

# RAISING CAPITAL: SECURITIES LAW AND BUSINESS CONSIDERATIONS

## A Collaborative Effort

Minnesota Department  
of Employment and  
Economic Development

Oppenheimer  
Wolff &  
Donnelly LLP

**Raising Capital: Securities Law and Business Considerations** is available without charge from the Minnesota Small Business Assistance Office, 1st National Bank Building, 332 Minnesota Street, Suite E200, St. Paul, Minnesota 55101-1351, telephone (651) 296-3871 or 1-800-657-3858 toll free; or from Oppenheimer Wolff & Donnelly LLP, at Plaza VII, 45 South Seventh Street, Suite 3400, Minneapolis Minnesota 55402, telephone (612) 607-7000 (Attention: Director of Marketing).

**RAISING  
CAPITAL:  
SECURITIES LAW  
AND  
BUSINESS  
CONSIDERATIONS**

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A Collaborative Effort

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**Minnesota Department of Trade and Economic Development  
Oppenheimer Wolff & Donnelly LLP**

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## SECTION ONE: OVERVIEW

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The process of raising capital to fund a start-up or an early stage developing business can be a very complex and intimidating experience for an entrepreneur. Yet, it is an experience an entrepreneur needs to confront in order to start or grow his or her business. This booklet is intended to acquaint entrepreneurs, who are considering raising capital for their businesses, with the variety of legal and business issues that should generally be addressed. We have written the booklet for entrepreneurs and other business people rather than for lawyers.

Accordingly, we would like to mention a few precautions to keep in mind as your review this booklet:

- *First*, of necessity, some rather complex legal topics are summarized in this booklet and distilled to fit into the space and content limitations we were under. The reality is that raising capital is an area that you will need to seek expert outside advice—legal, accounting and perhaps investment banking.
- *Second*, failure to comply with federal and state securities laws can have significant consequences—including criminal penalties—for those involved. This statement is not intended to scare any one, but rather to emphasize that when a business raises capital it needs to work with experienced legal counsel who is familiar with federal and state securities laws.

- *Finally*, in choosing your advisors to assist in your capital raising, including lawyers, accountants and investment bankers, we would strongly urge entrepreneurs to look for advisors who are not only technically competent but also have been through the process many times before. It is the practical, as well as technical experience of your advisors that we believe will prove critical to the success of your efforts to navigate through the capital raising experience.

With those precautions out of the way, here is a brief overview of the topics which we will cover:

- *Section Two: Preparing the Company*—What should an entrepreneur do to get ready to raise capital for the first time? What should be included in a well-done business plan? What does it mean when an investor says he wants to perform “due diligence” on the company? This chapter is intending to provide a practical overview of what a business should do to get ready to raise capital and what to expect once the process begins.
- *Section Three: Securities Law Considerations*—What are “securities laws” and why is it important to comply with them when a business is raising capital? Do the legal requirements change depending on how much capital is being raised? What is the point of the securities laws and who are they trying to protect? This chapter is intended to provide an introduction and overview of the federal and state laws and regulations (including exemptions) which govern the raising of capital through the sale of securities.

**Editor’s Note.** At the time of this writing, there is a movement underway to substantially revise the Minnesota Securities Act. While it is expected that the state law exemptions discussed in this chapter will remain effective, other exemptions may become available if the proposed revisions are enacted.

- **Section Four: Venture Stage Financing**—What is the process for obtaining venture capital financing? What are venture capital investors typically looking for in their investments? What are some of the terms that venture capitalists will likely require be part of the deal? This chapter provides an overview of what to expect if you are seeking an investment from venture capital sources.
- **Section Five: Private Equity Offerings**—What is a “private placement”? What is the process to obtain capital through a private placement? Why does the private placement memorandum need to have so many “risk factors”? This chapter provides an in depth look at the process and issues involved in conducting a private placement of debt or equity securities.
- **Section Six: Strategic Alliances**—What is a “strategic alliance” and how does it provide capital to an early-stage company? What are some of the pros and cons of entering into a strategic alliance? What are some of the key elements of a successful strategic alliance? This chapter discusses one of the alternative methods of raising capital—seeking a joint venture or strategic alliance with an established company.
- **Section Seven: Initial Public Offerings**—What are the advantages and disadvantages of “going public”? How do you select an underwriter and how is the underwriter typically compensated? What is the process of doing an “IPO”? This chapter explores the ins and outs of the “IPO” process, i.e. “going public”.

**Editor’s Note.** At the time of this writing, the staff of the Securities and Exchange Commission is considering a significant overhaul to the IPO process. Certain proposed rules are discussed in this chapter, but it is important to recognize that the final rules may be substantially different

from the proposed versions. It is generally expected that the Commission will adopt the final rules sometime during 2005.

- ***Section Eight: Loans, Leases, Grants and Other Financial Resources***—Suppose you don't want to dilute your equity ownership. What are some non-equity alternatives to raising capital? This chapter reviews a variety of alternative sources of non-equity capital—such as commercial loans, lease financings and governmental grants.
- ***Section Nine: Private, Public and Offshore Offerings on the Internet***—How has the Internet impacted raising capital efforts? Do the regulators permit entrepreneurs to use the Internet to distribute information about their company in order to raise capital? Are their websites which investors can go to for investment opportunities? This chapter summarizes how the Internet is currently being used to raise capital and what legal restrictions apply.

## **SECTION TWO: PREPARING THE COMPANY**

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Almost every entrepreneur or business owner who has raised capital for his or her company has found that raising capital was far more difficult, expensive and time-consuming than anticipated. For many entrepreneurs and business owners, raising capital becomes a full-time job in addition to the full-time requirements of running the business.

Entrepreneurs and business owners should assume that every aspect of the business will be scrutinized carefully each time that capital is raised. This scrutiny may come from investors themselves (particularly venture capitalists), from placement agents who assist in the private placement of securities, from underwriters of registered offerings, and from the company's own advisors such as attorneys and auditors. Although often perceived by companies as an obstacle to raising capital, this scrutiny or due diligence can give the company and its directors and executive officers great protection against claims of fraud or misrepresentation.

### **PREPARING A BUSINESS PLAN**

Entrepreneurs seeking to raise capital should develop a written business plan that demonstrates to lenders and investors that the entrepreneurial team has thought through the key drivers of the venture's success or failure. A business plan is a distinct document which is separate from other documents which will need to be

prepared in order to raise capital—such as a private placement memorandum or a prospectus (both of which are discussed in later sections of this book). Numerous books and articles have been published on the topic of business plans with differing opinions as to the proper form and content. At a minimum, a business plan should describe:

- the business opportunity, including a market analysis reflecting a deep knowledge of the industry and the distinguishing characteristics of the primary target market segments;
- the company, its core competencies, competitive advantages and stage of development;
- the company's products or services, key aspects of its intellectual property, its research and development activities and, if applicable, its regulatory history and anticipated pathways;
- the company's sales and marketing strategies, distribution channels, promotional activities and sales force;
- the ownership of the company;
- the people who will be managing the business and any other key employees or consultants, with highlights about their backgrounds and business experience;
- the factors that may influence the success or failure of the business; and
- relevant financial data and analysis which may include a description of anticipated research and development or regulatory milestones and the amount of capital necessary to reach each of those milestones.

A written business plan is usually necessary for a company to obtain debt or equity financing, and it can also serve as a guide for a company's development. Writing a business plan helps the entrepreneur identify the strengths and weakness of a new business venture and develop a strategy for the company's future growth. The business plan can also provide a framework for turning ideas into actual business practices, products and services.

Business plans tend to be overly optimistic and often contain highly unrealistic financial projections. While sophisticated investors, such as venture capital firms, are cognizant of this tendency and usually discount exaggerated statements, the entrepreneur should always present an accurate and realistic business plan. If a business plan is distributed to prospective investors in a capital raising effort, as is often the case, the entrepreneur could be subject to liability under the securities laws for any fraudulent statement. The entrepreneur is well-advised to have his or her business plan reviewed by a competent securities lawyer before giving it to prospective investors.

## **EQUITY STRUCTURE CONSIDERATIONS**

Raising equity capital involves selling additional shares of a company's stock to new investors, who will become shareholders in the company. Before selling equity securities and increasing the number of shareholders, the company's founders should consult with legal counsel to determine whether there are any corporate actions requiring shareholder approval that the company should take while there are still a small number shareholders and shareholder approval is relatively easy to obtain. State corporation statutes, for example, generally require shareholder approval to amend a company's articles of incorporation, change its capital structure or undertake certain other corporate restructurings. In addition, the federal tax laws require shareholder approval of certain stock option plans in order for certain types of options to be eligible for favorable tax treatment.

The company's equity structure (i.e., the way ownership in the company is divided up and represented) should be designed to achieve maximum flexibility in structuring future equity investments. The form of business entity and its jurisdiction of organization should also be reviewed before undertaking a significant capital raising transaction. The company may have been formed as a C corporation, an S corporation, some form of partnership, a limited liability company, or some other entity. The advantages and disadvantages of each type of entity vary based upon the jurisdiction of organization. In addition, an entity's organizational documents could limit the particular type or amount of securities that it may issue, or the issuance of a particular type or amount of securities could have adverse tax consequences or other implications for the company or its owners.

## **PREPARING FOR THE DUE DILIGENCE PROCESS**

Entrepreneurs who expect someday to seek capital financing should be mindful during the early stage of their business of the legal and business "due diligence" process associated with raising capital. "Due diligence" refers to the detailed examination of a business which is performed by sophisticated investors, such as venture capitalists and investment bankers before they will make an investment or attempt to raise capital for a company. Even if financing may not be sought for several years, it is generally easier and cheaper to deal with issues appropriately at the company's development stage rather than later when the financing is imminent. In these early stages, the entrepreneur, with the assistance of competent counsel and financial advisors, should pay careful attention to details in the following areas:

- Maintaining accurate and complete corporate records, such as charter documents, bylaws, and minutes of meetings of the board of directors and shareholders;



- Maintaining appropriate financial records;
- Protecting intellectual property (trade secrets, patents, trademarks);
- Compliance with laws in a variety of areas, including corporate and business licensing, securities, employment, workers' compensation, ERISA, tax (federal, state, local, sales and use, and withholding), environmental, zoning, restrictions on investment in the U.S. by foreign persons, and import/export;
- Avoiding burdensome contractual commitments that may reduce flexibility or be difficult to meet or terminate;
- Developing appropriate forms of standard contracts, purchase orders and invoices; and
- Capitalization (the manner of structuring the company's debt and equity)—the capital structure should permit maximum flexibility for various methods of raising capital.

## **LEGAL DUE DILIGENCE VS. BUSINESS DUE DILIGENCE**

Business owners should anticipate both business and legal due diligence to be conducted in connection with the financing. Business due diligence will involve a careful analysis of the company's business plan, financial statements, products, technology, markets, competition and management team. Counsel for the investors will conduct the legal due diligence.

## PRINCIPAL CONCERNS OF LEGAL DUE DILIGENCE

Legal due diligence will usually focus on several principal areas of concern:

- **Ownership and Protection of Technology.** The principal assets of many start-up companies are technology and the founders' ability to develop and market the technology. Therefore, prime concerns will be establishing the ownership of technology, ensuring that it does not infringe other technology and verifying that it is not being infringed by others. If a patent is vital to the company's business, the company should have competent patent counsel available to advise it and, if required, to deliver a legal opinion.

If the entrepreneur developed the technology while employed by another company, he or she should be prepared to establish that the technology was developed on his or her own time without the facilities or resources of the employer and that there has been no misappropriation of trade secrets of the former employer. In addition, the ability of the entrepreneur to develop and market the technology may be restricted if the entrepreneur has executed any non-competition or confidentiality agreements with former employers. Any necessary transfer of ownership of technology from the entrepreneur to the corporation should be properly documented.

- **Employees.** Closely related to concerns about protection and development of technology are concerns relating to arrangements with employees in sensitive areas.

Employees, particularly those involved in research and development or marketing, should have executed agreements regarding confidentiality, ownership of inventions and, if possible, non-competition. Minnesota does not have a statute

directly dealing with non-competition agreements. Generally, such agreements in the employment context will be enforced by the courts if they are reasonable in scope (i.e. coverage) and duration, and are supported by adequate consideration.

Employees should be carefully screened to ensure that they have not misappropriated technology or trade secrets or violated non-competition agreements with former employers. A company can also become liable to a former employer if it hires an employee to entice customers from the former employer.

Equity incentives for employees should be carefully structured to vest over time to avoid problems with employees leaving after a short period of time with a significant equity position.

- **Issuances of Securities.** Compliance with securities laws in prior stock issuances is of great importance because violations may result in rescission rights for the early investors and future investors generally will not be willing to allow their investments to be used to rescind prior sales. Investors may also be concerned that their investment not be used to repay early capital contributions made in the form of loans.
- **Contractual Commitments.** Counsel will generally review all of the material contracts of the company for various purposes, including:
  - the verification of contractual rights claimed by the company (e.g., ownership of technology or exclusive rights, employment terms for key employees, sources of scarce materials, leases of facilities and equipment, and insurance);
  - avoidance of potentially burdensome contractual commitments of the company that are not easily terminable; and

- ensuring that contractual arrangements between the company and principal shareholders and other insiders and affiliates are fair and reasonable.

## **CONFIDENTIALITY AGREEMENTS BETWEEN THE COMPANY AND THE POTENTIAL INVESTORS AND THEIR REPRESENTATIVES**

To lessen the likelihood of undesired disclosure of sensitive technology and trade secret information, it may be wise for companies to request that potential investors and their representatives execute confidentiality agreements before disclosing confidential and/or proprietary information to them. Whether such agreements are appropriate will depend on the level of sensitivity of the information to be disclosed.

## **THE ENTREPRENEURS' DUE DILIGENCE**

Entrepreneurs should also be careful to conduct their own due diligence review of potential investors. Investors vary widely in areas of expertise, types of desired investments and contact with other potential investors. In particular, potential venture capital investors should be thoroughly evaluated to ensure that they have a sound reputation and that they will bring not only their initial investment of money, but also necessary managerial skills and sufficient resources and contacts to help support future financing rounds. Venture capital investors should be chosen carefully.

It may also be necessary for the company to verify the status of investors as “accredited investors” (see discussion below under “Investors” in Section Five of this book) for federal and state securities laws purposes to take advantage of exemptions from registration.

## **SECTION THREE: SECURITIES LAW CONSIDERATIONS**

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### **THE IMPORTANCE OF SECURITIES LAW COMPLIANCE**

A company that is attempting to raise funds by issuing securities needs to comply with federal and state securities laws. Securities laws regulate the manner in which all securities, including stock and debt instruments, can be sold. Securities laws may also dictate the amount of securities that can be offered and the persons to whom securities can be offered in a particular offering.

Securities laws are exceedingly complex and technical. To add to the complexity, federal and state securities laws are not completely consistent with each other, and compliance with federal securities laws does not assure compliance with applicable state securities laws. In addition, a particular transaction may require a business to comply with the securities laws of several states, all of which may be different from each other. Compliance with applicable federal and state securities laws is important even with respect to sales of securities to friends or family members, which are not uncommon at the start-up or development stages of a business. A failure to comply with these securities laws can result in significant penalties for both a company and its directors and officers. Some of these penalties include:

- Imprisonment;
- Monetary fines;

- Refund of amounts paid by investors; and
- Prohibition on conducting future sales.

**These materials have been prepared to provide entrepreneurs and other business owners with a general understanding of securities laws and some of the procedures that are necessary to comply with them. However, businesses interested in raising capital through the sale of securities should seek competent professional advice, both legal and financial, prior to commencing any capital raising activities.**

## **OVERVIEW OF SECURITIES LAWS REQUIREMENTS**

As a general rule, in order to comply with federal securities laws, a person selling any security, must either (i) “register” such sale with the Securities and Exchange Commission (“SEC”) or (ii) identify a specific exemption that allows such sale to be conducted without registration. Note that this general rule applies to all sales of securities by all persons and companies. Companies are often surprised to learn that they have sold a security when engaging in seemingly innocuous activities. This surprise is attributed to a lack of understanding of the term “security.” Most people think a security is either a share of stock or a bond. However, the definition of security for purposes of federal securities laws is quite broad. Section 2(1) of the Securities Act of 1933 (the “Securities Act”) sets forth a definition of the term “security,” and the term includes, in addition to stock and bonds, any note, evidence of indebtedness, option or investment contract. This broad definition of security means that virtually any type of instrument in which the investor has a reasonable expectation of profit solely as a result of the investment of money will be subject to the rigor of the federal securities laws, regardless of the structure of the investment. For example, a company that sold investors strips of land in an orange

grove and then entered into contracts with the investors to cultivate the land and harvest the oranges on behalf of the investors was found to have engaged in the sale of a security (and to have violated a multitude of federal and state securities laws).

Another consequence of the broad definition of a security is that a company that borrows money from a founder (or, as is often the case, from a relative of a founder) and issues a promissory note as evidence of indebtedness to the person making the loan has engaged in the sale of a security for purposes of federal securities laws. Fortunately, this type of transaction usually does not result in a violation of federal securities laws because the sale of the note is often exempt from the registration requirements under Section 4(2) of the Securities Act. However, this example illustrates how a company can unwittingly run afoul of securities laws which, as alluded to earlier, can have significant adverse effects on the company and its officers. Other common types of securities that newly formed companies often sell to raise capital include:

- **Common Stock.** Shares of common stock evidence a proprietary interest in the issuing company and typically give the holder voting rights (although common stock can be both voting or non-voting). Common stock is typically the last class of securities on which payments will be made in the event of liquidation of a company and affords the holder little protection other than voting rights. For this reason, venture capital firms will seldom be interested in receiving common stock of a company in which they invest.
- **Preferred Stock.** Like common stock, shares of preferred stock evidence a proprietary interest in the issuing company. However, unlike common stock, shares of preferred stock often afford the holders some protection through class voting rights, preferred dividend rights and liquidation rights. The attributes of preferred stock vary widely and are often heavily negotiated between investors and the issuing companies. The

relative bargaining positions of a company raising money and potential investors will greatly influence how many (or how few) protective provisions will be included for a particular class of preferred stock. Most classes of preferred stock provide for the conversion of the preferred stock into common stock at the option of the investor and the number of shares of common stock that are issuable upon conversion of the preferred stock often increases if the company conducts future offerings at lower prices.

- **Promissory Notes.** A promissory note is a promise to pay someone a fixed amount of money by a certain date or upon the occurrence of certain events (e.g., the sales of a company reaching a certain threshold). Promissory notes usually bear interest at a stated rate, with the interest being payable at some fixed interval or upon repayment of the principal. Promissory notes can be secured or unsecured. A secured note means that the note holder is granted a lien on the assets of the company issuing the note and if the note is not paid on its due date, the note holder is entitled to foreclose the pledged assets. If a company defaults on an unsecured note, the note holder must sue for damages and will only be paid if the company has sufficient unencumbered assets to pay the amount of the note. A promissory note can be either payable at the request of the holder (a demand note) or payable in one or more installments on an agreed upon date or dates (a term note). A promissory note will often provide for an early repayment date in the event that the issuing company fails to meet certain liquidity tests or if the company takes certain prohibited actions that are specified in a note purchase agreement.
- **Convertible Notes.** A convertible note is a promissory note that, by definition, is convertible into equity securities of the issuing company (usually common stock). Most convertible notes are structured so that they can be converted at any time at the option of the investor. In addition, convertible notes are



usually automatically converted into common stock if a company conducts an initial public offering of its stock.

- **Options/Warrants.** An option or a warrant entitles the holder to purchase securities from a company in the future for a certain price. Early-stage investors often receive warrants from the company in which they invest, with the number of shares covered by the warrant equal to a percentage of the number of shares purchased (often between 50% and 100%) with a strike price often equal to the price at which the investor is sold stock of the company. For example, a venture capitalist who purchases 10,000 shares of preferred stock at \$1.00 per share might receive a warrant to purchase 5,000 shares of common stock of the company for \$1.00 per share at any time within the five year period following investment. Early stage companies who are trying to preserve cash often use warrants to partially compensate consultants or other third parties who are providing critical services to the company.
- **Units.** A unit is not a security itself but is often used to describe the offering of two or more types of securities that are sold together. For example, a company may offer to sell units that consist of 100 shares of preferred stock and a warrant to acquire 50 shares common stock.
- **Limited Liability Company Interests.** The owners of a limited liability company are referred to as members and the ownership rights are evidenced by membership interests. In Minnesota, membership interests are very similar to common stock. Members generally have voting rights based on the number of membership interests they hold. In addition, members typically have participation rights upon dissolution of the company.

