrate that you have to be aware that you no longer can keep secrets, and we are not talking intellectual property here. We are talking what your business is, how it is, what I am paying you, the fact that you get to fly on a company jet, how many times you want to do it a year, suddenly your neighbor knows that.

MS. DELLINGER: And now it is disclosed as compensation with the comp table.

MR. PENHALE: Right. The fact that you know you have got three houses that the company pays for you, your neighbors know that or the fact that you don't, also. Maybe you are CFO of a company that never allowed you to get those kinds of perks, and you live in a neighborhood where everybody thinks you do.

MS. DELLINGER: Yeah. So I think both Anthony and I have indicated: don't enter into the IPO lightly. I think that's the message there. One other exit that I wanted to touch on – and I will not spend too much time on it – is recapitalization. I always like to toss it out, and I said earlier, so often it is easy to have people say, "Sell your business in sort of a commodity type sale." The recap is unique to every business. I call it the method by which the entrepreneurial business owner can sell his business twice.[25]

It is sort of a hedging strategy, and there are different ways to do it. Basically, let's say you have a family that built the business from scratch, good business, still has good growth potential ahead of it, the family may be wealthy, but it is all part in the business.

The recap would be a way of basically being in, you know, selling a portion of the equity. It could be 20 percent, 80 percent, selling a portion of the equity of the company and keeping a portion of it to enjoy future growth.[26] So you are looking for a passive investor, some type of equity fund if you are selling equity.

Another way to do it would be to layer the company up with a lot of debt.[27] Usually, the type of debt you would be looking for, you have to make sure the balance sheet and the performance for the company can support debt service, but the plan is that the entrepreneur pulls cash out of the business in connection with some type of leveraged or equity recapitalization of the business.

But they still own a good portion of the business and can still run the business if they need to grow the business. Five years down the road maybe they are ready for a sale to a private company or an equity fund or even an IPO. At that point, they sell the remaining portion of it or at least another

[25] *See generally* Barbara Pellow, *Vertical Marketing: It Starts with Market Analysis, available at* http://www.ondemandjournal.com/specialfeatures/pellow59.cfm (last visited on Sept. 27, 2007).

[26] Beth Fitzgerald, *Colleges Buy into Entrepreneur Classes*, THE STAR-LEDGER, Nov. 10, 2004, at 50.

[27] *See generally* Siseko Njobeni, *Funds Still Biggest BEE Start-up Hurdle*, FIN. TIMES INFO. LIMITED: EUR. INTELLIGENCE WIRE, July 21, 2006, at 15.

portion of the business and experience, you know, a second part of the business.

The opportunity here, you get virtually cash out of the business earlier on, and you don't have all of your eggs in one basket.[28] If the business continues to grow tremendously and commands a multiple twice what you value the recap at, you will be kicking yourself down the road when you sell the second half and you realize $100 million, but now you realize it could have been $400 million.

If the business gets eaten up in the market or has competitors coming out of the woodwork and that performance in the second half as opposed to recap is less than you expected, you may be thanking your stars. So it is something that when I think I want to sell my business and, do you want to keep it, do you want to let go, it is something very much worthwhile exploring. Not every business can do one because it has to be something that you can layer debt on. It has to have through the asset base, has to be attractive if it is a leverage recap or has to have appeal to an equity fund, but it is something out there worth considering.

MR. PENHALE: It also could be worth it to think about a situation where you have, let's say, two partners 50-50 and they don't see eye to eye on the direction of the business or what it ought to be. Sometimes coming in what we would coin a thin ledge minority position puts a third player in. He gets some money out, allows them to enjoy life a little more perhaps and maybe also having a third person split some of that, well, I guess not seeing eye-to-eye and using debt in that context, convertible debt or debt that is an equity kicker can also prepare – further the interest in the business.

MS. DELLINGER: I want to make one comment on valuation in a leveraged and a debt heavy recapitalization. It is almost as if you don't have to figure out the true enterprise value or equity value of the business in a recap when you bring in debt because debt is going to look at pay me back with the rate of return that I am looking for.

If they wanted to move, trying to estimate some type of return on their equity, they want to get a good deal, but a debt is a fixed return instrument as long as they can cover those, going to be an ability to pay it back, fixed return and repay the principal. You can layer it that way.

So the true valuation, never going to be arguing about that, and that can have some pros or can be sensed there is really no way of valuing it or not prepared to hire an investment banker to do it, or you don't think the market, private or public, is going to respect what you think it is worth and this is another option.