These types of securities are the most common types of securities sold by companies. However, as noted above, securities laws

cover transactions by all persons and entities, not just companies. In fact, the selling of stock of publicly traded companies by private investors for their own personal investment accounts is probably the most common type of transactions involving securities. These types of sales are exempt from registration under Section 4(1) of the Securities Act which exempts “transactions by any person other than an issuer, underwriter, or dealer.” However, a company seeking to raise funds by selling one of the types of securities described above or any other type of security cannot avail itself of this exemption and therefore, as stated earlier, must either (i) register the sale with the SEC or (ii) find a specific exemption from registration under the Securities Act.

The registration process under the Securities Act is often a time consuming and expensive process. Section Seven of this book discusses in more detail the process involved in conducting a public offering through the registration process. Many companies, including those at an early stage of their development, are not able to comply with the registration requirements or are otherwise not suitable for registration of a sale of securities. As a result, finding exemptions from registration is an extremely important part of capital raising activities. An exemption may be granted where sales of securities are deemed not to need the protection of registration, either because the purchaser of the security is deemed not to need the protection of the securities laws or because the capital raising activity is being conducted in such a manner that registration is not necessary to protect the interests of the public.

The particular exemption that can be used in a given situation is dependent upon a number of factors. These factors include:

- The amount of money that is to be raised;
- The number of investors being targeted;
- The types of investors being targeted; and

- The amount of information about the business that can be furnished to investors.

After these factors have been evaluated, the number of exemptions available, if any, may be limited. The ability to conduct a securities offering may further be limited by the fact that an exemption that is available under federal securities laws may not be available in a particular state in which a business intends to sell securities. The next section of this chapter looks at the most commonly used federal exemptions and evaluates some of the major criteria that must be satisfied in order to use each of them. The Securities Act contains detailed and complex provisions for these exemptions. A full explanation of the operation of these rules is beyond the scope of this book. However, the overview of each exemption that is provided should provide business owners with a general understanding of what exemptions from registration are available for a particular offering.

## **PRIVATE OFFERINGS**

The most common exemptions used by entrepreneurs and businesses for early-stage capital raising are the “private placement” exemptions. Private placement exemptions are often utilized when a relatively small amount of money is being raised from a limited number of investors. The private placement exemptions consist of Regulation D and Section 4(2) of the Securities Act, which are described below.

### **Regulation D**

The substance of Regulation D is contained in three separate rules of the Securities Act, Rules 504, 505 and 506. Each of these rules allows a company to raise different amounts of money, and each contains different requirements that must be complied with when conducting an offering under such rule. A comparison of these rules is set forth in the table below.

|   | <b>Rule 504</b>   | <b>Rule 505</b>   | <b>Rule 506</b>   |
|---|---|---|---|
| <b>Offering Amount Limitation:</b>        | \$1,000,000<br>(during any 12 month period)                           | \$5,000,000<br>(during any 12 month period).                          | Unlimited   |
| <b>Number of Investors:</b>               | Unlimited   | Unlimited accredited investors;<br>up to 35 non-accredited investors  | Unlimited accredited investors;<br>up to 35 non-accredited investors  |
| <b>Limitations on Types of Investors:</b> | None  | None  | Investors who are not accredited must be “sophisticated”              |
| <b>Limitations on Issuers:</b>            | Must not be a reporting company                                       | None  | None  |
| <b>Information Requirements:</b>          | None  | Non-accredited investors must be furnished specified information      | Non-accredited investors must be furnished specified information      |
| <b>Filing Requirements:</b>               | Form D must be filed with the SEC within 15 days after the first sale | Form D must be filed with the SEC within 15 days after the first sale | Form D must be filed with the SEC within 15 days after the first sale |
| <b>Solicitation Restrictions:</b>         | General solicitation permitted only in limited circumstances          | No general solicitation permitted                                     | No general solicitation permitted                                     |

A key definition embodied in Regulation D is the term “accredited investor.” An accredited investor is generally a high net worth individual (i.e., an individual with a net worth of at least \$1,000,000 or an annual income of at least \$200,000 or a company with at least \$5,000,000 in assets). Directors and executive officers of a company are also “accredited investors” for purposes of acquiring securities from such company.

As indicated in the table above, the concept of an “accredited investor” is important for two reasons. First, both Rule 505 and Rule 506 allow sales to be made to an unlimited number of unaccredited investors. This is particularly noteworthy for offerings made under Rule 506, which has no limitation on the offering amount, because by targeting a large number of accredited investors, a substantial amount of money can be raised. Secondly, if securities are sold to a non-accredited investor under either Rule 505 or Rule 506, the investor must be furnished with specific information about the business. The amount of information that must be furnished is dependent upon the size of the offering. However, regardless of the size of the offering, some audited financial information will need to be provided to the non-accredited investor. The cost of preparing audited financial statements can be prohibitively expensive for businesses. Therefore, most businesses conducting an offering under Rule 505 or Rule 506 will sell only to accredited investors.

It is important to note that Regulation D, like all exemptions from registration, is only an exemption from registration and does not provide an exemption from other federal and state laws. Transactions under Regulation D remain subject to the anti-fraud, civil liability and other provisions of the federal securities laws. Accordingly, regardless of the requirements of any particular exemption, businesses should always consider the appropriateness of full and complete disclosure of all material information regardless of the requirements of Regulation D. If there is some materially adverse information about a business that

has not been made public, such information should be disclosed to investors prior to a sale of securities. If such information is withheld, a purchaser may be able to rescind the transaction at a later date.

Finally, as is the case with all exemptions under federal securities laws, complying with Regulation D will not eliminate the need for a company to comply with applicable state securities laws. This caveat is extremely important with respect to Rule 504. Although many states do not require registration for an offering conducted under Rule 505 or Rule 506, very few have exemptions for offerings conducted under Rule 504. This has the practical effect of limiting the ability of a company to conduct an offering under Rule 504, whereby a large number of investors each contribute relatively small amounts of money, because such an approach would likely require registration in one or more states.

## **Section 4(2)**

Under Section 4(2) of the Securities Act, a transaction by an issuer “not involving a public offering” is exempt from registration. Unfortunately, Section 4(2) does not provide any guidelines as to what does and does not constitute a “public offering.” While a company can assure itself of compliance with federal securities laws by following the specific rules set forth in Regulation D, a company that avails itself of an exemption under Section 4(2) can not look to a set of requirements that must be complied with to assure compliance with federal securities laws.

A company seeking to determine whether an offering will be exempt from registration under Section 4(2) will need to evaluate number of factors which, although routinely addressed by courts, seldom lead to a definitive answer as to whether an offering is a “public offering” under Section 4(2). Different courts emphasize different factors critical to the Section 4(2) exemption, no single one of which will necessarily control. These factors are simply

used as guidelines. The five factors given the most weight in this determination are:

- (i) offeree qualification (i.e., whether the investors are accredited or not);
- (ii) manner of offering (i.e., whether the company engaged in advertising or other promotional activities);
- (iii) availability and accuracy of information given to offerees and purchasers (i.e., whether the people to whom the company proposes to sell securities to have access to basic financial information about the company);
- (iv) number of offerees and number of purchasers (i.e., whether the company solicited investment from a large group of people); and
- (v) absence of intent to redistribute (i.e., whether the people to whom the company proposes to sell securities have an intention to hold the securities for investment purposes (generally a minimum holding period of 24 months)).

Generally, the fewer the number of offerees and the more current the information available to, the greater the likelihood that an offering will not be considered a “public offering.” Due to the uncertainty about whether any particular offering will constitute a public offering, Section 4(2) is usually not an exemption that companies rely upon when conducting a securities offering.

## **OTHER OFFERINGS**

In addition to the private placement exemptions, there are several other exemptions available to companies that wish to raise capital without going through the registration process. Some of these exemptions are summarized below.

## **Section 4(6) – Accredited Investor Offerings up to \$5 Million**

Section 4(6) of the Securities Act exempts transactions involving offers and sales of securities by a company under the following circumstances: (a) the offers and sales are made solely to one or more accredited investors; (b) the aggregate offering price does not exceed \$5 million; (c) there is no advertising or public solicitation; and (d) the company files a Form D with the SEC.

## **Regulation A – Unregistered Public Offerings up to \$5 Million**

Regulation A provides an exemption from registration under the Securities Act for certain offerings not exceeding \$5 million.

Regulation A is available to corporations, unincorporated associations and trusts and individuals. Regulation A is not, however, available to investment companies or a development stage company that either has no specific business plan or purpose, or has indicated that its business plan is to merge with an unidentified company. Regulation A is also unavailable to companies filing reports under the Securities Exchange Act of 1934, as amended (the “Exchange Act”).

Although Regulation A is technically an exemption from registration, the consequences of relying upon it are in fact similar to those encountered with a registered offering. The similarity arises from Regulation A’s requirement that an offering circular be prepared and filed with the SEC and furnished to investors. Regulation A offering circulars contain much of the same information as is required in a registration statement, and requires a significant amount of time to prepare. For this reason, Regulation A is not often used by most start-up companies looking to do an early stage financing round. Companies typically use Regulation A when (i) looking to raise funds from a large group of non-accredited investors or (ii) selling securities to a large number of their employees.



## **Section 3(a)(11) – Intrastate Offering Exemption**

Section 3(a)(11) of the Securities Act exempts from registration any offering conducted entirely within the state where the company raising funds is incorporated and doing business. Rule 147 provides objective and rather stringent requirements for determining the availability of the Section 3(a)(11) exemption. These requirements state that for the Section 3(a)(11) exemption to be available:

- 80 percent of the company's consolidated gross revenues must be derived from the state in which the offering is conducted;
- 80 percent of the company's consolidated assets must be located within the state in which the offering is conducted;
- 80 percent of the offering's net proceeds must be intended to be used, and actually used, in connection with the operation of a business or real property, the purchase of real property located in, or the rendering of services, within the state in which the offering is conducted;
- the principal office of the company must be located in the state in which the offering is conducted; and
- during the offering period and for a period of nine months from the date of the last sale by the company, all resales of the securities purchased during the offering must be made only to persons resident in the state.

Because of the difficulty of complying with all of the requirements of Rule 147, and the fact that state registration requirements must also be complied with, companies do not typically rely on the intrastate offering exemption.

## **Regulation S – Offshore Offerings**

In general, the registration requirements of the Securities Act apply only to offers and sales made in the United States. Regulation S creates certain “safe harbors” for offshore offerings. A meaningful discussion of these resale safe harbors requires a discussion of detailed and complex rules and is beyond the scope of this booklet.

Companies considering using the exemption available under Regulation S should carefully evaluate whether such an offering is appropriate to their needs. Significant precautions must be taken to ensure adherence to the limitations and restrictions of the applicable rules. As a result, securities offered pursuant to Regulation S are commonly sold at prices significantly discounted from the public or actual market price of a company’s security. Also, the SEC is becoming increasingly skeptical of the validity of any safe harbor where a Regulation S transaction appears to be structured as a way to avoid registration or the resale limitations on securities sold in a previous transaction. Thus, any offering pursuant to Regulation S must be timed so that integration issues and other questions are not raised relating to a previous offering.

## **EXEMPTIONS FROM REGISTRATION IN MINNESOTA**

A company selling securities to residents of the state of Minnesota must comply not only with federal securities laws, but the securities laws of the state of Minnesota as well. The securities laws of Minnesota require the registration with the Minnesota Department of Commerce of all offers and sales of securities made to residents of Minnesota unless a particular exemption is available. If registration is required, it should be noted that Minnesota is a “merit” review state not a “disclosure” only state.

The most frequently used exemptions from registration in Minnesota are set forth below. It is important to note that at the time of this writing, there is a movement underway to substantially revise the Minnesota Securities Act and the exemptions from registration. While it is expected that the exemptions from registration discussed below will remain effective, other exemptions may become available if the proposed revisions are enacted.

### **Isolated Sales**

Isolated sales of securities in Minnesota are exempt from registration. No person may make more than ten sales of securities of the same company during any period of twelve consecutive months pursuant to this exemption. In the case of sales by a company (except sales of securities registered under the Securities Act or exempted by Section 3(b) of the Securities Act), the seller must reasonably believe that all buyers are purchasing for investment and the securities must not be advertised for sale to the general public in newspapers or other publications of general circulation or otherwise, or by radio, television, electronic means, or similar communications media, or through a program of general solicitation by means of mail or telephone.

### **Institutional Investors**

Minnesota provides an exemption for any offer or sale to a bank, savings institution, trust company, insurance company, investment company, pension or profit sharing trust, or other financial institution or institutional buyer, or to a broker-dealer, whether the purchaser is acting for itself or in some fiduciary capacity.

## **Limited Offerings**

Sales by a company to no more than 25 persons in Minnesota are exempt if the following conditions are met:

- The company reasonably believes all the buyers in Minnesota (other than those designated as institutional investors) are purchasing for investment;
- No commission or other remuneration is paid or given directly or indirectly for soliciting any prospective buyer in Minnesota (other than those designated as institutional investors), except reasonable and customary commissions paid by the company to a licensed broker-dealer; and
- Ten days prior to any sale under this exemption, the company has filed with Minnesota a statement of the issuer on the form prescribed.

## **Rule 505 or Rule 506 Offerings**

Offers and sales by an issuer are exempt under Minnesota law if made in reliance on the exemptions provided by Rule 505 or Rule 506 of Regulation D and if certain other conditions are met, including the following:

A notice on Form D must also be filed with Minnesota;

- No remuneration may be paid for soliciting a prospective purchaser unless the recipient is registered (or exempt from registration) in Minnesota as a holder-dealer; and
- The exemption is not available if certain people associated with the offering have been found within the last five years to have violated certain securities laws.

## **Sales to Existing Security Holders**

Any transaction pursuant to an offer to existing security holders of the company, including persons who are holders of convertible securities, nontransferable warrants or transferable warrants exercisable within not more than 90 days of their issuance, is exempt from registration under the following circumstances:

- No commission or other remuneration (other than a standby commission) is paid or given directly or indirectly for soliciting any security holder in Minnesota; and
- The commissioner of commerce has been furnished, no less than ten days prior to the transaction, with a general description of the transaction, and with such other information as the commissioner of commerce may by rule prescribe.

## **Other States**

The securities, or “Blue Sky” laws of many states have similar exemptions to those outlined above, but may structure the exemptions in different ways. For example, all states provide exemptions for offerings conducted under Rule 506, but some states require the filing of a Form D in that state prior to any sales taking place, some require that the form be filed within 15 days after the first sale, and others require no filing whatsoever. A company selling securities in any particular state should carefully review the securities laws of that state prior to engaging in any capital raising activities.

Regardless of whether a securities offering is registered, a company selling securities is often required to furnish potential investors with information. Despite the increasing popularity of using the Internet and other forms of electronic media to quickly and efficiently communicate information to large groups of

people, any company considering using such media to deliver information in connection with an offering and sale of securities should proceed with extreme caution. Section Nine of this book discusses Internet offerings in greater detail.

## **Offerings Exempt from Registration**

Companies relying on federal or state law private offering exemptions from registration for the offer or sale of their securities should use particular caution in determining whether to use the Internet for the delivery of information. Such delivery would very likely be considered a general solicitation or general advertising in violation of the manner of offering limitations of Regulation D and in violation of the private placement exemption provided by Section 4(2) of the Securities Act.

## **Offerings Registered Under the Securities Act**

When the Internet is used to disseminate information in a public offering, the considerations raised regarding its use center around the adequacy of the delivery of information. The concern, specifically, is whether the proposed electronic delivery complies with the notice, prospectus delivery and confirmation of sale requirements of the Securities Act.

In October 1995, the SEC issued an interpretive release which made clear that the use of electronic distribution would generally be deemed an acceptable alternative to paper delivery, even encouraging further technical research, development and application of such media. The release focused on procedures to ensure that prospectuses delivered over the Internet provide potential investors with adequate notice of available information and access to disclosure. In general, the SEC considers electronic delivery to be adequate delivery or transmission for the purposes of federal securities laws when the electronic delivery results in the "delivery to the intended recipient of substantially equivalent

information as the recipients would have had if the information were delivered to them in paper form.” The interpretive release also laid out certain guidelines to ensure adequate notice and delivery, which generally include the following considerations:

- Steps must be taken by companies to ensure that an electronic delivery results in actual delivery of the information. For example, companies can obtain: (i) evidence that the investor actually received the information (e.g., written confirmation of accessing, downloading or printing the document); or (ii) an informed consent from an investor to receive information through a particular medium, coupled with assuring appropriate notice and access. If a potential investor does not have access to the Internet or refuses to consent to receive electronic disclosure, the company may not offer or sell the security electronically to that investor and will be required instead to make a paper copy to deliver.
- Even if all the investors participating in an offering consent to the use of a certain electronic medium, a company offering and selling its securities in its initial public offering must still make paper copies of its prospectus available for a period of time after the offering to post-offering purchasers to meet the secondary market prospectus delivery requirements of the Securities Act.
- The posting of a prospectus will not, by itself, meet the requirements to provide notice of the availability of a final prospectus, even if consents are received from all investors. Thus, if an investor has not provided an e-mail address to confirm delivery of the notice (e.g., via a return receipt message), a paper notice may be required to be delivered by mail or other means.

- The potential investors must have the opportunity to retain the information delivered or have ongoing access equivalent to personal access to paper copies. Thus, document retrieval procedures should not be overly burdensome or complex.

Discretion is still required, however, in determining whether the Internet should be used in public offerings because meeting the procedural guidelines of the SEC's interpretive release will not assure compliance with any state or foreign securities laws. For example, an electronic offer made over the Internet may be subject to a state's securities regulations where the offer is accessible within that state, regardless of whether actual delivery of the offer occurred in that state. Thus, a company could be subject to the securities laws of numerous states, even though offers are actually made only in a few. Such broad applicability of state law could be prohibitive to certain small or development stage companies because numerous state laws may be applicable and the state law exemptions typically relied upon in public offerings may not be available to such companies if they are not listed on a national securities exchange or on the Nasdaq National Market System.



## **SECTION FOUR: VENTURE STAGE FINANCING**

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A common form of raising early-stage working capital is through the sale of securities to venture capital firms or to “angel” investors. Venture capital firms are generally investment funds which specialize in investing in early-stage or high-risk ventures. Angel investors are high net worth individuals who are willing to make the same type of investments.

### **THE INVESTOR’S PERSPECTIVE**

Both venture firms and angel investors make high-risk investments in order to receive a profitable return on investment. While there are notable differences between the two, the motivations and the financing processes are largely the same. But for occasional circumstances, both venture firms and angel investors are interested primarily in the amount and timing of their returns. Some angel investors may be more flexible than venture firms, which typically maintain rigorous policies to reduce portfolio risk. For example, a communications industry veteran investing his own money may be more flexible (and possibly more empathetic) when investing in a communications start-up than a venture firm which might require the company to sign more comprehensive covenants. Of course, there is relatively little investment money to be found from such angel investors and the vast majority of angels (and certainly those who make large numbers of investments) should be treated in most respects exactly like a venture firm. Accordingly, except where otherwise noted, the discussion contained in this Section encompasses both types of venture investors.

## **Venture Capital Firms**

Venture capital firms are investment funds or capital pools organized principally to purchase equity early in a company's life cycle, guide the company through any growing pains, and then make an exit once a large return on their investment has been made.

Venture capital firms are managed by a group of partners who are each knowledgeable and well-connected in their chosen industry. These individuals are responsible for finding the portfolio companies, negotiating the financing terms and providing subsequent guidance to the company. Venture firms typically can provide very helpful business insight and direction but their guidance may also be a source of problems. Among other things, they can be useful in recruiting management, keeping management focused, locating vendors or distribution channels and generally making the right connections. Moreover, they are often invaluable when seeking additional future funding. The flip side is that a venture firm may demand more control of the company, for example through percent of ownership or number of board seats, than the entrepreneur wants to give.

## **Angel Investors**

Angels may or may not possess the same level of expertise as venture capitalists. Many angels are entrepreneurs who have found success, possibly in the same industry. Such savvy angels certainly can (and may demand to) provide helpful guidance. Others might simply be moneyed individuals who can afford to make high-risk investments and then sit silently on the sidelines.

## WHAT THE VENTURE CAPITAL INVESTOR IS LOOKING FOR

It is difficult to judge the worth of early-stage companies and venture investors take extreme care when selecting their portfolio companies. They accept extraordinary risks because of potentially extraordinary rewards. Investment returns of 35 percent per year are not uncommon. One rule of thumb is that venture capital firms look for a return of three to five times their investment in five to seven years. One or two investments of every ten made by the investor may reach these heights. The investor may more or less break even on another five to seven investments of the ten and lose money on two or three.

Venture firms receive thousands of business plans a year. Around 90 percent of these plans are quickly rejected either because they are poorly prepared or because they do not fit the specific geographical, technical or market niches that the venture capital firm is seeking. Angel investors also are extremely selective. Few plans warrant a face-to-face presentation. Even fewer actually receive funding.

There are many considerations. Most venture firms maintain internal policies which set thresholds for deal size and company maturity and provide evaluation protocols. Candidate companies are diligently investigated. Venture investors consider the quality of the business plan and idea; the character, experience and reputation of the management team; the size and accessibility of the existing and potential market; and the availability of future exits. Consultants may be hired to fully evaluate prospects, especially when considering any new or complex technologies. The market size and competitive position of the company are measured. The investors may interview present and potential customers, vendors and others. Production costs are reviewed. The company's budget is thoroughly analyzed and the time to market for potential products is estimated. The financial condition

of the company is generally confirmed by an auditor and a review of the company's legal status is made.

## **Investment Size**

The typical venture investor is interested in making an investment of \$250,000 to \$5,000,000. Projects of under \$250,000 are usually rejected because of the high cost of evaluation and administration while those over \$5,000,000 may present exposure problems to the investor. A number of investors may invest in each round of financing. Depending on funding needs, start-ups should be prepared to give up least 20-30 percent of the company to these investors in the first round of financing (or "series A" round, with subsequent rounds called series B, series C and so on). Usually the series A financing will require aggregate funding of around \$5,000,000 with subsequent rounds increasing in size as the company's capital needs grow.

## **Company Maturity**

Most venture investors limit their interest to companies with some operating history, though there may be no profit. Companies that can use additional funds to readily expand into a new product line or a new market are particularly attractive. Such companies can use venture money to grow quickly rather than gradually as they would on retained earnings. Companies that are just starting out or that have serious financial difficulties will interest some venture investors if the potential for significant gain can be identified and assessed, and depending upon the existing risk in the investor's portfolio. A small number of venture investors will do only "start-up" or "seed capital" financing.

## **Company Management**

Most venture investors concentrate initially on the competence and character of the company's management team. There is belief that even mediocre products can be successfully manufactured, promoted and distributed by an experienced, energetic and well-connected management group. Venture investors look for a group that is able to work together easily and productively, especially when under stress from temporary reversals and competitive problems. Investors know that even excellent products can be ruined by mismanagement.

Many venture investors invest primarily in management capability and not in product or market potential. Toward this end, they may spend a week or more at the offices of the candidate company talking with and observing management. Depending on the company's maturity, venture investors like to see a complete and focused team already managing the important functional areas (product design, marketing, production, finance and control). Responsibilities should be clearly assigned and, in addition to a thorough understanding of the industry, each member of management must be firmly committed to the company and its future.

## **The Business Plan and Idea**

Most venture investors seek a distinctive element in the company's strategy or product/market/process combination. This distinctive element may be a new feature of the product or process or a particular skill or technical competence of the management. It should provide an actual competitive advantage.

## SUMMARY OF THE PROCESS

Once an initial evaluation has been made and the venture investor has decided to proceed, the financing process will likely move quickly. The investor will propose a term sheet setting forth the terms of and conditions to the financing. If there is more than one participating venture investor and, depending upon the investor group's dynamics, the largest investor may take the lead, negotiating and investigating on behalf of the others. The term sheet may be a rather comprehensive document and may be negotiated for some time or it may be a relatively scant document containing little more than a valuation of the company.

Among other things, the term sheet will value the company. Venture valuations seldom correlate to tangible measurements like price to earnings ratios, but instead emerge from other factors including management's contacts, abilities and prior record as well as the intellectual property portfolio and the market attractiveness of the particular niche.

Until closing, the venture investors typically will continue investigating the entity. This "due diligence" investigation provides them with a comprehensive look at the strategic, financial and legal status and outlook of the company. The investors' analysts and attorneys may at this time make an exhaustive review of the company's intellectual property portfolio, corporate documents, existing contracts and financial data.

Once the term sheet has been substantially finalized, the certificate setting forth the terms of the purchased securities, the purchase agreement itself and other documents will be drafted and negotiated. The investors and the company then will sign the various documents and the investment will be made.

## PRINCIPAL TERMS OF CONVERTIBLE PREFERRED STOCK

Typically venture investors purchase preferred stock which is convertible into the company's common stock. Preferred stock offers great flexibility. It gives the investors the rights they want while using traditional equity concepts to align the incentives of the investors and the company. The venture investors will require that the company file an amendment to its articles or certificate of incorporation issuing this preferred stock in accordance with negotiated terms. These preferred stock terms should be carefully considered and likely will be among the more heavily-negotiated deal provisions. The prevalent terms fluctuate with the economy, and the investor's or the company's market and they vary from industry to industry. The specific negotiations will proceed depending on each particular company and the parties' respective bargaining powers. The section below discusses typical preferred stock terms.

### Dividends

- **Rate.** Fixed dividends and the dividend rate are negotiable terms that depend on the investors' objectives. Typically, venture investors do not expect to receive current dividends, preferring instead to keep the money in the company.
- **Cumulative.** Cumulative dividends accrue even if unpaid and must be paid before any dividends are paid on common stock. Depending on current market conditions, investors usually do not require cumulative dividends.
- **Participating.** Participating preferred stock permits holders to participate again in all dividends paid on common stock after dividends are first paid on preferred stock. This may not be as important to investors as other provisions because dividends

are usually not paid on common stock until after the preferred stock has been converted.

## **Liquidation Preference**

Venture investors will likely require that they, as holders of preferred stock, be paid immediately after creditors are paid and before any assets can be distributed to other equity holders. This “liquidation preference” usually is the original price (or two or three times that, depending upon negotiations) paid for the preferred stock plus all accumulated and unpaid dividends. Preferred stock may also be “participating” with regard to liquidation, allowing preferred stock to share ratably in distributions to holders of common stock after the liquidation preference has been paid, either on an unlimited basis or until the investor has received a set return on the investment (for example, three or four times the original price of such preferred stock). Usually the investors will require that mergers or material acquisitions as well as substantial sales or exclusive licenses give rise to this right.

## **Conversion**

Preferred stock will almost always be convertible into common stock at the option of the holders at any time. In addition, preferred stock will often be subject to mandatory conversion upon certain events, such as an underwritten public offering with a minimum per share price and minimum aggregate proceeds going to the company. Mandatory conversion may also be automatic upon the achievement of defined financial objectives or by the vote of some specified majority of the preferred stock holders.

- **Rate.** The conversion rate is usually set by establishing a conversion price per share of common stock. Generally, the initial conversion price is the same as the price per share paid



by the investors for the preferred stock and is subject to adjustment for antidilution protection.

- **Antidilution Protection.** Conversion terms are structured to protect the preferred stockholders' percentage of holdings and rights from being diluted as a result of stock splits or similar recapitalizations, sales of common stock, other preferred stock or the equivalent at prices lower than the price of the subject preferred stock, and mergers and consolidations.
  - **Stock Splits and Recapitalizations.** At a minimum, the preferred stock conversion rate is subject to adjustment to reflect the effects of stock splits and similar recapitalizations. For instance, if a two-for-one split of common stock is declared, the conversion price will be reduced by one-half and the preferred holders will receive twice as many shares of common stock upon conversion.
  - **Protection Against Dilutive Sales of Common Stock or its Equivalent.** The conversion rate will usually be adjusted to give the holders of preferred stock the right to receive additional shares of common stock if the company sells securities (including warrants or options) at prices lower than the then effective conversion price. The adjustment may be based on the "weighted average" price paid for all outstanding shares (including shares issuable upon exercise of options and warrants) or it may simply adjust the conversion price to the lowest price paid for common stock (or the lowest price at which options or warrants are exercisable) under a more investor-friendly "full ratchet" adjustment.

In most cases, the antidilution protection does not apply to the issuance and exercise of options granted to employees up to some fixed number of shares or some fixed percentage of the number of outstanding shares of common stock.

Some investment agreements have a “pay to play” clause which limits antidilution protection to those investors who make an additional pro rata investment in a future dilutive round of financing. More aggressive “pay to play” provisions will penalize an investor who does not participate in a future round of financing by automatically converting the preferred stock held by such investor into common stock.

- **Provisions for Mergers and Consolidations.** The conversion terms usually are structured to permit the holders of preferred stock to have the right following a merger or consolidation to convert their preferred stock into the number of shares of stock of the surviving company that they would have received had they converted the preferred stock immediately prior to the merger or consolidation.

## Voting Rights

- **Regular Voting Rights.** Preferred stock usually has the right to vote the number of shares of common stock that would be received upon conversion on all matters submitted to a vote of shareholders.
- **Rights to Elect Directors.** Preferred stock voting as a single class may have the right to elect a fixed number of directors which may roughly equate the percentage of the company that the investors are purchasing. For example, if the investors are purchasing 20 percent of the company, they may expect to vote exclusively on 20 percent of the board seats (in addition to voting alongside the common with regard to the other seats). Additionally investor dynamics may play a role. Two large investors may insist that they each have a board seat. To this end, a separate voting agreement might be signed by the investors, the company and the principal shareholders. The

board will likely grow alongside the number of financings with, for example, the series A, B and C holders each electing one seat separately.

- **Rights Upon Default.** Preferred stock voting as a single class often has the right to elect a majority of the company's board of directors upon company default under the investment agreement.
- **Other Special Voting Rights.** Often certain actions will be prohibited without the approval of the preferred stock voting as a single class (sometimes by a supermajority vote). Such actions may include: the issuance of a new class or series of stock; amendments to the company's articles or certificate of incorporation or bylaws; redemptions of stock; payment of dividends; increases to the Company's stock option pool; or mergers or material dispositions of assets.

## Redemption Rights

- **Redemption at the Option of the Investor.** Preferred stock often is "puttable" or redeemable at the option of the investor at some fixed price, sometimes including a premium over the original issuance price plus accumulated and unpaid dividends. The investors' right to put the preferred stock will usually only arise after a fixed period of time. In some circumstances, the preferred stock is "callable" or redeemable at the option of the company.
- **Mandatory Redemption.** The company will often be required to redeem the preferred stock (again, sometimes at a premium over the original issuance price) after a fixed period of time or upon certain other events, such as the death of a key employee. It is important that mandatory redemption be structured to ensure that the company will continue to have sufficient

liquidity. The company may be required to establish a sinking fund or maintain key person life insurance policies to finance mandatory redemptions. Any redemptions will be subject to state corporate law restrictions on distributions to equity holders.

## **Preemptive Rights**

Preemptive rights give an investor the right to maintain the investor's current level of ownership in a company by purchasing, during a limited time period, the investor's pro rata portion of any additional securities sold by the company. Sometimes investors are also given the right to exercise the preemptive rights of other investors who fail to purchase their entire pro rata portion of such additional securities being offered. In most cases, preemptive rights do not apply to the issuance and exercise of options granted to employees up to some fixed number of shares.

## **THE INVESTMENT AGREEMENT**

A comprehensive investment agreement (usually a stock purchase agreement) will serve as the operative document with other important documents deriving from the same. Together, these memorialize the various terms and conditions of the purchase of convertible preferred stock by the venture investors. Each provision should be carefully read and considered. The sections below discuss typical treatments.

## **Representations and Warranties**

The company will be required to make extensive "representations" (legally binding assurances) and "warranties" (legally binding guarantees) regarding its formation, capitalization, authority to

enter into the agreement, financial condition, contracts, litigation, employees, defaults and other matters. The agreement will provide for a “disclosure schedule” or “schedule of exceptions” which will include specific exceptions to the company’s representations and warranties. The goal here is to provide the investors with all pertinent information concerning the company.

The investors too will make representations and warranties regarding their authority to enter into the agreement and certain other items necessary for the company to comply with exemptions to the registration requirements of federal and state securities laws.

### **Affirmative Covenants**

The company will be required to comply with “affirmative covenants” (legally binding promises to do certain things) including the maintenance of corporate existence in good standing, corporate books and records, properties and insurance, a fixed structure of its board (and the provision of investors’ rights to observe board meetings or elect a number of directors), and key person life insurance.

Additional affirmative covenants typically include providing financial statements and rights of inspection, preparing annual budgets, payment of taxes, application of the proceeds for specified purposes, compliance with laws, applying for and maintaining rights to patents, trademarks and copyrights, obtaining confidentiality agreements, and obtaining agreements regarding ownership of inventions and non-competition agreements with new employees.

## **Negative Covenants**

The company typically will be subject to “negative covenants” (legally binding promises **not** to do certain things) which prevent the company from taking certain actions without the approval of the investors. Negative covenants may include restrictions on mergers and acquisitions, dispositions of assets or purchases of capital equipment, payment of dividends, issuances of securities unless the investors are given a right of first refusal to purchase such securities, granting registration rights to other investors, making corporate guaranties, loans or investments, increasing salaries, amending charter documents, entering new lines of business, and violating financial covenants such as those requiring the maintenance of a minimum net worth or a minimum liquidity ratio.

## **Termination of Covenants**

Usually the affirmative and negative covenants will terminate when the investors no longer hold a minimum percentage (often 15 to 25 percent) of the purchased securities. The covenants should additionally terminate upon the closing of a public stock offering at a minimum per share price with minimum aggregate proceeds received by the company.

## **Closing Conditions**

The purchase agreement will provide that the investors are not required to invest until certain conditions are met or waived by the investors. Typically such closing conditions require that:

- The amendment to the company’s certificate/articles of incorporation which issues the preferred stock has been filed with the relevant state authority;
- The representations and warranties are accurate as of the closing date;

- The company has complied with the investment agreement and is not in default;
- Certain officers have certified as to the accuracy of the representations and warranties, that the company has complied with the agreement and that no defaults exist on the closing date;
- The company's counsel has delivered an opinion as to various matters, including valid corporate organization and existence, due authorization, execution and delivery of the agreements, due authorization and issuance of securities, proper corporate proceedings, compliance with securities laws, and no conflicts with the company's charter documents and other agreements;
- Certain documents have been delivered, including certified resolutions of the company's board of directors, incumbency certificates, and certified articles/certificate of incorporation and bylaws; and
- If necessary, certain agreements such as voting agreements, employment agreements, and right of first refusal and co-sale agreements have been executed and delivered.

## **Registration Rights**

Registration rights give security holders the right to cause the company, under defined circumstances, to register their shares under the Securities Act and applicable state securities laws in order to permit public resale of such shares. Usually registration rights apply only to the common stock issuable upon conversion of the preferred stock or debentures or the exercise of warrants held by the investors, although the rights could extend to other securities.

- **Demand Rights.** Demand registration rights permit the shareholders to initiate a registration by requiring that the company prepare, file and maintain an effective registration statement for the shares. Usually demand rights may be exercised only when investors holding a minimum number of securities demand registration. Demand rights are normally exercisable only after a specified period of time has lapsed because most start-up companies are not in a position to file a registration statement in the first few years of development. Typically the investors will only be permitted to exercise demand rights once or twice.
- **Incidental or “Piggyback” Registration Rights.** Piggyback registration rights permit shareholders to include their shares in registrations initiated by the company and, sometimes, by other investors. Usually there is no restriction on the number of times that piggyback registration rights may be exercised, but there may be a time limit on the exercise of rights, such as three or five years after the company first goes public. Piggyback rights typically do not apply to registration statements prepared by the company in connection with mergers or acquisitions or in connection with the registration of shares under employee benefit plans.

Cutback provisions permit the company to exclude shares held by investors from a registration if the underwriter concludes that inclusion of the shares may adversely affect the market for shares being sold by the company. In the company’s initial public offering, the investors’ piggyback registration rights may be subject to a total cutback, while in subsequent registrations the cutback provisions may permit the investors to have some specified percentage of the offering, usually 15 to 25 percent.

- **Short-Form Registration.** The agreement may grant additional rights to the investors to exercise demand



registration rights if a Form S-3 registration is available to the company. Form S-3 is an abbreviated registration form that is easier and less expensive to prepare, but is only available to certain public companies. The number of times that Form S-3 registrations may be demanded is usually limited to some number per year (usually two or three), rather than an overall number, and the minimum number of shares required to trigger registration on Form S-3 is usually specified.

- **Payment of Expenses.** The company will generally pay all expenses of registration and sale, other than underwriting commissions on the investors' shares. At times, investors are required to pay the expenses of registration on Form S-3.

## **Rights of First Refusal and Co-Sale Rights**

Venture investors will usually require that the existing principal shareholders enter into a separate co-sale agreement that gives the investors the right of first refusal and co-sale rights with regard to proposed sales of securities by the principal shareholders. This is chiefly designed to ensure that the pre-money principal shareholders (typically the founders) remain with the company.

## **Provisions for Waivers and Amendments**

The investment agreement will usually provide that the investors may waive or amend any provision of the agreement with the consent of fewer than all of the investors. If waivers or amendments can be effected with a majority or a supermajority, it becomes less likely that one or two small investors will be able to exercise leverage over the company or the other investors. However, such waivers or amendments generally cannot change fundamental terms of the purchased securities without unanimous approval.

## THE CLOSING

Once the terms have been conclusively negotiated, the company and investors will sign the investment agreement along with the ancillary documents. The financing will then proceed as soon as all closing conditions have been met or waived. There may be follow-up closings by additional investors on the same round of financing until the express financing need has been met and the round closed.

## **SECTION FIVE: PRIVATE EQUITY OFFERINGS**

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### **THE PRIVATE PLACEMENT**

A “private equity offering” or “private placement of securities” is the process of offering and selling securities to select investors without first registering the securities with the Securities and Exchange Commission (“SEC”) or, for securities sold only in Minnesota, with the Minnesota Department of Commerce. In a private placement, a company raises capital by selling equity to institutional investors, venture capital companies and individual investors meeting certain qualifications. Although both privately held and publicly traded companies can offer their securities through private placements, this section will focus on private offerings by non-public companies.

Companies opting to raise capital by means of a private placement usually do so because of the lesser time and cost associated with the offering’s preparation and execution, as compared to a public offering, which requires, among other things, the filing of a registration statement with the SEC. In addition, private placements offer companies the ability to customize the offering for targeted investors, allow the terms of the offering and information regarding the company to remain private and potentially foster long-term relationships with investors for additional offerings.

Individuals affiliated with the company and third party advisers play a significant role in making the private placement process a

success. Depending on the size and type of offering, the players involved can include the founders, officers and directors of the company, attorneys, accountants, other third party advisors, finders, brokers and, of course, the potential investors.

Founders and officers of the Company coordinate the private placement process and provide input and information to ensure the offering is structured in a manner that best suits the company's goals. In addition, the company's board of directors should be involved in all stages of the offering. The directors can not only provide guidance to a company in its formative stages, but can legitimize the company to potential investors if its members are credible or well-known experts in the field or business community.

The selection of proper advisers is critical in making the private placement a success, as well as in protecting the company from potential liability. At a minimum, the company should hire legal counsel to guide it through the complex morass of securities laws. Accountants are also necessary to provide current financial reports and projections, some of which may need to be audited. Also, depending on the size of the offering, the company may want to hire finders to locate potential investors or brokers to actually offer and sell the company's equity.

The company should investigate the potential value an outside party adds to the company's private placement process prior to retaining it. The assistance of some third parties, if not monitored and controlled, could jeopardize the offering's exemption from registration. In particular, the use of finders and brokers, as discussed below, carries this risk.

Finally, the potential investors are involved in the process. The company should focus on the number and type of investor it is seeking to attract and the features of the offering should be tailored with that type of investor in mind.

## **STRUCTURING THE OFFERING**

### **Securities Law Considerations**

The process of undertaking a private equity offering is regulated by securities law, primarily the Securities Act of 1933, as amended (the “Securities Act”), as well as state securities (“Blue Sky”) laws. A private offering is an offering which qualifies for one or more exemptions that prevent it from being considered a “public offering” requiring registration with the SEC or a state regulator. Careful attention should be paid to these exemption requirements to prevent the loss of an exemption. Section Three of this book entitled “Securities Law Considerations” contains a more detailed discussion of these exemptions and their requirements.

Businesses engaged in raising capital often look at compliance with securities laws as an obstacle to their objectives and, at best, a nuisance. It is important to remember that the securities laws were developed to protect the interests of the investing public by requiring that certain disclosures be made prior to investment. The securities laws should also be looked at as a means of protecting the business entity. A business entity that diligently complies with the securities laws will find itself better protected against lawsuits and other claims by disgruntled investors.