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[28] *See generally* University of Akron School of Business Administration: Entrepreneurship Program, How to Get Financing, http://www3.uakron.edu/cba/fitzgerald/startbusiness/financing/debt.htm (last visited on Sept. 27, 2007).

This is a little bit of a recap. Private sales, pros and cons, I think the pros include flexible structures. The company can be very flexible post-sale and not subject to the scrutiny we have been talking about.[29] They are likely faster to be put together than any type of public offering.[30] No public reporting.[31] I am still in the limited shareholder group so you can still pick the partners in a private sale potentially as a seller if you choose who is going to be your buyer. Cons: there might be a lower valuation, I am not so sure. You know, future management, strategic buyer, there may be some displacement that goes on; access to future capital, not in the public market.

So if you want to go to public market for capital, you have to do an IPO at that point.[32] And probably the one that should have a star next to it, if you sell your company at private sale and you roll over, an entrepreneurial rollover the equity into the company, there is no public market liquidity,[33] so whatever shareholder agreement terms you have negotiated, that's now the terms you are going to be subject to for the next liquidity of the business,[34] which at this juncture is not within your control.

Public sale IPO, I think we hit the points here. Pros include a potentially higher multiple. Shareholder liquidities,[35] a number of bells and whistles, but it is out there. Continuing role for management, and you know once the company is public, it does have access to both the public debt and the public equity markets.[36] The cons include public scrutiny, the lockouts, and you are now subject to the whims of the market.[37]

MR. PENHALE: Yeah, you also probably tend to shift to a quarter view as opposed to the longer-term view, or at least you have the pressure to do so, which you never had to deal with before, just reporting and dealing with the analysts. On the pros, perhaps a new currency. If you are going quickly or sustaining growth, perhaps you can use your equity to finance that growth, either by financing or by using it to pay the consideration of any acquisition.

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29 *Swapping Privacy for Growth*, 68 CAN. & WORLD BACKGROUNDER 6 (May 1, 2003).

30 *Id.*

31 *Id.*

32 *See generally* Kristen Hays, *Oil Vessel is Designed to Ride Out Hurricanes: Houston-based Firm Going Public on Strength of its Innovative Platform*, HOUSTON CHRON., Aug. 27, 2007, at 1.

33 *See generally* Fred Baldassaro, *Economy, 144 A Surge Drives Private Market to Shatter Record*, CORPORATE FINANCING WEEK, March 2, 1998, at 1.

34 *Id.*

35 *See generally* Laura Slattery, *Investors Deal in Shades of Grey as IPOs Loom*, IRISH TIMES, July 21, 2006, at 7.

36 *See generally* T. Prescott Kessey, *Energy Finance 101*, OIL & GAS INVESTOR, June 1, 2003, at 5.

37 Andrea Knox, *High Costs Send Dupont Out of the Drug Business*, PHILADELPHIA INQUIRER, Dec. 15, 2000, at C01.

Although perhaps with a little less relevance these days, maybe it is a means to attract and retain personnel that you couldn't afford to have before.[38] I say a little less because there are issues, options that we won't talk about, but it is still a way to align interest in your managers with the long-term growth and viability of the business.

The cons, one that does not appear on this list, there are costs to be public. There are real-time resources and real dollar costs. If you pick up a prospectus of any Canadian company in terms of the last five years, we did a lot of income trusts. This was a booming business, and there is also a line on any performer's financial statements of administrative cost.

The average is probably a million dollars a year, some two, some 700 but paying a million dollars is a lot of money every year to take off your top line to pay to be public. Sometimes you don't think about it, but it is a real cost. It is not money you are generating.

I am happy because now I have been retained to help you in your disclosures. I probably have the lead – the best interest in serving public companies when they do disclosure stuff, but I am not a profit center for them at all. I am a real expense. My tax partners are good because they help them save money. I am just an invoice.

Why do I need to say this again? Why do I need to explain it five times, and how many risks can you possibly think somebody would have to face for an investor?

Nobody has thought of his or her business like that before, and there is risk allocation between this is what you are not allowed to do. Now, they need to worry about strike suits, or if I miss one quarter, what's going to happen? Somebody is going to sue.

MS. DELLINGER: Right.

MR. PENHALE: It is more prevalent in the United States than Canada but nonetheless an issue.

MS. DELLINGER: In the U.S., obviously, you know, the legal fees increase for companies dramatically, but that's nothing compared to the accounting fees under the new rules. So you have those issues. The equity, you know, for finance that is newly public, an issue that came up pre-going public, it would be: we don't have to worry about that.