### **General Considerations**

There are many considerations outside of securities law that must also be taken into account when undertaking a private offering of equity. Ultimately, the goal of a private equity offering is to raise enough capital to accomplish a company’s business objectives. To make this a reality, the company must undergo a certain amount of planning and decision making prior to actually offering securities. Among other things, the company needs to consider the potential

investors, the amount of capital needed and the timing of the offering.

## **Investors**

There are generally three types of investors: accredited, non-accredited and sophisticated. The number and type of potential investor impacts the applicability of certain securities laws exemptions and their disclosure requirements. In addition, there are certain requirements to maintain a private offering, which are discussed below, that require the company or its broker to have pre-established relationships with the potential investors. The company should also evaluate whether or not it or its affiliates have those types of contacts, or if it will need to secure the services of a third party to assist in the process.

An “accredited investor” has particular significance under certain securities regulations in two principal respects: (1) the disclosure required where all investors are accredited, and (2) the calculation of the number of purchasers. To be an accredited investor, an investor must be within one or more of the following categories:

- **Institutional Investors.** These include banks, savings and loans associations and other similar institutions; registered securities brokers or dealers; insurance companies; registered investment companies or business development companies; and various other institutions.
- **Private Business Development Companies.** Generally, these are non-public venture funds.
- **Certain Entities.** Any organization described in Section 501(c)(3) of the Internal Revenue Code, or any corporation, Massachusetts or similar business trust or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of \$5 million.

- **Directors and Executive Officers.** Directors, executive officers or general partners of the company, or of the general partner of the company.
- **Natural Persons with Net Worth in Excess of \$1 Million.** This category is limited solely to natural persons (i.e., individuals as opposed to business entities). The net worth calculation may be jointly with the person's spouse.
- **Natural Persons with Substantial Annual Income.** A natural person who had an individual income in excess of \$200,000 in each of the two most recent years, or joint income with that person's spouse in excess of \$300,000 in each of those years, and has a reasonable expectation of reaching the same income level in the current year.
- **Trust with Assets in Excess of \$5 Million.** This category only includes trust that were not formed for the specific purpose of acquiring the securities offered and whose purchase is directed by a sophisticated person.
- **Entities Owned 100% by Accredited Investors.** Any entity in which all of the equity owners are accredited investors under any of the above-described tests.

A "non-accredited" investor does not fulfill the requirements of any of the above listed categories and is subject to strict disclosure requirements to gain the benefit of applicable securities law exemptions.

Two exemptions that are closely linked to each other, the Section 4(2) exemption and Rule 506 exemption, deal with the concept that the potential investors must be "sophisticated" in nature. For example, Rule 506 requires the issuer to reasonably believe that each purchaser who is not an accredited investor have such knowledge and experience to judge the merits and risks of the

prospective investment. Such factors as education, investment background, net worth and investment experience should be taken into account in making this determination. This information is typically solicited in a questionnaire and is clearly more subjective than the accredited investor standard. A careful record should be kept by the company showing its basis for determining that an investor is sophisticated in nature.

## **Amount of Capital**

The company needs to undertake an honest evaluation of the current outlook for private capital in the market in conjunction with the amount of capital it needs to accomplish its business goals. The company should attempt to raise enough capital to effectively execute its plan (the last thing a company wants to do is to complete an offering and run out of cash prior to reaching its desired business objective). A shortfall implies a lack of planning and forethought, which may impact the willingness of current and potential investors to participate in future offerings. If the company is planning to raise capital in stages, it should make sure that it is in compliance with all securities laws (see the discussion of the integration of offerings below) and disclose that fact to potential investors. Obviously, an investor would want to know that the company is planning to undertake multiple offerings prior to getting its product commercialized.

Once an amount is selected, the company must decide what percentage of the company it is willing to sell to outside investors. The company founders or principals typically retain control over a majority of the issued shares, usually offering equity ownership of between 5% to 40% of the company to potential investors. This amount may vary depending on the current capitalization of the company, the availability of capital in the market, the potential for additional future offerings and the viability of the product or service that the company is offering and the time period projected for the company to “cash flow” on a break-even basis.



A number of options exist when structuring the amount of the offering. The offering is typically set up with a maximum dollar amount, or goal, that is being sought. The company must decide, and the disclosure document should clarify, whether the company must raise the entire amount to actually close the offering, an “all-or-none” arrangement, or if there is a minimum amount that will be considered adequate, a minimum-maximum (“mini-maxi”) arrangement.

Under an “all-or-none” arrangement, the company or broker must sell all of the securities within the specified timeframe. If the amount is not sold, the offering is off and the money collected is returned to the investors. Under a “mini-maxi” arrangement, the company or broker must sell a minimum amount to allow the closure of the offering and sale of securities. The offering closes when the maximum is sold or at any point above the minimum when the specified timeframe expires. If the minimum amount is not met, the offering is cancelled and the money that has been collected should be returned to investors. During either type of offering, the company should deposit all amounts collected in escrow until the required dollar amount is met.

## **Type of Securities to be Offered**

In general, securities that are offered are classified as equity, debt or a hybrid form of debt and equity, some of which may have conversion features. These alternative forms of securities are more fully described in Section Three of this book.

## **Timing of Offering / Integration of the Offering**

The timing of the offering is dictated by a number of factors. The company should allocate enough time on the front-end of the process to allow itself to undertake its own internal due diligence. This time should be used to organize and collect information that

will be disclosed to potential investors. The actual duration of the offering should allow for a realistic timeframe to raise the amount of desired capital while still giving the company enough time to take advantage of the existing market opportunity and enabling the company to meet its business plan.

In addition, the timing of the offering needs to take into account when the last private offering of the company occurred and when the next private offering might need to occur. Company's that undertake multiple private placements, by plan or by need, should be aware of a concept known as integration. Integration is a concept by which two or more private placements of securities, which are intended to be exempt from registration, could be considered as one offering. If each sale was considered by itself, each might be exempt, but if integrated with each other, the sales might not meet the requirements of an exemption from registration (i.e., the integration of the two private placements may place the company over the dollar limitation of its intended exemption). The concept of integration is intended to prevent a company from circumventing the registration requirements of the Securities Act by claiming a separate exemption for each part of a series of transactions that comprises a single offering.

Although the term "offering" for the purposes of integration has not been explicitly defined, several factors are considered relevant in determining whether offers and sales can be regarded as part of a single offering and thus be integrated: (i) are the sales part of a single plan of financing; (ii) do the sales involve the issuance of the same class of securities; (iii) will the sales be made at or about the same time; (iv) is the same type of consideration received; and (v) are the sales being made for the same general purpose.

It should be noted that Regulation D contains a safe harbor from integration. This safe harbor excepts from integration any offers and sales made more than six months before the start of the Regulation D offering or made more than six months after completion of the Regulation D offering, so long as during either

six month period there are no offers or sales of securities by or for the company that are of the same or a similar class as those offered in the Regulation D offering, other than offers and sales pursuant to an employee benefit plan.

## **ORGANIZING THE OFFERING**

Once the company has selected the type of investor, size and timing of offering as well as its applicable exemption, it will need to focus on the proper way to efficiently and effectively undertake the offering. The offering process can be divided into a number of stages, which include:

- Internal Due Diligence;
- Preparation of the Private Placement Memorandum;
- Offering; and
- Closing.

Each stage offers its own challenges and traps for the unwary or ill prepared. Throughout the process the company should never lose sight of its ultimate goals of raising capital and maintaining its securities law exemption.

## **INTERNAL DUE DILIGENCE**

Prior to preparing its disclosure document that will be distributed to potential investors, the company should conduct extensive due diligence of its current business operations. This due diligence is important for a number of reasons, but mostly due to the fact that exempt transactions are still subject to the antifraud or civil liability provisions of federal securities law. This places a burden upon the company to never give false or misleading statements (whether written or oral) about the company or offering. Full disclosure is always the best way to prevent future liability. The

company and its attorneys and accountants should make certain that facts are supported and opinions have a reasonable basis. It should be noted that the accreditation of an investor does not remove the need for this type of disclosure.

Founders must be planning, even in the formative stages of their company, the consequences of selecting one form of business entity over another. They should be mindful of the legal and business due diligence process associated with capital raising from the moment the business entity is formed, even if financing may not be sought for several years, because at the time of financing it may be difficult and costly to correct problems created in the early stages of the venture. Potential investors may have serious issues if the business is not in good order. Incomplete documentation or organizational issues can be red flags to potential investors that something may be wrong with the company.

## **PREPARATION OF PRIVATE PLACEMENT MEMORANDUM**

### **Purpose of PPM**

Most companies start out with a business plan to attract initial investors. The more detailed the plan, the better off a company is to begin the process of raising capital. Although not required for all private offerings, a company will most likely need some sort of document to be distributed to potential investors. The business plan is typically not the proper document to be used for this purpose, but can be used as a starting point or integrated into the company's disclosure document.

The standard disclosure document is known as the private placement memorandum, or PPM, which typically gives potential investors the same general type of information that a public

registration statement would provide. PPMs range in format and detail depending upon exemption requirements, the goals of the company and even the sophistication of the recipients. In most circumstances, a private placement memorandum is drafted primarily to meet potential disclosure requirements of state and federal law and federal securities laws, including certain anti-fraud provisions. Savvy companies use it as a marketing tool to outline management's business philosophy and the company's products or services. An additional benefit is that a private placement memorandum creates a mechanism for managing consistent disclosure to a number of individual potential investors.

## **Disclosure Requirements**

As detailed in Section Three of this book, each exemption has its own requirements regarding the amount and type of disclosure that is required to be given to certain potential investors. Therefore, the level of detail in the PPM is directly impacted by the exemption the company is using and the potential audience (i.e., accredited, non-accredited or sophisticated investor). For example:

- No specific disclosure is required to be furnished for offers and sales under Rule 504 or for offers and sales made solely to accredited investors in reliance upon either Rule 505 or Rule 506. However, detailed disclosure is required for non-accredited investors under both Rules 505 and 506.
- Under Section 4(2) the potential investors must be sophisticated and possess the same kind of information that they would receive under a registration statement, but that may be satisfied by the individual's access to the knowledge or by specific disclosure.
- Section 4(6) does not prescribe any disclosure.

The length, organization and type of disclosure should be carefully considered and outlined before drafting and distributing the PPM. Depending on the applicable exemption and the intended investors, the company may want to scale back the disclosure document to save on costs. However, full and complete disclosure of material information is always recommended as a method to insulate the company from potential anti-fraud liability. And it is strongly suggested that the PPM be developed in conjunction with attorneys and accountants who have a working knowledge of securities laws. If a placement agent is used in the offering, its representative and counsel will also be included in the drafting process. These “anti-fraud” rules basically require that the information disclosed does not misstate a material fact, or omit to state a material fact, that could impact the investor’s decision to invest. The PPM provides a record of disclosure, which may be very helpful should a claim ever arise.

## **Non-financial Information**

It is up to the company and its attorneys to figure out the proper amount of disclosure for the potential investors. For discussion purposes, this chapter will focus on the most detailed disclosure that would be required under a Regulation D, Section 4(2) or Section 4(6) exemption, which is an offering to non-accredited investors under Rule 505 or Rule 506 of Regulation D. Private companies using this exemption are required to provide the same kind of business and non-financial information the issuer would be required to provide if registering securities or if it utilized Regulation A. This information is required to be delivered to the purchaser within a reasonable time before the sale and would include such things as:

- Description of the Company
- Risk Factors

- Business and Properties
- Financial Information
- Offering Price Factors
- Use of Proceeds
- Capitalization of the Company
- Description of the Securities Offered
- Plan of Distribution
- Dividends, Distributions and Redemptions
- Officers and Key Personnel of the Company
- Directors of the Company
- Principal Stockholders
- Management Relationships, Transactions and Remuneration
- Litigation
- Federal Tax Aspects
- Management's Discussion and Analysis of Financial Condition and Results of Operation

In addition, the PPM should include a cover page, offering summary, details regarding the administration of the offering and a list of documents available for inspection. These areas of information are only provided as a guide, and are not a checklist. The company should always disclose all material information to

potential investors regardless of whether or not it is in one of these categories. A detail discussion of each section is outside the scope of this chapter, however, several of the key sections are described further below.

## **Risk Factors**

The private investment of capital in most companies is highly speculative and involves a high degree of risk. The risk factor section is probably the most important section in the PPM to potential investors as well as the company. This section provides the greatest insight to potential investors by disclosing risk factors associated with investment and offers the company some protection from potential liability to the extent these risk factors are well crafted.

There is no specific number of risk factors that are required to be identified. The company should attempt to disclose all risks associated with the company and the investment that would materially affect the investor's decision of whether to make an investment. These risk factors may relate to the company's business, its financial situation, the industry in which it does business and the type of security itself. Concepts that companies may want to consider when drafting their risk factors include:

- cash flow and liquidity problems;
- inexperience of management;
- dependence upon key employees;
- dependence on a single product;
- dependence on certain suppliers, license agreement or other material relationships;



- lack of commercialized product;
- lack of market acceptance of product;
- significant regulatory hurdles;
- absence of operating history;
- company is currently unprofitable;
- nature of business opportunity;
- conflicts of interest with management;
- lack of protection for intellectual property;
- highly competitive industry;
- need for additional capital;
- arbitrary determination of offering price / nominal book value;
- restrictions on transfers of shares or lack of market for shares; or
- potential for dilution from future equity issuances.

As a general rule of thumb, the company should try to avoid generalized statements and attempt to include factors that are unique to the company's situation. The company's risk factors should be carefully crafted after consultation with, and assistance from, its attorneys and financial advisors to convey the inherent risks associated with becoming an equity owner. When drafting the risk factors, the company and its advisors should attempt to balance the need of the investors for a concise list of potential risks against the company's goal to carefully outline the real risks in the

business. Moreover, they should avoid the temptation to hedge or candy-coat certain issues.

## **Management's Discussion and Analysis of Financial Condition and Results of Operation**

This section is based on the requirement in registration statements that the company should discuss liquidity, capital resources, results of operation and any other information that the company believes is necessary to understand its current and future financial condition. The company's analysis should focus on its financial statements and other statistical data that enhances a potential investors understanding, as well as material events and uncertainties known to the company that would cause reported financial information to not be necessarily indicative of future results. Throughout this discussion, the company is encouraged, but not required, to provide forward-looking statements.

The closer a company is to its formative stages, the more difficulty a company will have providing meaningful information under the typical disclosure required in the Management's Discussion and Analysis of Financial Condition and Results of Operation. A discussion of liquidity, capital resources and results of operation for a company lacking an operating history would be of limited use to an investor. In that instance, the sections describing the company and business would need to include detailed information regarding a plan of operation to allow potential investors a glimpse into the present and future operations of the company.

## **Financial Information**

The amount and type of disclosure regarding financial information depends on the size of the offering. Non-reporting companies are required to provide the following information depending on the size of the offering.

- For offerings of up to \$2 million, the company is required to provide in writing specified financial statement information such as a balance sheet and statement of income, cash flows and changes in stockholder's equity for each of the two years proceeding the date of the balance sheet. Only the company's balance sheet, dated within 120 days of the start of the offering, must be audited.
- For offerings of up to \$7.5 million, the company is required to provide in writing specified financial statement information such as an audited balance sheet as of the most recent fiscal year and audited statements of income, cash flows and changes in stockholder's equity for each of the two fiscal years preceding the date of such audited balance sheet.
- For offerings in excess of \$7.5 million, the company must provide in writing the specified financial information as would be required in a registration statement filed under the Securities Act on the form that the issuer would be entitled to use.

## **Projections**

The company is not required to include projections of potential revenues as part of the PPM, unless its omission would be considered material to the potential investor's understanding of the business. The tendency is to provide projections under the assumptions of the best possible outcome. Such a tendency leads to significant legal risk, especially if the projections are never met and investors become upset. Even though there is no requirement to include projections, most companies feel that it is necessary to show investors the potential gain or return on their investment. The benefits of including projections needs to be weighed against the potential risk of providing a permanent record of the returns that the company "promised" to potential investors.

Since projections are based on assumptions that may or may not be accurate, the company should label all projections with caveats indicating that such forecasts are not guaranteed. In addition, risk factors should be referenced as possible issues that could prevent the realization of the projections. To decrease their risk the company should be sure to:

- Have a reasonable and supportable basis for all assumptions;
- Describe all assumptions in reasonable detail;
- Be conservative in their approach; and
- Always include a legend indicating that the results of the projections are not guaranteed.

In some circumstances projections extending out well into the future are necessary to the understanding of the business (i.e., building leases, mining leases), but in the case of most startup companies three to five years is appropriate. In fact, the farther the projections extend into the future, the more likely the assumptions will fail and the more likely the investors will have something to take issue with.

### **Other Important Disclosures**

In addition to the financial and non-financial disclosures that provide details about the business, the PPM should include some general disclosures and warnings to provide additional protection to the company.

Written disclosure of resale restrictions are required to be provided to all non-accredited investors in Rule 505 and 506 offerings. Securities sold pursuant to Rule 505 are non-restricted and freely transferable by non-affiliates. When required to give such disclosure, the company should state that:

- The offering is being made pursuant to exemptions from registration under the Securities Act and applicable state securities laws.
- The securities are subject to restrictions on transferability and resale and may not be transferred or resold in the absence of an effective registration statement or an exemption under the Securities Act and applicable state securities laws.
- Prospective investors should assume that they will be required to bear the economic risk of an investment in the shares for an indefinite period of time.
- No market exists for the shares and none will exist after this offering.

In addition to this disclosure, the company should include the form of the legend that will place on the securities indicating that they are indeed restricted.

Due to the potential distribution to unintended third parties, the PPM should contain language and disclaimers that decrease the risk of becoming a public offering. This is especially a problem with the advent of e-mail, which gives third parties the ability to forward the PPM to others without the company's knowledge. Careful consideration should be given before forwarding the PPM in electronic form to anyone. The unchecked distribution of the company's PPM may blow its private placement exemption. It is always recommended that the PPM include language that it may not be given to any person other than the specific prospective investor and those persons retained to advise prospective investor, and that any reproduction of the PPM, in whole or in part, or any disclosure of any of its contents without our prior written consent is prohibited.

Due the fact that the PPM may include sensitive or proprietary information regarding the company's business, the company should include a requirement that the investor keep all information contained in the PPM or received from the company in the strictest of confidence. Special permission is given to share such information with the investor's financial advisors or attorneys.

## **THE OFFERING**

### **Organizing the Offering**

Organization is the key to a successful private equity offering. Procedures should be established to ensure compliance with exemptions, including:

- all PPM packages should be numbered and logged to record each recipient's name and address as well as the nature of any pre-existing relationship with the company or broker;
- executed subscription agreements and investment letters should be checked for completeness and reviewed to determine the suitability of each investor;
- the company should require all PPM packages be returned from investors that choose not to participate in the offering;
- all offers should be monitored to ensure compliance with each state's securities laws;
- the company should develop procedures for solicitation of potential investors, which prevent general solicitation;
- offers should only be extended by the PPM; and

- the company and its counsel should monitor deadlines for state and federal filings required under securities laws.

## **Investor Due Diligence**

Once the offering is underway, the company must afford each investor, prior to purchase, the opportunity to ask questions, receive answers and obtain additional information that the company possesses or can acquire without reasonable effort or expense that is necessary to verify the information furnished.

Occasionally, if prospective investors indicate sufficient interest, the company will schedule one or more informational meetings. This type of meeting should be approached with caution. The decision to make oral representations should be weighed carefully against the risk of inappropriate or inadvertent disclosures. It is strongly suggested that copious notes should be taken at any investor meetings to provide a historical record to prevent problems down the road. And, any new or additional disclosures should be forwarded to all potential investors, especially if they were not present at the meeting. Additionally, all non-accredited investors have the right to be notified of any written material information concerning the offering that was provided to accredited investors and to receive such information upon written request a reasonable time prior to the purchase.

Efforts should be made to update the information throughout the offering. Circumstances change throughout a six-month offering. In fact, it may be necessary to update the information provided in the original PPM and highlight those changes to all investors, even ones that have already purchased securities. In some circumstances, if the information is material, prior investors must be given the opportunity to rescind their initial investment and be given a refund.

## Ancillary Documents

In addition to the PPM, a company will need a subscription agreement and investment letter, which will be executed by the potential investor once they have made their investment decision. The subscription agreement should be worded in such a manner that the potential investor offers to purchase the securities from the company. The agreement is typically drafted so that the potential investor's offer remains open for a predetermined amount of time, and the acceptance of which is within the total discretion of the company. A well-drafted subscription agreement will contain representation and warranties by the potential investor that they (i) are purchasing the shares for their own account and not with an intent to resell or otherwise participate in a public distribution of the shares, (ii) have such knowledge and experience in financial and business matters that they are capable of evaluating the merits and risks of an investment in the shares, (iii) understand they must bear the economic risk of an investment in the shares for an indefinite period of time because the shares have not been registered and, therefore, cannot be sold unless they are subsequently registered or an exemption from such registration is available, and (iv) have sufficient net worth and/or recurring income that they could afford the loss of their entire investment. In addition potential investors may be asked to acknowledge in the subscription agreement, that they were given the opportunity to ask questions, receive answers and obtain additional information from the company.

To the extent not already documented in the subscription agreement, it is important to have each potential investor fill out an investment letter, or questionnaire, documenting their status, which typically requests information regarding the investors net worth and investment experience. The company should always make the determination regarding suitability of potential investor rather than relying on their agent or affiliate.



## General Solicitation and General Advertising

The goal of any company undertaking a private placement is to avoid having it misconstrued as a “public offering.” However, that term is never actually defined in the Securities Act of 1933. Guidance has been given over the years in various interpretations by the SEC and the courts.

Rule 502(c) of Regulation D prohibits general solicitation or general advertising by an issuer or issuer’s agent, and offers a non-exhaustive list:

- Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and
- Any seminar or meeting whose attendees have been invited by general solicitation or general advertising.

A company’s general advertising that is generic and unrelated to the offering remains acceptable. The determination of a Rule 502(c) violation boils down to whether the advertising is used to offer or sell securities.

The SEC has offered some guidance discussing what is and what is not considered a general solicitation. They consider such factors as the number of offerees, the identity of offerees, knowledge and experience of offerees, and the relationship between the company and offerees. However, the critical issue is whether the company or its agent can demonstrate a substantial and preexisting relationship with the potential investors. A substantial relationship should include a discussion of financial goals with the investor, but also relates to the nature and quality of the relationship. A preexisting relationship typically means that it existed before the terms of the offering are developed and communicated to potential investors. A prior relationship is not

the only way to show absence of a general solicitation, but it is definitely one of the safest.

Under Rule 504, small businesses are allowed a limited offering exemption to raise seed capital. General solicitation is allowed only under a set of very limited circumstances: (i) in offerings registered under state law requiring public filing and delivery of a substantive disclosure document to investors before sale; or (ii) offerings exempted under state law permitting general solicitation as long as sales are made only to accredited investors.

## **Self-Managed**

A company may attempt to offer and sell the securities without the aid of third parties. Bearing in mind the substantial and preexisting relationship requirements, the company should evaluate its ability to locate investors meeting the requirements of its exemption. A company can use an “associated person” in connection with the sale of its securities, which is a partner, officer, director, or employee of the company or certain companies affiliated with the issuer. Certain rules provide a nonexclusive safe harbor from the definition of broker for the persons associated with a company who are engaged to sell securities related activities incident to their duties on behalf of the company.

## **Finders**

A “finder” is a person (company, service or individual) who brings together buyers and sellers for a fee, but who has no active role in negotiations and may not bind either of the parties. There are a couple of fine lines that a finder must not cross. As with the company, a finder can only distribute offering materials or pre-offering materials to prospective investors where a substantial and preexisting relationship is in place. If finders are too active in their solicitation, their actions may be considered a general solicitation

and therefore a public offering. If a finder is too active in consummating the transactions, which may include such things as involvement in negotiations, discussing details concerning securities or making recommendations or receiving transaction based compensation, the finder will be required to register as a broker-dealer, which it may or may not be able to do in a timely fashion.

A company should carefully evaluate the use of a finder. In addition to the risks under federal securities law, the use of a finder may implicate some state securities laws, which may limit the role of finders. In some states any sale through an unregistered agent, like a finder, is voidable. A company should check with its legal counsel to determine whether these state laws are implicated.

## **Placement Agents**

A placement agent, unlike a finder, is registered as a broker-dealer under the appropriate state and federal laws. It is important for the company to evaluate the ability of the placement agent to sell the company's securities, the number and nature of prior successful private placements, the time taken to complete each offering and their experience and prior history complying with securities laws.

Once a firm is selected, the appropriate documents should be pulled together and the company should meet with its broker to discuss questions and issues. It is not uncommon for the company to execute an agreement with the broker in which the broker: (i) designates which brokers are approved for the deal; (ii) agrees to certain policies and procedures regarding the offering to prevent general solicitation; and (iii) represents that it has all appropriate licenses.

## **Use of Internet**

The risk of becoming a public offering increases with the use of the internet as a tool to solicit offers from potential investors. The SEC has suggested in certain no-action letters that the electronic solicitation of investors where the prospective investors were pre-qualified through the use of questionnaires and then permitted to participate in the current offerings was acceptable. A detailed discussion of the advantages and risks of offering securities in this manner can be found in Section Nine of this book, "Private, Public and Offshore Offerings on the Internet."

## **THE CLOSING**

The company should officially "close" the offering in the manner that is disclosed in its PPM, which is dependent on the official deadline of the offering and whether it is an all-or-none arrangement or a mini-maxi arrangement. Once the offering is closed, the company should notify each investor that has executed a subscription agreement whether or not the offering was a success, and if necessary, return the investors funds held in escrow if the minimum funds were not raised.

It should be noted that it is not uncommon for the company to reserve the right in the PPM to extend the offering without the permission of the investors. If the company chooses to extend the offering, it should send a letter notifying all investors that have executed subscription agreements as well as those with outstanding PPMs.

Once a successful offering has closed, the company should prepare and distribute stock certificates to each investor. The company should retain copies of all stock certificates delivered as a record that they included a restrictive legend. Since the offering is closed, the capital is now available for use and the company should begin to use the funds consistent with the manner it disclosed in the PPM.

## **SECTION SIX: STRATEGIC ALLIANCES**

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### **DEFINING A STRATEGIC ALLIANCE**

Emerging growth companies in search of capital may find that “strategic alliances” offer a good alternative to traditional equity capital sources such as “angel” investors or venture capital firms. What is a “strategic alliance”? While it can take many forms, in essence a strategic alliance is an agreement or joint venture between two (or more) businesses to collaborate and pool resources for mutual benefit. The joint enterprise is called “strategic” when at least one party believes that the joint venture is fundamental to its strategic objectives.

Unlike commonly recognized business entity forms, such as a corporation, partnership or limited liability company, a strategic alliance in and by itself is not a legal form governed by state laws. Take the corporate entity form as an example, if a company that is incorporated in the State of Minnesota does not specifically address certain matters such as preemptive rights in its articles of incorporation, then Minnesota law will fill in the gap and provide for preemptive rights to shareholders. For a strategic alliance, however, it is up to the parties to define their relationship by contract because there is no state or federal law that will per se fill in any blank terms of such alliance.

Frequently, strategic alliances involve an established, mature company (the “Senior Party”) and an early-stage company (the “Junior Party”). The focus of the alliance can involve a wide variety of subjects, such as research and development,

manufacturing, product distribution or licensing. In the biotech industry, a common theme among strategic alliances is for a mature biotech or pharmaceutical company to fund an R&D project that will be carried out primarily by the Junior Party. In return, the Senior Party obtains certain licensing or distribution rights to the product. Many strategic alliances also involve an equity investment by the Senior Party in the Junior Party.

## **BENEFITS OF A STRATEGIC ALLIANCE**

What do companies get out of strategic alliances? What are the benefits? From the **Junior Party's perspective**, strategic alliances can offer a number of benefits, such as:

- access to capital at attractive rates
- obtaining financing for specific R&D projects
- increasing the Junior Party's visibility in its industry and marketplace through affiliation with a more established Senior Party
- access to governmental and regulatory expertise (e.g., the FDA approval process) possessed by the Senior Party
- developing a relationship with one or more potential acquirers

On the other hand, from the **Senior Party's perspective**, there are a number of different benefits to be derived from a strategic alliance, such as:

- access to new technology
- "locking-up" new technology from competitors

- conducting “off balance sheet” R&D
- shortening R&D project cycles
- filling in gaps in product lines
- evaluating a potential acquisition target over an extended time period

## **RISKS OF A STRATEGIC ALLIANCE**

While both parties to a strategic alliance will experience a number of risks, such as the risk of failure, the Junior Party will more often bear a larger number of risks than the Senior Party. The Junior Party may experience a loss of control and independence or even an unintended acquisition by the Senior Party, either through the contractual terms of the alliance or as a result of issuing a significant amount of equity to the Senior Party. For example, the Junior Party may be required by the terms of the agreement to grant to the Senior Party an exclusive license to use the alliance’s product for certain applications or in certain geographic markets. The Junior Party may have to relinquish to the Senior Party substantial control of the technology used by the alliance. The risk of failure may also have a greater impact on the Junior Party than on the Senior Party given the relative size and importance of the undertaking to the Junior Party. Finally, care should be taken in structuring the strategic alliance to avoid anti-trust problems or creating an unintended partnership with potential adverse tax consequences to one or both parties.

## **KEYS TO A SUCCESSFUL ALLIANCE**

The reality is that most strategic alliances do not meet all of the expectations of their participants. Why is this? What distinguishes the successful strategic alliances from the unsuccessful ones? What have companies learned that will help insure a more successful alliance?

Here are some observations which companies have identified as keys to a successful strategic alliance:

- **Choose a Strategic Partner Carefully.** Prepare a list of potential candidates. Find out what experience they have with strategic alliances and joint ventures. Investigate them thoroughly, taking into account their resources, product and service lines, market position, company culture and reputation. Take time to select the right partner—it will be time well spent.
- **Select the Right Form of Alliance.** Since a strategic alliance may take any form such as a partnership, joint venture or licensing relationship, it is essential for the parties to evaluate their respective needs and goals and select the most suitable form for their alliance. Important factors affecting the selection of the form of alliance include tax planning, accounting and other related considerations.
- **Develop Well-Defined and Mutually Beneficial Goals for the Alliance.** It is important to establish the goals for the alliance at the outset. This will help avoid misunderstanding or disputes that might arise later. Equally important is that the alliance work for both parties—not just one. If it is not mutually beneficial, then it won't pass the test of time.
- **Make Certain there is Multi-Level “Buy-In” and Support for the Alliance at the Senior Party.** Frequently the Senior Party is a large company with a large bureaucracy. Having only one advocate at that company—however strong he or she might be—is very risky. There should be “buy-in” for the strategic alliance on multiple levels at the Senior Party for it to succeed over the long term. People come and go—particularly at large companies—and the strategic alliance should not be dependent on the backing of a sole advocate who may leave the organization.



- **Develop Key Personal Relationships, Built on Trust, Throughout the Life of the Alliance.** Equally important to the business issues involved in the alliance are the people who must work together to make the alliance succeed. Take the time to develop and maintain those relationships as they will likely be key to resolving the inevitable issues that will arise over the course of the alliance.
- **Provide for Effective Communications and Management of the Alliance.** Most alliances are living relationships that need clear communications and management to develop and thrive. Make sure the lines of communication are open and the responsibilities for managing the project are clearly established from the outset.
- **Build in Reasonable “Exit Strategies” for Both Parties.** When the strategic alliance is being put together, the parties naturally have great expectations for success. Experience, however, has shown that many alliances don’t meet the parties’ expectations and frequently need to be unwound early. In order to avoid disputes, the agreement should provide a method for each party to get out of the alliance under reasonable circumstances.
- **Agree on Means of Conflict Resolution.** No matter how well a strategic alliance is set up and operated, it is also worth the time and effort at the start of the relationship to provide for ways to resolve potential conflicts. The more specific conflict resolution terms are, the better the parties may later rely on such terms to smooth out any obstacles in the due course of the alliance.



## **SECTION SEVEN: INITIAL PUBLIC OFFERINGS**

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“Going public” is the process by which a company sells its stock to the general public through the registration process. The decision to take a company public is an important decision in the life of a company and should not be taken lightly. There are many good – and bad – reasons to go public, and being a public company has both its advantages and disadvantages, all of which should be considered carefully before embarking on the road to becoming a public company.

### **ADVANTAGES AND DISADVANTAGES OF GOING PUBLIC**

Many times the need to raise capital through the public markets or to provide liquidity to venture capital and other investors will put significant pressure on a company to go public. Nevertheless, companies should carefully consider all of the various advantages and disadvantages before making the decision to go public.

#### **Advantages**

- The company will raise additional capital and improve net worth.
- A public trading market will be established for the company’s securities.

- The company's shareholders will have greater liquidity and a potentially higher price for securities than generally available in a private offering.
- The company will have greater ability to use equity incentives for employees under stock option or other similar plans.
- The company will have greater flexibility to make acquisitions with stock rather than cash.
- If the company's stock performs well, going public provides the company with greater ability to obtain additional capital through future public or private offerings or to pay for acquisitions with stock.
- The company may receive increased attention from the investment community and greater publicity.
- The company may have a competitive advantage over other companies and provide customers with a greater feeling of stability.

## **Disadvantages**

- There will be immediate dilution of the company's securities and, potentially, a loss of control.
- The company will be required to file Forms 10-Q and Forms 10-K with the Securities and Exchange Commission, or SEC. The company will also be required to comply with SEC proxy rules for shareholder meetings, insider trading restrictions and various accounting regulations. These rules make certain types of transactions more complicated and expensive. Moreover, as a result of the recently enacted "Sarbanes-Oxley Act of 2002", public companies and their officers and directors are subject to significantly more restrictions and liabilities than previously existed.

- The company will be required to reveal significant information about its business and management, including executive compensation, which would not otherwise need to be disclosed.
- Public availability of certain proprietary information may give competitors an advantage.
- Significant corporate action will be scrutinized by the investment community, shareholders and security regulators, resulting in a loss of management flexibility and greater risk of shareholder lawsuits.
- Public shareholders tend to focus on the ongoing market price for company shares, which may lead to a preoccupation with short-term financial performance.
- Public offerings are expensive. Depending on the size and type of the offering, expenses typically range from \$500,000 to \$1,000,000 in addition to underwriting commissions. The company will be responsible for much of the expense even if the offering is not completed. Additionally, the costs of operating a public company are greater than those of a private company.
- Completion of a public offering will take three to four months and will require a significant time commitment from senior management.

## **SELECTING AND COMPENSATING THE UNDERWRITERS**

The selection of a managing underwriter is one of the first and most important steps in the public offering process. A company which is going public should engage in a careful and thorough

evaluation to determine which investment banking firm is best suited to lead its public offering. Choosing the “right” managing underwriter can often make the difference between a successful and unsuccessful offering.

## **Selecting a Managing Underwriter**

The managing underwriter provides the basic advice and strategy in structuring the offering, manages the mechanics of the underwriting process and the offering, and generally leads the effort to provide post-offering support, such as market making and research.

The type of investment banking firm available to the company will depend on the size of the offering and the size, financial performance and industry of the company. There are several brackets or levels of underwriters. The larger and more prestigious the investment banking firm, the more likely it is that they will have minimum requirements regarding the size and per share price of the offering as well as the level of profitability of the company. For example, while exceptions may be made if the company is in a “hot” industry, national and major regional investment banking firms will generally only become involved in offerings raising at least \$50 million for companies with several years of operations and which have already achieved profitability.

While the higher bracket investment banking firms may be more prestigious, other factors should also be considered. The company should look at the candidate firm’s reputation and record of successful offerings, ability to put together a strong group of underwriters, access to retail and institutional investors, knowledge of the company’s industry, after-market support potential, ability to provide research and financial advisory services as well as the proposed terms of the underwriting (i.e. the price for the underwriter). The investment banking firm’s commitment to the offering is also an important factor. Because

other offerings by the same firm will compete for the time and attention of potential investors and the firm's sales force, it is important to make sure that the investment banking firm is strongly committed to the offering.

Once a managing underwriter has been selected, a basic understanding should be reached regarding the essential business terms of the offering. These terms are sometimes set forth in an "engagement letter" that is not binding except for certain provisions such as reimbursement of the underwriter's expenses if the company does not go forward with the offering.

## **Underwriter Compensation**

The basic form of underwriter compensation is a cash commission or discount from the public offering price, expressed as a percentage of the price. While the commission will depend largely upon the size and quality of the offering and the company, commissions for an initial public offering will typically range between six and ten percent. Depending again on the size and quality of the offering, the underwriter may request additional compensation in the form of stock warrants or a right of first refusal to act as underwriter for the company in its next offering.

In most offerings, the company will pay some of the underwriter's expenses. Usually, expenses incurred to comply with various state securities laws, including legal fees, are paid by the company. Depending on the size and quality of the offering, the underwriter may request that other legal fees be paid, and may request that the company pay a non-accountable expense allowance based on a percentage of the offering. Under rules of the National Association of Securities Dealers, or NASD, the non-accountable expense allowance may not exceed three percent of the offering.

## **STRUCTURING THE OFFERING**

The type, size and pricing of the offering are crucial to its success. Although the company may have a sense of how the offering should be structured, the company and the underwriters will ultimately need to agree on the terms.

### **Type of Offering**

The most common and the most desirable type of underwriting is a “firm commitment” underwriting. In a firm commitment underwriting, the underwriters contractually commit, as of the effective date of the registration statement, to purchase the securities following the effective date of the registration statement. As a result, nothing is “firm” until the underwriting agreement is signed and the registration statement is effective and even then there are certain “market outs” which allow the underwriters to forego their commitment upon the occurrence of certain events (e.g., suspension of trading, significant lawsuits, adverse changes in the business or events that make statements in the prospectus untrue).

In a “best efforts” underwriting, which is generally perceived as a less prestigious type of underwriting, the underwriters contractually agree, again as of the effective date of the registration statement, to use their best efforts to sell the securities as an agent on behalf of the company. Typically, best efforts offerings are done on a minimum/maximum or an all-or-nothing basis. In such cases, funds are usually held in escrow until the requisite amount of securities (either the stated minimum or all) is sold.

### **Size of Offering and Type of Security**

The size of the offering will depend both upon how much capital is needed by the company and how much capital the underwriters believe can be raised. If the offering is too large, the underwriter



may have difficulty selling all of the securities, which may cause the offering to be perceived as a “weak” deal. If the offering is too small, it will be uneconomical for all concerned and may not result in sufficient “float” to create a viable after-market for the securities.

Although most initial public offerings are of common stock, some offerings, particularly in higher-risk transactions, involve a combination of common stock and warrants. Although warrants sold in combination with common stock may provide a source of additional capital down the road, they may require the company to keep a registration statement effective, which can be expensive and burdensome, and may interfere with future financings.

### **Pricing of the Offering**

The company should reach an early understanding with the underwriter about the price of the securities being sold as well as the basis for that price. Usually a price range will be set forth in the preliminary prospectus. Although this is not binding and can be changed, a downward adjustment may be interpreted as a sign of weakness.

National and major regional underwriters generally prefer a per share price of over \$10. A price range of \$10 to \$15 is often considered attractive to both institutional and retail investors. Smaller regional and local underwriters are generally willing to accept (and may prefer) a lower per share price.

The final pricing of an offering usually takes place after the close of the market on the effective date of the registration statement, with the offering “brought to the market” the following day. The price will be determined during a pricing meeting between the underwriter and the company and will be based upon a number of factors such as the demand for the offering, any large-order price limits, as well as current market conditions.

## **Inclusion of Selling Shareholders in the Offering**

An offering may consist solely of shares sold by the company, by existing shareholders or by both. The inclusion of these “selling shareholders” allows the company to eliminate large blocks of shares that might otherwise “overhang” the market following the offering and depress the company’s stock price in the after-market. Including selling shareholders in the offering also provides liquidity to shareholders who might otherwise be prohibited from selling shares into the market for a period of time following the offering because of resale restrictions under the securities laws or “lock-up” agreements (i.e., agreements not to sell shares for a period of time following an offering).

Determining the appropriate mix between company-issued shares and selling shareholder shares is important. Money which goes to selling shareholders obviously does not go to the company. Additionally, the company must avoid the appearance of a “bailout” by inside shareholders. The underwriter will generally prohibit the inclusion of selling shareholders in an IPO. If selling shareholders are involved, the company should consider its contractual obligations to register shares held by shareholders, the method for cutting back shares if the size of the offering is reduced, the sharing of registration expenses, the mechanics of binding the selling shareholders (custody agreements for certificates and powers of attorney to make final decisions, including price) and lock-up agreements.