I know theoretically it is a risk, but nothing bad is ever going to come of it, and you know, I am comfortable even if it will cost a few more dollars. Now, they had that reaction, but then they go, "Oh, it is disclosable," and call their securities attorney and have to go through a whole analysis and get 17 other people in the company involved in discussing and deciding whether

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[38] *See generally* Kansas Technology Enterprise Corporation, Initial Public Offerings, http://www.ktec.com/sec_business/section/erc/money/ipo.htm (last visited on Sept. 27, 2007).

they have an incentive in the prospectus or the 10(k) or the 10(q) about whatever the matter is, and then they have to talk to the accountants in protecting the reserve and numbers and financial statements about whatever this thing that the business owner or the business CEO prior to the IPO never would have cared about because he knew in his heart wasn't going to be a real issue.

So everything becomes a little more complex. I have a client that did a public offering about a year ago, and now they just know they need general counsel in the company, and they have a lead management team, the last thing in the world they want but they know they need. So that's the consequence of the IPO from a mere perspective.

MR. PENHALE: And it is not a big issue, but sometimes it is. It breaks your heart when you are an entrepreneur and think about it. In the recap, you sell your business or maybe will sell it twice. Maybe the valuation has gone down between the first and second time and so be it, and maybe it has gone up tremendously.

And you say, "Oh, I never should have sold it at that price the first time." But you didn't do too badly. The trouble with public companies, however good you are, if you don't have a big stake in it, you are really making money for someone else. It is no longer for you that you are –

and suddenly you become a balance to all these people that have not done anything in reality.

They just bought a piece of paper from you, and a lot of the accountability I find is what entrepreneurs have a lot of hard time with. They talk to VCs, talk to the angel. They talked to whoever was the money before, but it was someone with a face and name and was a half dozen to dozen people.

It didn't matter what, but they were someone with a name who they talked to. But now it is the market. I never met the market, but I hear about it everyday, and that's also not to mention management earnings, quarterly reporting, and the whole focus shifts from just one number four times a year, and that's how the business was managed before.

MS. DELLINGER: A lot of companies post their stock price in their lobbies for all the employees to see. It is going good. It is a great motivator, and employees have small options. But the stock is going bad, and there is not a good explanation for it. It is transparent to customers and so forth, so we sort of beat up on that point.

Recapitalization, again summary: a great opportunity for partial liquidity.[39] Have continuing investment in the company. Sell the company twice. The complex structure, having it structured once you get the right

[39] *See generally BASF Chief's Letter Makes Case for Offer Shakers Marketplace*, INT'L HERALD TRIB., May 24, 2006, at 3.

partners in place. I put it under kind of hedge strategy, that's a pro and con as I discussed.

To the extent that it is a leverage recap, a company bringing on something that is in debt potentially and debt services, by definition expenses, but, you know, if you run a spreadsheet type show, rates of return on equity, there is some point where debt dramatically increases the rate of return on equity, and it is more important where it inflows. So the trick is to get that right balance.

MR. PENHALE: You talked about debt a little bit. Now, you are dealing with a bunch of covenants you didn't have before. You know, if it is purely financed on debt, you may have someone saying, "Hey, you got pretax with X, and I am going to get the first slice of whatever you make." And suddenly, it may impede your ability to say, "What do I do in three months time or nine months or three years time when I want to build my business further, but I don't have the pre-capital on servicing debt?" That's also in there.

MS. DELLINGER: Right. Liquidity drive, who makes the decision? To the extent that the entrepreneur who grew the company on the back of venture capital funding, the venture fund will more often dictate the time line.[40] Venture funds will say we looked it to be an investment two to four years, two to five years, something like that.

It can be longer, but they are going to be looking for an exit, and that exit either is to sell the company outright or bring in another round of venture funding that does take out some of the old venture funds.

Second, whoever it is, however the company is structured, the majority owners in a venture-funded company may be the entrepreneurs, but the venture fund is really going to drive the timing.[41] The family-owned businesses, you know, the majority owners, at the end of the day can push the buttons and make the decision.

The deal terms, to the extent that the deal terms of an entrepreneur raising outside money dictated certain outcomes, quick rights, for example, on the part of the shareholder, that may drive a decision to sell the company. And then for non-venture-funded companies, basically market conditions, you know, companies that make X right now are incredibly popular in the market, it is a good time to sell.

I want to retire in three years. It is a good time to sell. Those can become the driver's on decision-making. Anthony, do you have –

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[40] *See generally* Getting Through the Initial Venture Capital Screen, http://www.amplifiernetwork.com/tabid/93/ctl/ArticleView/mid/399/articleId/276/Default.aspx (last visited on Sept. 27, 2007).