## **Lock-Up Agreements**

To facilitate an orderly distribution and stable post-offering trading market in the company’s shares, the underwriter typically will require that officers, directors and other large shareholders agree not to sell their shares for a period of time after the effective date of the registration statement. Typically, this period of time is between 90 and 180 days. The underwriter may also require that

sales made after the end of this lock-up be made through the underwriters for a certain period of time.

## **THE REGISTRATION PROCESS**

The registration process is a time consuming process made up of four phases:

- Preparation Period - the period during which the company prepares for commencement of the offering.
- Pre-Filing Period - the period from the organizational meeting to the filing of the registration statement with the SEC.
- Waiting Period - the period from the date of filing to the date of effectiveness of the registration statement.
- Post-Effective Period - the period following effectiveness of the registration statement.

### **Preparation Period**

The company must initially consider taking a number of steps:

- The company's articles of incorporation may need to be changed to better accommodate the offering and/or to better meet the needs of being a public company. It will be easier to change the articles at this point rather than after the offering. Such changes may include: effecting a recapitalization, reincorporation, stock split or increase in the authorized number of shares; creating a class of "blank check" preferred stock; implementing a staggered Board of Directors or other anti-takeover measures; and removing preemptive rights.
- It may be necessary to amend the company's bylaws. For example, the company should consider strengthening the

indemnification of officers and directors, removing all transferability restrictions on shares, altering the size of the Board of Directors and providing for future amendments without shareholder approval.

- The company may wish to amend or adopt stock-based employee benefit plans.
- Agreements with existing shareholders and other insiders should be examined. Notification requirements for all registration rights should be satisfied and buy-sell agreements, rights of first refusal and other similar provisions should be terminated or waived in light of the offering.
- The company should determine which financial statements are needed. In addition, accounting issues should be considered, such as earnings charges for options granted prior to the offering at too steep a discount from the public offering price.
- A financial printer should be selected.
- A registrar and transfer agent should be selected.
- All existing material contracts should be reviewed to determine whether there are any potential conflicts or issues.
- Potential patent or other intellectual property issues should be considered.

### **Pre-Filing Period**

An organizational meeting of the working group should be held. The working group will consist of representatives of the underwriter, the company, company's counsel, underwriter's counsel and the auditors. The responsibilities of each participant in the working group should be established and a timetable

prepared. The following primary activities will need to be completed during this time:

- The form of registration statement should be determined. Typically, a Form S-1 or Form SB-2 is used for an initial public offering.
- Company's counsel will typically prepare the first draft of the registration statement. The drafting process will consist of a series of drafting sessions and due diligence meetings. The members of the working group, including senior management of the company, typically attend these meetings.
- While drafting and redrafting the registration statement, the underwriter and its counsel, as well as company's counsel, will conduct "due diligence." This is a process by which the accuracy and completeness of the information contained in the registration statement is confirmed. All information regarding the company, including its products, operations, facilities and management, will be analyzed. While lengthy, expensive and burdensome, this due diligence process is also crucial.
- The company's auditors will prepare the necessary audited and interim financial statements. The number of years of audited financial statements required depends on the form of registration statement used.
- Questionnaires should be prepared and circulated to officers, directors, greater-than-five percent shareholders, and any selling shareholders. These questionnaires elicit information about these persons that is required to be disclosed in the registration statement or elsewhere.
- Extensive exhibits must also be filed as part of the registration statement, and the company should begin identifying and collecting all material agreements early in the process. This is

particularly important now that all SEC filings must be transmitted electronically through the EDGAR system. Exhibits that are not stored on disk or other electronic medium must be scanned or typed into such a format. At this point, the company should consider seeking confidential treatment with respect to certain information contained in some of these exhibits.

- At the end of the process company's counsel will file the registration statement with the SEC and underwriter's counsel will file the registration statement and the underwriting documents with the NASD and with state securities commissioners if Blue Sky filings are required.

During this period, the fact that a company is undertaking a public offering should remain confidential. Until the registration statement is filed, the company must be very careful about what its employees and agents say about the company. The SEC has stated that corporate publicity that has the effect of conditioning the public market or arousing public interest in the offering constitutes an offer to sell a security – which is prohibited unless a registration statement has been filed. As a result, certain activities or publicity prior to the filing of the registration statement may result in illegal “gun jumping.”

On November 3, 2004, the staff of the SEC proposed significant new rules (the “Securities Act Reform”) that directly affect communications made prior to the filing of a registration statement. It is generally expected that the SEC will take action with respect to the Securities Act Reform sometime during 2005.

If adopted as proposed, the Securities Act Reform will modify the current prohibitions against “gun jumping.” For example, one proposed rule creates a safe harbor for communications made more than 30 days prior to the filing of a registration statement. There are numerous detailed requirements that must be complied with in order for a company to qualify for the safe harbor.

Accordingly, a company undertaking a public offering should consult with its counsel before releasing any important communications.

## **Waiting Period**

The waiting period commences upon the filing of the registration statement with the SEC and ends when the registration statement becomes effective. Because the term “prospectus” is broadly defined to mean any prospectus, notice, circular, advertisement, letter or communication, whether written or transmitted by radio or television, the pre-filing guidelines regarding corporate publicity and advertising must continue to be followed. A press release and “tombstone” ad may be done at the time of filing, but the information contained in the press release or ad, while more extensive than that contained in a pre-filing press release, is still limited.

During this period, the following activities take place:

- The legal and accounting staff at the SEC will review the registration statement to ensure that it meets all of the SEC’s disclosure rules. Generally, 30 days after filing the SEC will provide the company with comments to the registration statement. These comments must be addressed to the relevant SEC examiner’s satisfaction and will necessitate the filing of one or more amendments to the registration statement. Depending on the nature and extent of such comments, it will take two to four weeks to address all of the SEC’s comments by filing amendments to the registration statement. If the company has filed a request for confidential treatment with respect to information contained in certain exhibits, it may be necessary to respond to the SEC’s comments regarding this as well.

- The NASD will review the registration statement and the underwriting documents to determine that the compensation to be paid to the underwriters is fair.
- The company will file an application to have its shares listed on a stock exchange such as the NYSE or the Nasdaq Stock Market immediately following effectiveness of the registration statement. The stock exchanges and the Nasdaq Stock Market each have their own listing requirements which a company must meet in order to have its shares listed. The stock exchange or the Nasdaq Stock Market will evaluate the company's past performance and likely future performance and will then make a decision whether to list the company's stock.
- During the waiting period, offers to sell may only be made by means of the preliminary prospectus or "red herring." The underwriter will circulate the red herring to prospective purchasers. The underwriter may receive "indications of interests" but no offers may be accepted at this time.
- Once the most significant of the SEC's comments have been addressed, the underwriters will arrange and conduct informational meetings where company management makes presentations to members of the selling group and potential investors. These presentations are referred to as "road shows" and may occur in a number of cities in the United States and foreign countries, depending on the offering. While extremely important, road shows impose significant demands on the company management's time and attention. It is therefore important for the company to prepare in advance so that its operations are not neglected during this time.
- Another significant aspect of the Securities Act Reform is in the area of promotions during the waiting period. The SEC has proposed rules that would treat electronic road shows



(typically distributed via the company's website) as free writing prospectuses. Therefore, so long as a company files the information presented in the road show with the SEC, it can make information beyond the statutory prospectus available through electronic road shows.

- Moreover, another rule present in the Securities Act Reform provides a cure period for companies that make unintentional and immaterial violations of the free writing prospectus filing requirements mentioned above. At the time of this writing, it cannot be determined whether the SEC will adopt these rules as currently proposed. Accordingly, companies should seek the assistance of counsel before implementing an electronic road show of their offering.
- After the SEC's comments have been satisfactorily addressed, the NASD has completed its review and the road show has been completed, the company and the underwriter will request acceleration of the effectiveness of the registration statement. The SEC will typically declare the registration statement effective within 48 hours of the request for acceleration.
- A pricing meeting will be held following the close of the market on the day of effectiveness. Pricing meetings can often be intense and difficult negotiations. It is at this time that the per-share price and the underwriting discount will be established.

### **Post-Effective Period**

At this point the offering process is nearly complete. The following activities are left to occur:

- Trading of the company's stock will begin when the market opens on the first business day after the registration statement is declared effective.

- The underwriter will immediately confirm orders, delivering to the parties placing an order a copy of the final prospectus along with the confirmation of their order.
- A closing will occur three or four business days after the effective date. At the closing, the company will deliver stock certificates, which is generally done electronically, legal opinions from its legal counsel, comfort letters from its accountants and various other closing documents. The underwriters will deliver the proceeds of the offering to the company.
- For initial public offerings, dealers must continue to deliver final prospectuses for a period of time following the effective date. Until this prospectus delivery requirement ends (the “quiet period”), the pre-filing and waiting period guidelines regarding corporate publicity and advertising must generally continue to be followed. In addition, during the quiet period, the company, the underwriter and their respective counsels must continue to monitor developments and consider supplementing the prospectus if any material developments do occur.
- Under the Securities Act Reform, the SEC has proposed a significant change in the prospectus delivery requirements during the IPO process. Because many investors who participate in IPOs are sophisticated and familiar with the process, the SEC has proposed a rule which would eliminate the requirement that a paper copy of the final prospectus be delivered to investors for a specified period of time during the post-effective period. Under the proposed “access equals delivery” rule, so long as the final prospectus has been filed with the SEC, underwriters will be relieved of the obligation to deliver a paper prospectus to each investor.

## **BLUE SKY LAWS**

State securities laws, or “Blue Sky Laws”, must be considered throughout the process. Pursuant to recent federal legislation, some state Blue Sky regulation of public offerings is preempted by federal law. If there is no preemption, the offering must comply with the Blue Sky Laws of all states in which securities are to be sold. Although many states have adopted uniform laws and policy statements, there is still a certain degree of variation from one jurisdiction to another. In addition, state securities law administrators generally have a broad degree of discretion in applying the laws and policies of their state.

The regulatory approach followed by various states may be divided into those that do and those that do not apply “merit review.” States that have adopted the concept of merit review prohibit or restrict sales of securities that are considered by the state administrators to be highly-speculative or low in quality. States that have not adopted merit review generally require only that notice of the offering be given, that copies of certain documents be filed, and that the state be notified of the effective date of the registration statement.

A more detailed discussion of Blue Sky Laws in Minnesota can be found in Section Three of this book, “Securities Law Considerations”.

## **FEDERAL REGULATION OF PUBLIC COMPANIES: THE SARBANES OXLEY-ACT**

On July 30, 2002, President Bush signed the Sarbanes-Oxley Act of 2002 (the “Act”) into law, which imposes significant new duties on public companies and their directors, executive officers, auditors and plan administrators. The Act was intended to restore trust in the integrity of capital markets by holding public companies and

the people that work for them more accountable to shareholders. Following the effective dates for various sections of the Act, there have been a number of substantial developments in many of the major provisions of the Act. The following summary highlights the most significant aspects of the Act.

## **Director and Executive Officer Obligations and Restrictions**

- **Certification of Financial Reports and Internal Controls.** One of the more noteworthy obligations, is the requirement that a public company's principal executive officer and principal financial officer make certifications as to the veracity of each annual and quarterly report filed with the SEC, as well as the effectiveness of the company's internal controls.
- **Certification of Annual and Interim Reports.** In addition to the more extensive certification discussed above, the Act mandates that the CEO and CFO of every public company provide a written statement with each periodic report that the report "fully complies" with the Securities Exchange Act of 1934 and "fairly presents, in all material respects," the financial condition and results of operations of the company.
- **Accelerated Disclosure of Insider Transactions.** In a significant change, the Act amended Section 16 of the Exchange Act to greatly accelerate the reporting obligations of directors, executive officers and 10% shareholders of a public company. Such persons will be required to report any change in their ownership before the end of the second business day following the transaction or "at some other time the SEC shall establish, by rule," in any case in which the SEC determines that such 2-day period is not feasible.
- **Ban on Personal Loans.** The Act prohibits "extensions of credit" in the form of personal loans or otherwise, directly or

indirectly, to directors and executive officers, subject to certain limited exceptions.

- **Bonuses and Other Compensation.** If a public company is required to restate its financial statements as a result of material noncompliance, due to misconduct, with any financial requirement under the securities law, the CEO and CFO must reimburse the company for (i) any bonus or other incentive-based or equity-based compensation they received from the company during the 12 month period following the issuance of the misstated financial statements and (ii) any profits realized from any sale of the company's securities during such 12-month period. The SEC has authority to exempt any person from the application of this rule.
- **Insider Trading Restrictions During Blackout Periods.** The Act prohibits a director or executive officer from purchasing or selling employer securities acquired in connection with his or her service or employment as a director or executive officer, during any "blackout period" of any individual account plan. This restriction will not apply to securities exempt from federal securities registration.

For purposes of the insider trading restriction, a "blackout period" is defined as a period of more than three consecutive business days during which at least 50% of all participants under all individual account plans of the employer are unable to buy or sell employer stock held in the plan(s). Regularly scheduled prohibitions on trading and suspensions imposed due to a corporate merger, acquisition or divestiture or a similar transaction involving the plan or plan sponsor are exempted from the definition of blackout period.

The Act requires the issuer of the employer securities to provide timely notice of the blackout periods to directors or officers, as well as the SEC.

- **Other Provisions.** Directors and officers will be subject to substantial penalties if they improperly influence or mislead the company's independent accountants in the performance of an audit.

The Act provides a lower standard of proof for the SEC to meet in order to bar a person who violates the Federal securities laws from acting as a director or officer of any public company.

## Enhanced Review and Disclosure Requirements

- **Enhanced Review of Periodic Disclosures.** The Act requires the SEC to review the disclosures, including financial statements, of every public company on a regular and systematic basis. The Act identifies factors the SEC may consider in determining the frequency of such reviews, but mandates review of every issuer's disclosures no less frequently than once every three years.
- **Real Time Disclosures.** The Act requires public companies to disclose, on a rapid and current basis and in plain English, such information concerning material changes in the financial condition or operations of the company that the SEC may by regulation require. On March 25, 2004, the SEC released final regulations discussing the additional Form 8-K reporting requirements. In general, the SEC increased and accelerated the events that trigger current reporting requirements under Form 8-K.
- **Management Assessment of Internal Controls.** Pursuant to the Act's mandate, the SEC has prescribed rules requiring each annual report to contain an "internal control report" that (i) states the responsibility of management for establishing and maintaining adequate internal controls for financial reporting and (ii) contains an assessment of the effectiveness of the

issuer's internal controls. The company's independent accountants are required to attest to and report on management's assessment of the companies internal control structure and procedures.

- **Other Disclosure Rules.** Additional rules adopted by the SEC require disclosure concerning:
  - the company's code of ethics for senior financial officers;
  - the financial expertise of the company's audit committee;
  - off-balance sheet transactions, arrangements, obligations (including contingent obligations) of the company with any unconsolidated entity or other persons; and
  - pro forma financial information included in any periodic or other report filed with the SEC.

## **Auditor Independence Issues**

- **Non-Audit Services.** The Act prohibits registered public accounting firms from performing any of the following non-audit services while also performing audit services for a public company:
  - bookkeeping and other services related to accounting records or financial statements;
  - financial information systems design and implementation;
  - appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
  - actuarial services;

- internal audit outsourcing services;
- management functions for human resources;
- broker or dealer, investment adviser, or investment banking services; and
- legal services and expert services unrelated to the audit.

The prohibition on non-audit services is scrutinized by the Public Company Accounting Oversight Board (the “Oversight Board”), which has oversight powers over all firms that audit public companies. A registered public accounting firm may engage in any non-audit service not listed above, such as tax services, if the activity is approved in advance by the company’s audit committee.

- **Additional Conflicts of Interests.** The Act prohibits an accounting firm from performing any audit service for a public company if the company’s CEO, CFO, controller, chief accounting officer or person serving in a similar position was employed by that firm and participated in any capacity in the audit of that company during the previous year.
- **Audit Partner Rotation.** The Act requires that, effective immediately, the lead audit partner responsible for the audit and the audit partner responsible for reviewing the audit be rotated at least every five years. The Act directs the General Accounting Office, moreover, to study and report on the issue of mandatory periodic rotation of the entire audit firm.
- **Auditor Reports to Audit Committees.** Each registered public accounting firm performing an audit must make timely reports to the company’s audit committee concerning (i) all critical accounting policies and practices to be used, (ii) all alternative accounting treatments discussed with management, the ramifications of such alternatives and the treatment preferred



by the registered public accounting firm; and (iii) other material written communications between the accounting firm and management.

## **Audit Committees**

- **Audit Committee Responsibilities.** The Act makes the audit committee directly responsible for the appointment, compensation and oversight of the company's auditors, who are required to report directly to the audit committee. Accordingly, the audit committee has the sole responsibility for hiring and firing the company's independent auditors, and for approving any significant non-audit work to be performed by the auditors.
- **Independence.** The audit committee must be comprised solely of members of the company's board of directors who are otherwise "independent," meaning that they may not accept any consulting, advisory or other compensatory fees from the company (other than for serving on the board of directors or a board committee) or otherwise be affiliated with the company.
- **Authority to Engage Advisors and Funding.** The Act gives the audit committee authority to engage independent counsel and other advisers necessary to carry out its duties and requires the company to provide appropriate funding to pay for such independent counsel and advisers, as well as the company's auditors.
- **Complaints.** The Act requires the audit committee to establish procedures for (i) receiving and dealing with complaints received by the company regarding accounting, internal accounting controls, or auditing matters and (ii) the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters.

## Rules of Professional Responsibility for Attorneys

The Act requires the SEC to prescribe minimum standards of conduct for attorneys appearing and practicing before the SEC in any way in the representation of public companies including rules:

- requiring any attorney to report evidence of a material violation of the securities laws or breach of fiduciary duty or similar violation by the company or its agents to the chief legal counsel or CEO; and
- if the counsel or CEO does not appropriately respond to the evidence, requiring the attorney to report the evidence to the audit committee or another committee comprised solely of independent directors.

## Enforcement Mechanisms

- **Criminal Penalties.** The Act creates enhanced criminal penalties for securities fraud, for the destruction, alteration or falsification of records in connection with an investigation and for other white-collar crimes. As noted above, the CEO and CFO certifications as to the accuracy of financial statements and other disclosures are made at the risk of criminal penalties, including severe fines and up to 20 years imprisonment. Auditors are required to maintain their records for five years after an audit or risk imprisonment for up to 10 years.
- **Civil Enforcement.** The Act extends the statute of limitations for a private plaintiff to sue for securities fraud to a period of two years after discovery of the violation, or five years after the violation occurred, whichever is earlier. The Act also provides whistleblower protections for employees of public companies. Additionally, the Act amends the Federal bankruptcy laws so that a debtor cannot discharge in bankruptcy its liability for

violations of Federal or State securities laws or common law fraud, deceit or manipulation in connection with the sale of any security.

- **Increased Criminal Penalties for ERISA Violations.** Effective July 30, 2002, the Act increased the maximum criminal penalties under ERISA for willful violation of ERISA's reporting and disclosure requirements. Under prior law, an individual faced a fine of up to \$5,000 and/or up to one year in prison. The Act increases the penalties to a fine of up to \$100,000 and/or up to 10 years in prison. The Act also increases the maximum criminal penalty for corporations, partnerships and other non-individuals from \$100,000 to \$500,000.



## **SECTION EIGHT: LOANS, LEASES, GRANTS AND OTHER FINANCIAL RESOURCES**

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While equity is the most frequently used form of financing for start-up and early-stage companies, it is only one option. The following are additional sources of money or resources that companies should consider: loans (including government-guaranteed loans), leases, and free resources, including grants.

### **LOANS**

The most common form of financing for many start-up companies, after founder's equity, is debt financing. Companies must make sure they understand their obligations when incurring debt. First, the company must eventually repay the money received, called the principal, to the lender. Whether the principal must be repaid in installments or in one large payment at the end of the loan term varies. Second, the company generally must make interest payments at regular intervals during the loan term. These payments are in addition to the principal borrowed; they are payment to the lender for use of the principal. Interest is paid as a percentage of the principal, and the percentage, or interest rate, varies with the characteristics of the loan. Third, the lender may impose requirements on the borrowing company as a condition to making the loan. Examples of such conditions are maintaining a certain amount of equity, or net worth, for each dollar of debt, and investment of a specified amount in the company by its owner.

As with equity financing, there are advantages and disadvantages to debt financing that the company should consider when seeking start-up capital. Debt has two important benefits. Unlike the case with equity, lenders do not obtain an ownership interest in the company when a loan is made; instead, the company will likely owe the lender regular interest payments. Such interest payments are tax deductible, while dividends paid to investors with ownership interests are not. Moreover, the principal received as loan proceeds is not included in the company's taxable income when the loan is made (although neither is repayment of such principal deductible from income).

Debt also has some drawbacks. First, debt payments must be paid on a fixed date or upon the occurrence of a predetermined event regardless of the availability of the company's cash. In contrast, dividends are generally paid only when the company can afford it. If debt payments are not made, the company is in default on the loan. When the company defaults, a secured lender may be entitled to seize some or all of the company's assets, which may force the company into bankruptcy. Second, taking on current debt may restrict a company's ability to obtain debt financing in the future – even for a compelling purpose. Lenders are hesitant to make loans to companies, especially start-ups, if the companies already have significant debt, due to the higher risk of the investment. Third, and perhaps most significant, loans may be unavailable for start-up companies without positive cash flow. While venture-stage financing may not be readily available either, venture capitalists and angel investors generally seek to invest in moderate to high-risk companies. That is the nature of their business. Most lenders are interested in lower risk investments.

## **Types of Debt**

There are several types of debt. Probably the most important distinction among types of debt is whether the debt is “secured” or not. When debt is secured, the lender has obtained a lien on some

or all of the borrowing company's property including, in some cases, anticipated future property. A lien allows the lender to seize certain property if and when the company defaults on the loan. A default may consist of a missed or late payment, or a violation of another condition in the loan agreement.

In most loans to start-up companies, the lender will require that all of the company's assets be given as collateral, for two reasons. First, start-up companies present the significant risk that they will fail and the lender will lose its money. The lender seeks to minimize its risk by creating a method – the use of a lien – through which it can seize and sell the company's assets if a default occurs. This sale allows the lender to recoup some of its money. Second, many start-up companies do not own many assets. In such cases, the lender will need to use all of the company's assets as "collateral," or assets it may seize in case of default. Loans may, however, be unsecured, meaning the lender cannot seize and sell any of the company's property if a default occurs. Instead, the lender must sue the company for the loan amount. Such unsecured loans are rare for start-up companies, due to the lending risk involved.

Typical types of collateral include the following:

- Real estate
- Equipment
- Inventory
- Accounts receivable
- Intellectual property

In some cases, lenders may require only specific company assets as collateral. For example, if a company is seeking a loan to finance a piece of equipment, the lender may require only the purchased equipment as collateral.

A company agreeing to provide collateral to a lender is said to pledge, or grant a security interest in, those of its assets comprising the collateral. There are several consequences to obtaining a secured loan which should be considered. First, the procedure required to obtain a secured loan is somewhat different than that for an unsecured loan. Because the lien involved in a secured loan is legally an interest in the company's property, the Uniform Commercial Code ("UCC") requires a filing to alert others to the lender's interest in the property. Thus, a secured loan requires a security agreement between the lender and the borrower, which describes the collateral, as well as a UCC filing in the state where the borrower is organized (and, if the collateral consists of real estate, in the state where the real estate is located). Second, the default procedure for a secured loan will be different than that for an unsecured loan. In a secured loan, the lender has the right to seize and sell the property described in the security agreement and the UCC filing. In addition, unless the lender has failed to make the necessary filings, it can seize and sell such property without court approval. Finally, whether a loan is secured or not affects the lender's rights if the company should file for bankruptcy. Secured loans take priority over unsecured loans, meaning secured loans are paid first.

- **Term Loans.** One of the most common forms of debt is a term loan. A term loan is for a fixed amount of time and the loan payments will cease when the term expires (assuming all payments have been timely made). These loans are almost always secured. The length of the term varies, but generally extends to the useful life of the assets securing it. Thus, loans secured by real estate may have a term of 20 years or more, while equipment loans usually last five to ten years.

There are many payment options on term loans. One option, similar to that used with home mortgages, is to make regular payments that include interest and a portion of the principal. The payments at the beginning of the term generally include



more interest and less principal, and the payments at the end of the term are mostly principal, though it is possible to negotiate equal principal payments for the life of the loan. Another option is what is called a balloon loan. The company will only make interest payments for the life of the loan, and repay the entire principal upon expiration of the term. Third, in certain rare circumstances, it may be possible to negotiate a balloon loan on which no interest payments are paid currently; instead, the interest is added to the principal to be repaid at the expiration of the term. The company should consult a tax adviser in this instance, as this option has immediate tax consequences, even though no current payments are made. Finally, in very rare situations, a company may be able to make loan payments that vary with the company's ability to pay. This option will likely not be available unless the company is established, in a particularly strong financial position, in an obviously fluctuating industry, or a combination of all three.

When considering a term loan, a company should consider the issue of prepayment. Prepayment is when a company pays all or part of its loan off early. Upon prepayment in full, the company's loan obligations cease, including interest payments. Lenders generally dislike prepayment, as it deprives them of future interest payments. Often, lenders will build prepayment penalties into their loan conditions, which means that the company will have to pay a penalty if it prepays its loan. These penalties are usually structured as a percentage of the outstanding principal that decreases the longer the loan is held.

- **Demand Loans.** Another type of loan is a demand loan. Its characteristics are generally similar to those of a term loan, except that a lender can force ("demand") the company to repay the loan in full at any time. Obviously, this type of loan is not beneficial to the company unless it is the only form of financing available or the company is certain it will have

adequate funds to repay the loan at any time that the loan may be called. A company should carefully consider the possible effects of accepting a demand loan. The lender could demand repayment of the loan at a time when the company has very little cash. In fact, it may be more likely that the lender will demand repayment at such a time, as that is when the lender will perceive the company to pose the greatest financial risk.

- **Revolving Loans.** A third type of loan is a revolving loan, or a line-of-credit. These loans are similar to consumer credit cards. The lender extends a revolving loan to a company in a certain amount and the company can then borrow up to that amount. The loan is called a revolving loan because the company borrows money periodically as it needs it and makes payments on the loan when it can. These loans are not intended to be long-term loans, though the line-of-credit itself may be outstanding for a long time. Similar to the procedure with credit cards, the company is expected to make payments on the loan regularly. The interest rate on revolving loans is usually higher than that on term loans. These loans are generally used to provide working capital, not to purchase assets. Revolving loans are usually unsecured, meaning that the lender cannot seize the company's assets without going to court.
- **Factoring.** Finally, there are two types of asset sales that strongly resemble loans. The first is factoring. In factoring, a company sells its accounts receivable to a third party. The third party pays a set percentage of the value of the accounts, based on how old the accounts are. Usually current accounts will net 70%-90% of the outstanding balances. The third party will then collect the accounts receivable from the company's customers. Upon collection, the third party pays the company the remaining value of the accounts receivable, less a percentage. The percentage retained by the third party is generally higher than a typical loan interest rate. Factoring differs from a loan in that it is based on the credit-worthiness

of a company's customers. Therefore, the credit-worthiness of the company itself is largely irrelevant, and a factoring arrangement is often easier to obtain than a traditional loan. This ease in obtaining factoring is one of its major advantages. The other significant advantage provided by factoring is that it provides money for the company immediately; there is no delay in realizing most of the accounts receivable, as the third party is fronting the money. Finally, a factoring arrangement means that companies do not have to deal with collecting their accounts receivable; the third party collects them for the company.

In contrast, there are several negative aspects to factoring which should be carefully considered. Factoring is expensive, as the percentage charged by the third party generally exceeds even short-term loan interest rates. Also, the third party collection agent's interests are not the same as those of the company. While the company may be interested in retaining its customers, and may occasionally let a bill go unpaid or issue a payment extension in order to do so, the third party has no such concern. Its sole interest is in collecting the accounts receivable, and the tactics it may use to do so may cause the company's customers to refuse to buy from the company out of reluctance to deal with the third party collection agent.

- **Royalty Financing.** The second type of asset sale is royalty financing. In royalty financing the company receives an advance on its future sales; it actually sells a right to a percentage of the company's receipts. This type of financing is also much easier to obtain than a traditional loan, as it depends on the strength of a company's product rather than the company's credit-worthiness. In a royalty financing arrangement, the lender gives the company money. In return, when the company receives payments for sales, it sends a percentage of its income to the lender. This arrangement continues until the lender has been paid back, usually up to

five times the amount of its initial investment. In negotiating royalty financing, the company should make sure to put a time limit on the arrangement. If the company is unsuccessful with future sales, it will not want to owe the lender money indefinitely. Companies should consider negotiating for an end to the arrangement a few years after the investment is expected to be recouped. One tremendous advantage to royalty financing is that the payment terms automatically adjust to the company's ability to pay; the company only has to make payments when it receives cash. Also, the lender does not obtain an interest in the company in exchange for its investment. On the downside, however, lenders will not give money to a company for non-sale-related activities such as research and development. Additionally, the company is depriving itself of a significant portion of its income (usually 5% to 15% or more). If a company has a low profit margin, royalty financing is not really an option.

## **General Considerations in Determining Credit-Worthiness**

Lenders look at a multitude of factors in determining whether to make a loan to a company. The importance of the factors differs according to the type of loan involved. For example, the value of the company's assets may be less important when negotiating a line of credit than in trying to obtain a term loan. Moreover, strength in some areas may compensate for weakness in others. A company with a strong business plan may be able to obtain a loan despite its lack of operating history. The following is a list of general elements a lender will look to in determining a company's credit-worthiness:

- **Availability of Other Funding.** If a start-up company has not yet tapped the owners, their families and friends, and angel investors or venture capitalists for start-up capital, lenders are likely to refuse the loan. In particular, commercial lenders are often reluctant to make a loan to a company in which its owners have invested little money. Lenders see owner

investment as a concrete sign that the owners believe in the company. Moreover, such investment indicates to lenders that the owners will work harder to make the company successful, so as to retain the value of their investment. If owners are reluctant to invest in their companies, lenders see this as a sign of weakness in the company, its products or services, or its management. This raises the risk assessed by the lender, and decreases a company's chances to obtain a loan, on favorable terms, or at all. For this reason, loans are sometimes conditioned on owners' existing investment in an amount equal to a certain percentage of the loan value.

- **Availability of Collateral.** Certain types of lenders, such as banks and other financial institutions, strongly prefer to make secured loans. If a company has no assets available to pledge as collateral, the lender cannot make a secured loan. In such a situation, the lender is likely to refuse the loan.
- **Past Business Performance.** Lenders prefer companies with successful track records, as it gives them a more accurate assessment of the risk of the investment. While lack of past business performance may not defeat a company's loan by itself, the other factors considered will have to be significantly stronger, in order to assure the lender that it will be paid back.
- **Financial Statements.** Lenders prefer to review the financial documents of prospective borrowers, for much the same reason they review past business performance. Financial statements give the lender a way to quantify its risk in making the loan and, the stronger the company's financial position, the more risk a lender will generally take. Regardless of the financial position reported, clear, standardized financial statements are more likely to convince a lender to make a loan than confusing or incomplete statements.
- **Management.** The management of a company is often determinative in lending decisions. Lenders know that

management is key to the future success of a business, and a good management team may be able to overcome the lack of past performance in obtaining a start-up loan. If a company's management abilities are questionable, however, lenders may be more likely to substantially discount past performance and financial data.

- **Business Plan.** Companies should be very careful in drafting their business plans. They are important not only to lenders' loan decisions, but to other potential investors' decisions as well. Comprehensiveness and clarity are vital to a business plan. In addition, when applying for a loan, companies should include in the business plan a section that shows the prospective lender how they intend to repay the loan. Such a repayment plan shows the lender that the company has carefully considered its financing options and is prepared to undertake the commitment a loan requires.
- **Relationship with Lender.** If a company has no past performance, weak management and a confusing, incomplete business plan, simply having a relationship with the lender will not support a loan. In situations in which the lender has an interest in keeping the relationship, however, the existence of such a relationship may convince the lender to make the loan. This is why companies often start, when seeking a loan, with the lender (usually a bank) where they maintain accounts. Moreover, companies should consider creating a relationship with a lender before they need a loan, in case such a relationship later becomes the determining factor.

## Sources of Debt

There are many possible sources for getting a loan. Owners, family and friends, and lenders are the traditional sources for start-up companies. Many niche industries are springing up, however, in addition to these traditional sources. Companies now are

specializing in factoring, or royalty financing, or small business loans. Credit card companies are another source of credit for small businesses. Finally, many government agencies assist companies in obtaining loans through various guaranteed loan programs.

- **Owners.** The first place a company should look when seeking financing is its owners. Loans from owners to the company are common, though they have additional considerations that lender loans do not. First, a company should consult a tax expert. If certain loan formalities are not observed (i.e., proper loan documentation, application of market interest rates, provision for regular payments, etc.), the loan may be treated as equity by the IRS; such a determination may have unintended tax consequences. Second, even if certain formalities are observed, a loan from a company's owners may be subordinated to other debt and perhaps even equity if the company goes bankrupt. This means that the loan might be paid off, if at all, only after other debt the company has incurred, and perhaps even after redemption of any preferred stock.
- **Family and Friends.** The second source of loans is the owner's family and friends. Often, small loans from family members and friends will be enough to get the business off the ground. Owners generally like this source of loan financing because they think that there is less repayment pressure. While this may be true, owners should seriously consider the effect such a loan will have on their personal relationships. If the owner does choose to utilize this resource, he or she should think about signing formal documents and making regular payments on the loan.
- **Banks.** Third, many commercial entities may be a source for a small business loan; however, banks are the most common. Companies should look for banks that make a significant number of small business loans every year. The Small Business

Administration (“SBA”) compiles annual statistics by state on which banks make small business loans, how many loans are made, and in roughly what amount. For example, see the list of Minnesota banks compiled by the SBA at [www.sba.gov/mn/clpplpexpress.pdf](http://www.sba.gov/mn/clpplpexpress.pdf) and by the SBA’s Office of Advocacy at [www.sba.gov/advo/stats/lending/2002/bk\\_tmn.pdf](http://www.sba.gov/advo/stats/lending/2002/bk_tmn.pdf). Companies should also look for banks that engage in small business lending in their particular industry. Such banks are more likely to understand the needs of the company and the company will be able to spend less time explaining its industry, as well as its business, to the bank. If a company cannot find a bank that make loans to businesses in its industry, a bank that is willing and eager to learn about the industry is the next best solution. Finally, small business shouldn’t look only to large, national banks. Many community banks are seeking to actively expand their small business lending, and may be more likely to support local businesses through such loans.

- **Commercial Finance Companies.** Another type of commercial lender is a commercial finance company. These companies are not banks and do not engage in the wide variety of activities that banks do. Commercial finance companies specialize in lending – particularly asset-based lending – and are the source for most factoring arrangements. The interest rates charged by these companies may tend to be higher than those charged by banks.
- **Credit Card Companies.** Credit card companies can also be a source of financing for small business, either through the personal credit cards of the owners or through a business credit card. Clearly, credit cards are not an ideal solution, as debt tends to run up quickly and the interest rates are extremely high. If a company is unable to find financing from another source, however, credit cards may keep the business afloat.



- **Specialists.** Another commercial financing source is specialists, such as companies that provide royalty financing arrangements. There historically have been few of these companies, but the industry is growing in both size and importance. Companies should consider looking into this option when seeking financing.
- **Insurance Companies.** Insurance companies may also provide loans to small businesses or their owners. If an insurance policy contains a substantial cash surrender value (meaning the policy is currently worth a significant amount and allows the policyholder to borrow against it), it may provide a source of cash. When a policy-holder borrows against his, her or its insurance policy, the policy is reduced in value by the amount of the borrowing. As a result, the principal does not have to be repaid; instead, the value of the policy is permanently decreased. The policy-holder will have to make interest payments on the amount borrowed, however. Insurance companies may also in rare situations make loans not based on current policies. Usually the insurance company requires that the borrowing business be well-established, or that the loan be secured by a significant amount of assets. Thus, non-policy-based loans from insurance companies are generally unavailable to start-up companies.
- **Suppliers.** Suppliers, and others in a company's chain of production, may be a source of funding. A company can gain unofficial funding from its supplier simply by delaying the company's payments to its suppliers, thereby gaining additional days of cash on hand. Most suppliers have a set number of days in which they would like to be paid; then they generally have another period after the current payment period in which payment is due but not yet delinquent. A company in desperate need of cash can generally delay its payments to its suppliers for several weeks or a month without being charged interest or late fees.

In addition, suppliers may be willing to supply loans or resources to a company in several, more formal ways. A supplier may be willing to make a small loan to a company, either to keep the company in business or because of an established relationship. Suppliers may also extend their payment terms voluntarily to a certain company, usually because of an established relationship. Finally, suppliers may be willing to share or lease office space, and resources such as computers and telephones to a related company if they have extra resources. While such supplier arrangements are not always common, companies should consider such solutions if they have good relationships with their suppliers or others in their production chain.

## **GUARANTEES**

If a company, or its owners, cannot obtain a loan on its or their own credit, it may be possible to obtain a loan when a guarantee is used. A guarantee is a promise by a third party to pay the loan, or a part of the loan, if the borrower cannot. If a guarantee is made, and the borrower defaults, the lender can seek to recover the principal both from the borrower and the person making the guarantee (the guarantor). The lender can choose to seize and sell assets, if the loan was secured, or to sue the borrower and/or the guarantor for repayment. If the guarantor is called upon to repay the loan, or a part of it, the guarantor can then seek repayment from the borrower unless some other arrangement has been negotiated between them.

### **Personal Guarantees**

There are several types of guarantees. The first, and most common, is a personal guarantee by the owners of a business covering loans made directly to the business. In this case, by

signing the personal guarantee, the owners are promising to repay the loan if the company doesn't. Owners should carefully consider the effects of making such a guarantee, though loans to start-up companies generally require them. If owners make a guarantee and the company defaults, the lender can sue the owners for repayment. If the owners cannot pay cash, the court can force a sale of the owners' personal assets.

### **Third Party Guarantees**

If a personal guarantee from the owners (with or without their spouses) is insufficient to obtain a bank loan, additional parties can offer to guarantee the loan. These parties may include family, friends, or even entities related to the start-up company, such as a parent or a sister corporation.

### **Federal Government Guarantees**

Finally, different branches of federal, state and local government have loan guarantee programs to help start-up companies obtain loans. The largest program is the federal government's Small Business Administration ("SBA") guarantee program, which works with banks. The purpose of the SBA is to assist small business owners, and the main method for doing so is by providing loan guarantees. Under the SBA guarantee program, a bank makes the loan to the small business, and the SBA guarantees all or part of the loan, depending on which program is used. This provides the bank with assurance that the loan will be repaid – if not by the borrower, then by the federal government – such that the bank may be willing to make a loan it would otherwise be unwilling to make. The SBA has no funds for direct lending or grants; it only guarantees loans.

Most banks will support SBA-guaranteed loans, but since some will not, a start-up company should seek a bank that not only will

make SBA-guaranteed loans, but also has a history of doing so. If the bank determines an SBA guarantee is necessary, it requires that the borrower fill out the SBA application, and the bank sends the materials to the SBA. The SBA then determines whether it will guarantee the loan.

The SBA has several different loan guarantee programs. The most common is the 7(a) Loan Guaranty Program. Under this program, the maximum loan amount is \$2 million. The SBA maximum guarantee is 85% of the loan, if the loan is considered “small” (\$150,000 or less). If the loan exceeds \$150,000, the SBA can guarantee up to 75% of the loan. The maximum amount of the SBA’s guarantee is \$1.5 million, regardless of loan size. All owners of 20% or more of the borrowing company must provide personal guarantees for all SBA-guaranteed loans.

Another SBA loan guarantee is the Section 504 Loan Program. The 504 Program is designed to guarantee long-term, fixed-rate financing for investment in fixed assets. The program also includes a job creation requirement designed to increase local employment opportunities. As this program is limited to fixed-asset financing, it is generally used by established businesses seeking to expand, rather than start, companies. Start-up companies such as manufacturers, however, may find the 504 Program helpful if they wish to buy assets rather than lease them. A list of Certified Development Companies for the 504 Program can be found at [www.sba.gov/mn/cdcmn.html](http://www.sba.gov/mn/cdcmn.html).

The following types of borrowers have special features associated with them with regard to SBA-guaranteed loans and should check with the SBA to determine eligibility:

- Franchises
- Recreational facilities and clubs

- Farms and agricultural businesses
- Fishing vessels
- Medical facilities
- Eligible Passive Companies (small companies that do not engage in regular and continuous business activities)
- Borrowers undergoing a change of ownership
- Aliens
- Borrowers on probation or parole
- Academic institutions

No businesses seeking SBA loan guarantees may be engaged in illegal activities, loan packaging, speculation, multi-sales distribution, gambling, investment or lending. Additionally, non-profit organizations are ineligible for SBA guarantees.