[41] *See generally* Susan Schreter, *Founding CEO Wants to be There at the Finish, Too*, SEATTLE POST-INTELLIGENCER, Dec. 2, 2005, at E1.

MR. PENHALE: No. Growth ultimately, the source of capital needs.

MS. DELLINGER: And this ties into the question you asked earlier. When do you sell? How do you make that decision? Management equity, this could be a long, you know, 17-hour discussion on tax. Luckily, Anthony, I am not going to do that nor am I competent to.

But management equity, the entrepreneur equity in a growth company at the time of the exit as we put it enjoying the successes of entrepreneurship, you look for liquidity. For cash, you look for liquidity to pay your taxes on the growth of the business. You look for liquidity to diversify your personal investments if all your eggs are in the basket of the company, and there may very well be an opportunity to continue investment options to continue to grow with the business.

MR. PENHALE: I would add one point as well. At least in Canada, when you are a private company, there is perhaps certain tax treatment afforded, for example, with options that disappear and are less advantageous when you become public or a certain transaction happens.[42]

So depending how you compensated your managers or the people you are working with, they may have a nasty surprise as a result of the transaction. So bear that in mind.

MS. DELLINGER: Yeah. And it is well before an exit strategy, and I will get this on the last slide, as an entrepreneur and management of a company you want to talk to and have advice from legal counsel and experienced tax advisors prior to making – putting your pen to any piece of paper in connection with the structure of this transaction.

One thing that is tossed out – and I am sure you have some comments – equity rollovers. A deal comes to the table, the entrepreneur and management say, "Oh, great. Buy my company, and put a little cash out and do a tax free rollover."

I will say this: nothing is ever tax-free; it is tax deferred. The tax will always catch up with you, and the trick is to try to do strategizing whether to pay the tax now or pay it later. I want to touch on taxable first and then hit a couple things on the tax question. Taxable, taxable rollovers, what does that mean?

Basically, the entrepreneur taking his or her options, taking his or her stock, cashing it out and reinvesting some or all of that money in the business, buying together with a new private equity fund, buying stock of the company, taking some cash out and putting it right back in the company.[43] It

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[42] TECHNICAL COMMITTEE ON BUSINESS TAXATION, REPORT OF THE TECHNICAL COMMITTEE ON BUSINESS TAXATION (1997) http://dsp-psd.pwgsc.gc.ca/Collection/F32-5-1998E.pdf.

[43] See generally Gary Klott, The Rules of the Game Have Changed: IRS Reform Legislation Allows Greater Flexibility When you Convert a Traditional IRA to a New Roth, CHI. TRIB., Sept. 15, 1998, at 5.

can be structured a whole lot of different ways. You may never see a penny of cash hitting the balance sheet, but you recognize the tax, and you realize you pull cash out of that deal to cover the tax liability when it hits, which is usually on, in the United States, April 15th following the transactions, or there may be other taxes that are due.

You want to be very cognizant of that time period and, again, furnish rolling money over, save enough of the cash you got out and pay the tax. Tax-free transaction. As I said, nothing is ever tax-free.

MR. PENHALE: We generally don't use the word "tax-free." We say, "No immediate adverse tax consequences."

MS. DELLINGER: That's what the lawyers think about it out there. We have the investment banker selling something out here and have to be flexible. In terms of any type of, you know, tax-free structuring, I will give you an example: you have options in company A. Company A is being bought by company B. You end up with options in company B, and you think, "Great, I now have option to purchase stock in this new company that is going to grow faster and bigger and have a lot more confidence, is going to be dramatically more valuable going forward with more assurance of some type of liquidity on my personal horizon."

You want to consider a tax break and the timing of tax liability. A couple of examples: tax break. You have a situation where right now, if you exercise that option, you would owe tax on the spread. Let's say the spread is $100 between the option to exercise price and the value. You know, your tax net U.S. federal income tax rate roughly is 35 percent at the federal side and close to 40, 42 percent with everything else.

You paid $35 on that, but now you own a share of stock in that new company, and you experience capital gains rate on any additional depreciation at roughly a 15 percent rate. You should be able to run through some type of spreadsheets and projections and see whether you are better off recognizing that tax credit now, having less money to reinvest in the new stock because you paid your tax but then having future depreciation at a dramatically lower tax rate.

Second, let's say you have options. Your options are expiring. The company is not selling. There is no liquidity event. You can exercise your option. You roll it over into the new company. Now, instead of that $100, the company has been successful, now let's say that gain is $200. You have another six months left to exercise the option.

The company is likely to have a liquidity event in two years. Okay. What do you do? Do you let it expire and lose that $200 in value, or do you exercise your option, not just for that one share, but for all the shares and now have a very significant tax event but no cash because now you own equity?

But you have no way of selling it because you don't have a liquidity event, and that's being between a rock and a hard place. So I counsel clients in any liquidity event, think long and hard about choosing to defer that tax liability if you don't have complete control on the ability to raise cash concurrent with the timing of any tax liability, and think long and hard about the tax rates.

Everyone talks about tax rates may change. They don't change that much. They have been in the same ballpark for a long time and fluctuate in margins. Capital gain rates historically will continue to be in my prediction lower than ordinary tax rates.

MR. PENHALE: And the same would be true in Canada with the added nuance that, if we are talking private company as opposed to public company, you may lose advantages or include it in the income deductions or lose some capital gain, depending when that conversion would be done, and that would be important to speak to your tax advisors just to make sure you are not setting up yourself with the nightmare situation where you have no cash and taxes.

MS. DELLINGER: I think the next slide covers what I crossed out before and nothing new here, but you always want to be – management equity, you want to think long and hard how you do it and look at the numbers, look at the tax rates, run those numbers ahead of time, and don't think tax free is the way to go because it is definitely not tax free.

It is just a question of when. I guess the last thing I want to toss out there – and these are a couple of U.S. issues – any time you're dealing with entrepreneurs, equity in a business, management equity in a business, any type of exit, private company or public company – talk to that experienced tax advisor and legal advisor. 409 and legal issues are what we call the new "deferred compules."[44]

Let me just say the summary that my law firm has done on this is enough to fill a notebook this big, and that's a summary. And all the rules and regulations aren't out yet, and it has been around for two years. So it is a nightmare. Okay.

The 280(g) issues, these are references to the tax law.[45] These are payment concerns, and you think parachute payments, you make $50 million a year and up, no? The standard is much lower than that, and then good tax planning in terms of the tax effect on any potential tax shelter that might be out there, it is something the tax consultant wants to think about.

MR. PENHALE: And if the deal only exists because of tax laws or you have, more importantly, there is no reason to do any kind of transaction, you

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[44] *See generally* Claude Solnik, *Another Glance from Big Brother*, LONG ISLAND BUS. NEWS, May 25, 2007.

[45] *See generally* Executive Compensation, 61 EMP. BENEFIT PLAN REV. 12, June 1, 2007.

want to look long and hard. At least in this, in Canada, it disappears at least when the authorities look at it.

MS. DELLINGER: Whenever people get tax advice there are about three levels of tax advice. One is: this is absolutely consistent with the Tax Code. The second category is: it is a little aggressive. It is an audit risk. If you get audited, it could be challenged. It could be restructured, and X, Y, Z could happen, which would not be quite as favorable as what we are hoping.

The third category is what I call tax fraud. You simply can't justifiably take that position and file your return, but if you are caught, you are in big trouble. I think that sort of comes under the tax plans.

MR. PENHALE: You have nuances like will, should, could. You have got a filing position but no chance in hell to succeed. Best aspect is to ask the tax advisor for the glossary and what they mean in their opinion.

MS. DELLINGER: Those are all really sort of semi-prepared remarks. I would like to open it up for questions.

MR. PENHALE: Just before you do so, I would just draw one comment on going public. Don't forget, at least in Canada, you are going to become liable for what's in the prospectus, and much like in the U.S., also, we have secondary market liability.[46] So whenever you add a sentence in the public disclosure document that you thought was great when you put it in the confidential memorandum and you are trying to put your company in the best light possible, they don't have to even show they read it, that they relied on it.

It is in the book and they relied on it, then you are liable if it is a misrepresentation. It is a long, hard exercise before you start going public, or once you are public, pay attention to what you are saying because it may be wrong, and if it is wrong, it may cost you.

PROFESSOR GORDON: I would like to open it up for questions.

MR. PENHALE: Yes.

DISCUSSION FOLLOWING THE REMARKS OF ANTHONY PENHALE AND ELIZABETH DELLINGER

MR. GROETZINGER: What's your thought on earn net clauses if a seller has a business and neither party can agree on the current fee price and agree on some downstream multiple of earnings? What would you recommend?

MS. DELLINGER: I think they are great. I think that if you have a company and you have a willing buyer and seller but can't just get together on price and earn out a wonderful way to bridge that gap and align the two interests, that being said, there are a couple of nuances.

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46 Gloria Gonzalez, *Quebec Latest Province to Mull Corporate Disclosure Law*, 41 BUS. INS. 31, July 30, 2007, at 4.