The SBA offers a number of additional guarantee programs, including SBAExpress, which guarantees up to 50% of revolving loans with outstanding advances not exceeding \$350,000 at any one time, and SBA LowDoc, which guarantees up to 85% of term loans with loan amounts not exceeding \$150,000. SBAExpress covers revolving loans with terms of up to seven (7) years, with maturity extensions permitted if negotiated at the outset, and SBA LowDoc covers term loans of usually five (5) to ten (10) years.

The SBA also offers a microloan program, through which small businesses can obtain up to \$35,000. The average loan size is roughly \$10,500 for such loans. These loans are issued not through banks but through non-profit groups approved by the SBA, generally local and state governments or local economic development organizations. The SBA loans the money to the non-

profit agency that then pools the money with local funds, and then issues the loan to the small business. Microloans may be used for almost any purpose, but they may not be used to pay existing debt. For a list of SBA microloan intermediaries see [www.sba.gov/mn/microparticipants.html](http://www.sba.gov/mn/microparticipants.html).

Another SBA opportunity available to small companies regardless of their industry or product grows out of Small Business Investment Companies (SBICs) and Specialized Small Business Investment Companies (SSBICs). The SBA's website, at [www.sba.gov](http://www.sba.gov), is a good source for further information about the various SBA programs, their eligibility requirements, restrictions and other features.

Federal government programs other than the SBA should also be investigated, because a company's owners, industry or project may qualify it for special loans or guarantees. Businesses owned by minorities or women, those operating in rural, inner-city, or low-income areas, and those creating projects such as new pollution control systems, are examples of businesses which may be eligible for additional programs.

Many state and local government agencies also exist that are designed to provide loan guarantees or other resources to small businesses. The State of Minnesota, for example, has several small business loan guarantee programs. Its Capital Access Program is the most widely available and guarantees loans for a variety of industrial, commercial and agricultural purposes. Further information about this program may be found on-line at [www.deed.state.mn.us](http://www.deed.state.mn.us). In addition, the City of Minneapolis has a Community Planning and Economic Development Department (CPED) that provides loans and other services to start-up and small, more established businesses. Its website is located at [www.ci.minneapolis.mn.us/cped/index.asp](http://www.ci.minneapolis.mn.us/cped/index.asp).

## LEASES

While leases are not, strictly speaking, a method of raising capital, they can be useful to small companies that are short on cash. Purchasing such assets is generally cheaper in the long run, as the useful life of the asset is longer than the payments. Start-up companies that are short on cash, however, should look into leasing their assets, including office space, equipment, and computers. While leases don't purchase the asset, they can be significantly cheaper than loan payments that finance the purchase of an asset.

There are several advantages to leasing beyond saving the company's current cash flow:

- leases are generally easier to acquire than loans to purchase assets;
- leases usually only require six months to a year of credit history;
- leasing may help companies keep current technology in their workplace; and
- leasing may have a beneficial effect on a company's balance sheet, by reducing debt.

Companies should consult an expert regarding the tax benefits of leasing versus the depreciation deduction allowed to owners.

An additional option for companies that are truly in a bind financially is a "sale and leaseback." Under this arrangement, the company sells an asset and the buyer leases the asset back to the company. The only real advantage to this arrangement is that it provides the company with immediate cash. Additionally, companies will receive a tax deduction for the rental expense, but

this may be offset by the loss of the depreciation deduction a company receives from owning an asset. The downside is, of course, that the company no longer owns the asset.

## **OTHER RESOURCES**

### **Tax Incentives**

Some government entities may offer tax incentives to small businesses. The most common tax incentive is from the state government and rewards companies that have created jobs in that state. Businesses should always ask their tax expert if there are tax incentives available to small businesses that they may be able to claim, or that they may be able to claim with a small change to the business (such as addition of another employee). For a discussion of potential tax incentives available to start-up businesses in Minnesota see the discussion in the Department of Employment & Economic Development's A Guide to Starting a Business in Minnesota.

### **Business Plan and Innovation Competitions**

Companies seeking small amounts of cash may want to consider entering a competition that awards cash or resource prizes (such as computers). For example, a company may enter its business plan in a competition. Such competitions may require analysis of imaginary problems and preparation of a business plan for an imaginary company. These competitions present a less practical option to businesses with little free employee time. Another possibility is an innovation competition, in which the company can enter its technology or product. Prizes in these competitions vary, though a typical first-place award is roughly \$50,000. Nonetheless, these competitions probably are not worth the time



required unless a company can enter an existing product or business plan with little alteration or employee involvement.

## **Incubators**

Both profit and non-profit companies now use incubators as a way to get their businesses off the ground. For example, the SBA sponsors a program called Business Information Center ("BIC") which provides, in conjunction with state agencies, existing and prospective small business owners with access to computers, internet resources and business information and advice. The address of the BIC in Minnesota is 2324 University Avenue West, St. Paul, Minnesota 55114 (telephone: 651-209-1884.). While the incubator concept is still relatively new, it is worth looking into for companies seeking start-up capital. Incubators generally offer not only monetary assistance and investments to companies, but can provide other forms of free resources, such as consultation, training, and accounting. Incubators are usually very hands-on, so companies seeking to exercise greater control over their own activities should seek money elsewhere. Moreover, incubators usually limit themselves by industry; companies looking to use an incubator should seek one designed for their type of business.

## **Bartering**

Companies seeking basic supplies can always try to barter. This system works particularly well with other businesses in the start-up company's production chain. For example, a start-up could offer a discount on its products in exchange for office space in its buyer's offices. This option is generally used on a more informal basis, and between companies that have an established relationship. Bartering will not provide a company with a great deal of money, but may provide small advantages and benefits.

## CONCLUSION

Clearly, start-up companies have many alternatives to equity financing. Companies should spend some time researching their financing options before proceeding. Not all lenders are alike, and companies should seek one that meets their needs. Similarly, government and investment programs differ a great deal; companies need to investigate the programs for which they qualify and which programs are a good fit. Companies then need to consider what their needs and preferences are before settling on a financing option and choose an option or options accordingly. Companies should also think about getting help from a lawyer, an accountant, or both before proceeding with many of these options, as some involve detailed legal requirements and some may have unintended economic and tax consequences.

## **SECTION NINE: PRIVATE, PUBLIC AND OFFSHORE OFFERINGS ON THE INTERNET**

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The Internet provides entrepreneurs with a powerful tool that can be used to conduct capital raising efforts and to disseminate information about their company – so long as careful attention is paid to the applicable legal considerations. This chapter discusses potential implications of using the Internet for and during capital raising efforts, methods of raising capital via the Internet, and certain Internet resources available to issuers.

### **OVERVIEW**

Like any other communication medium, the Internet can be a valuable tool for issuers in the capital raising process, both as a means of providing information to, and seeking out, potential investors, in private and public offerings.

Although the Internet has not emerged as a widespread means of bypassing the traditional public offering process, as was once envisioned during the height of the “dot com” boom, it continues to be an area of significant opportunity for issuers, and a significant area of concern for the Securities and Exchange Commission and other regulatory authorities.

This section explores some of the unique issues involving use of Internet communications for or during private, public, and offshore offerings, as well as the increased regulatory scrutiny of Internet communications in connection with securities offerings. This section also discusses methods of raising capital in Internet

offerings and includes a summary of some of the resources currently available to issuers via the Internet, including informational resources and “matchmaking” services.

Readers should be aware, however, that this chapter is merely intended to be a summary of the implications of raising capital via the Internet and of other Internet-related matters. For a review of the more technical issues involved with securities offerings, it is strongly recommended that the reader consider the other chapters of this publication.

## **PRIVATE PLACEMENTS**

### **General Solicitation**

As discussed in Chapter Three, Regulation D provides a safe harbor exemption from registration for “transactions by an issuer not involving any public offering.” As a condition for the safe harbor, however, the issuer cannot engage in general solicitation or general advertising, except under limited circumstances. Issuers seeking to use the Internet in connection with a Regulation D private placement must be very careful to structure their Internet communications in order to comply with this prohibition.

The SEC has repeatedly stated that what constitutes a general solicitation is determined by the particular circumstances of the situation under consideration. One important factor that the SEC considers is whether the issuer had a prior relationship with the offeree. Another consideration is the extent of the issuer’s solicitation. Therefore, if an issuer makes a posting on its Web site indicating to any individuals with general access to the site that it is selling securities in a private placement, and further invites the readers to inquire for further information, that issuer is probably in

violation of Regulation D's prohibition of general solicitation and advertising.

To avoid running afoul of the Regulation D prohibition, issuers seeking to offer securities by means of a private placement should strongly consider doing the following:

- Limit access to offering materials only to pre-qualified accredited or sophisticated investors;
- When inviting potential purchasers to complete a purchaser questionnaire to determine whether they are accredited or sophisticated investors, make certain that neither the invitation nor the questionnaire reference a specific transaction that has or will be posted on the Web; and
- Post a notice of a private offering in a password-protected Web page that is accessible only to those accredited and sophisticated investors who have qualified as such.

### **Offshore Offerings Via Web Sites**

In a 1998 Interpretive Release, the SEC explained that the applicability of the registration provisions of the United States securities laws to offers or solicitations made via the Internet is dependent upon whether such communications are targeted to United States persons. Therefore, it is possible for a U.S. issuer to offer and sell securities offshore, solely via the Internet, as long as appropriate care is taken to avoid such targeting (or the appearance of such targeting, when viewed in hindsight by regulatory authorities).

Although the SEC has stated that what constitutes adequate measures to prevent persons residing in the United States from participating in an offshore Internet offer depends on the facts of each particular case, it has given some guidelines. To avoid

targeting United States investors, issuers should strongly consider following these procedures:

- Include a prominent disclaimer which makes it clear that the offer is directed to individuals living in countries other than the United States; and
- Implement procedures on the Web site that are reasonably designed to guard against sales to United States persons.

If, despite these measures, a person residing in the United States purchases securities in the offshore offering, and the issuer did not know, or could not reasonably have known that the investor was a United States person, the SEC would generally not view such Internet offer as having been targeted at the United States. Factors that should put an issuer on notice include:

- Receipt of payment drawn on a United States bank;
- Provision of a United States taxpayer identification number or social security number; or
- Statements by the purchaser indicating that, notwithstanding a foreign address, he or she is a United States resident.

An issuer involved in an offshore offering could take the following procedures to protect against United States persons purchasing its securities:

- Obtain and verify the mailing addresses and telephone numbers of the prospective purchasers prior to making any sales;
- Limit access to the posted offering materials to those who have provided the issuer with their addresses and telephone numbers;

- Implement password procedures that are reasonably designed to ensure that only non-United States persons can obtain access to the offer; and
- Post only those offering materials that relate exclusively to the offshore offering.

Nevertheless, it should be remembered that the adoption of suitable procedures will not suffice if the SEC determines that an issuer has been using an offshore Internet offering, ostensibly aimed at non-United States persons, to stimulate interest in an offering taking place in the United States.

## **PUBLIC OFFERINGS**

### **Gun Jumping Issues**

It is extremely important, both for non-reporting issuers preparing for their first registered public offering and established public company issuers conducting registered secondary or follow-on offerings, to be cognizant of what they are posting on their Web sites prior to effectiveness so as to avoid the SEC's prohibition against so-called "gun jumping;" – making pre-effective communications which can be viewed as increasing market interest in the offered securities.

Although the SEC has stated that an issuer in registration should maintain communication with the public concerning those matters that either arise in the ordinary course of business or relate to financial information, an issuer that first establishes or significantly enhances a Web site contemporaneously with the registration of its offering may raise the ire of the SEC. In the view of the SEC, such action tends to give the appearance that the site was constructed not in the ordinary course of business, but instead

to serve as a tool to condition the market and stimulate interest in the company or the offering.

Pursuant to various SEC releases, the following is permissible information that may be posted on an issuer's established Web site:

- Advertisements concerning the company's products and services;
- Exchange Act reports required to be filed with the SEC, if applicable;
- Annual reports to security holders and dividend notices;
- Press announcements concerning business and financial developments;
- Answers to unsolicited telephone inquiries concerning business matters from securities analysts, security holders, and participants in the communications field who have a legitimate interest in the company's affairs; and
- Security holders' meetings and responses to security holder inquiries relating to such matters.

### **Internet Road Shows**

A traditional road show involves efforts by managing underwriters during the registration waiting period to generate interest in the offering among qualified investors and investment professionals. Such events are not prohibited by the Securities Act because they involve oral and visual communications (as opposed to written communications) that do not meet the rather technical definition of a prospectus under the Securities Act.



In a series of No-Action Letters issued by the SEC in 1997 and 1998, the SEC seemed to make clear that Internet road shows would also be acceptable, provided they are conducted in accordance with the guidelines set out in the letters. The advent of the electronic road show brings with it significant benefits to both issuers and underwriters:

Cost savings in the promotion of an offering;

- Quicker dissemination of information, thus affording qualified investors more time to make fully informed investment decisions;
- Creation of a broader audience of potential investors, thus bringing about a leveling of the playing field;
- Reduction in the amount of time and effort expended by executives who are typically responsible for conducting road shows; and
- Assurance that prospective investors are being given a consistent message.

An issuer intending to conduct an electronic road show via the Internet would be best served by structuring it in such a way that the following procedures are adhered to:

- **Limit the Audience:** Limit the audience to the same types of qualified investors and investment professionals as would be invited to attend a traditional road show. Such investors should be pre-cleared by an institutional salesperson or an underwriter before being invited to view the show.
- **Limit the Viewings:** Either limit the number of times a potential investor can access the electronic road show, or limit the number of times the show can be viewed during a certain

period (e.g., a 24-hour period). This could, for example, be accomplished by the use of an access code.

- **Respect the Primacy of the Prospectus:** Make a printed version of the preliminary prospectus available to all who will be viewing the road show. Also, prominently display a clickable button to the preliminary prospectus which would make an electronic version available at all times throughout the road show. In addition, stress to potential investors the importance of reading the prospectus prior to making an investment decision. For example, this could be accomplished by programming a periodic crawl to run across the screen throughout the entirety of the show.
- **Prohibit the Copying, Downloading, Printing, and Distribution of Road Show Materials:** Before allowing a potential viewer the opportunity to watch the road show, ensure that he or she agrees not to copy, download, print, or distribute any of the road show material. In addition, post a constantly appearing disclaimer warning that such activities are clearly prohibited. Finally, the company's transmissions should include technology designed to prevent the copying, downloading, or printing of any part of the road show transmission, except for the preliminary prospectus.
- **Restrict the Content:** Ensure that the road show is not edited for content and is shown in its entirety. However, if the information changes between the time the road show is filmed and when it is available for viewing over the Internet, it is advisable to clearly inform the viewers of such and provide information on how they may contact an institutional salesperson to further discuss these changes. This could be accomplished through the use of a periodic crawl which provides a synopsis of the changes.

- **Use a Rule 134 Legend:** If the registration statement is not effective when a road show is transmitted, post a legend that informs potential investors of the following:

A registration statement relating to these securities has been filed with the Securities and Exchange Commission but has not yet become effective. These securities may not be sold nor may offers to buy be accepted prior to the time the registration statement becomes effective. This (communication) shall not constitute an offer to sell or the solicitation of an offer to buy nor shall there be any sale of these securities in any State in which such offer, solicitation or sale would be unlawful prior to registration or qualification under the securities laws of any such State.

Requiring the potential investor to click a button acknowledging the legend before being granted access to the transmission is also recommended.

- **Carefully Structure the Fees:** An issuer should structure a flat fee that is related to the production and transmission costs of the road show, rather than to the offering's size or success.
- **Make the Road Show Interactive:** If an electronic road show is being transmitted in "real time" along with a traditional road show, permit the Internet viewers to send e-mail inquiries that can then be read and answered at the "live" show if such questions are deemed to be of general interest to the audience.

## Electronic Prospectus Delivery and Confirmations

The federal securities rules do not explicitly state which medium issuers should use when disseminating information to the public. In a 1995 Interpretive Release, the SEC made clear that the focus is not on the medium that is used, but instead on the extent that required disclosure is actually made. Therefore, the SEC

concluded, the delivery of information via an electronic medium such as the Internet “could satisfy delivery or transmission obligations under the federal securities laws.”

In order for the distribution of information through electronic means to be acceptable, it would be necessary that “such distribution results in the delivery to the intended recipients of substantially equivalent information as these recipients would have had if the information were delivered to them in paper form.” Although not an exhaustive list, the following are major factors that should be considered in determining whether the legal requirements concerning Internet delivery or transmission of disclosure and offering documents:

- **Informed Consent.** In its 1995 Release, the SEC indicated that the recipient must first give his or her consent before an issuer may deliver required documents by electronic means. The informed consent requirements demand that the recipient be informed of the following prior to consenting to electronic delivery:
  - The media or medium used to transmit the information;
  - Which documents will be transmitted via this electronic delivery method;
  - How long the consent to electronic delivery will remain effective;
  - That he or she may revoke his or her consent to electronically receive documents at any time reasonably in advance of their delivery;
  - The potential that the recipient may incur such costs as online charges by receiving the information electronically; and

- That there exists a risk of system outages and slow downloading.
- **Silence Not Consent.** The SEC has indicated that an investor's silence as to his or her approval of electronic delivery by the issuer shall not be construed as consent. In other words, negative consent is not recognized. However, the 2000 Release clarified that an issuer may obtain an informed consent by telephonic means, provided the following two conditions are met:
  - The issuer must retain a record of the telephone consent in the form of an internal file memorandum or a copy of a letter sent to the recipient acknowledging such consent, and this record must contain the disclosure requirements necessary to make the consent informed; and
  - The issuer must obtain the investor's consent in such a manner that its authenticity is assured.
- **Notice.** The SEC requires that timely and adequate notice be given to investors informing them that certain information is available on a Web site. It may be necessary to supplement the electronic communication with another communication on an agreed upon format with the investor such as a computer disk, CD-ROM, audiotape, videotape, or e-mail. Such communication provides notice similar to that afforded by the dissemination of information via traditional print media, and, by itself, generally constitutes adequate notice. Until investors are provided with timely and adequate notice that the information posted on the Internet is available, such delivery is not deemed to be effective. Thus, the mere posting of information on a Web site, without more, will not suffice. The SEC's notice requirements must be read in conjunction with its informed consent requirements discussed immediately above.

- **Access.** The SEC takes the position that the use of a particular medium of electronic communication should not be so burdensome that it is difficult or impossible for the intended recipients to access the information provided. The electronically delivered document should be as accessible as a paper version mailed to the recipient. It is essential that the recipients have the ability to either personally retain the information or have ongoing access to it. Thus, information appearing on an issuer's Web site or made available through an online service should be available for as least as long as an SEC delivery requirement remains in effect. Finally, issuers must be prepared to make all of the information delivered via an electronic medium available in printed format. This might be required for any of the following reasons:
  - Revocation by the investor of his or her consent to receive documents electronically;
  - A specific request by the investor for a paper copy;
  - Computer incompatibilities; or
  - System failure.
- **The Use of Portable Document Format (PDF).** The use of PDF to transmit documents over the Internet has become quite commonplace. However, a concern with PDF is that not everyone owns the special software needed to read such documents. In response, the SEC discussed this issue in its 2000 Interpretive Release and approved its use by issuers to deliver documents electronically provided the following conditions are met:
  - That investors are informed of the necessary requirements to download documents in PDF at the same time consent is obtained; and

- That investors are provided with any necessary software (i.e., Adobe Acrobat Reader) and technical assistance at no cost, in addition to applicable system requirements for downloading and utilizing the software.

Perhaps the most effective way for an issuer to comply with these requirements is to provide a hyperlink from its Web site to that of Adobe Systems Incorporated, thus affording users the ability to easily download the Acrobat software and obtain any needed technical assistance. The Internet address for Adobe's free Acrobat Reader download page is [www.adobe.com/products/acrobat/readstep2.html](http://www.adobe.com/products/acrobat/readstep2.html).

- **Evidence of Delivery.** The SEC deems the following procedures to be satisfactory methods of ensuring that electronic documents have successfully been delivered to investors:
  - Obtaining an informed consent;
  - Obtaining evidence that an investor actually received the information (e.g., by electronic mail return-receipt or confirmation of accessing, downloading, or printing);
  - Affording an investor the ability to access required information by clicking a hyperlink on a document (e.g., sales literature containing a link to a prospectus); and
  - Using forms or other material that would become available to investors only by means of accessing the information (e.g., an e-mail file containing an application attached to a prospectus).
- **National Association of Securities Dealers (NASD) Guidelines on Electronic Delivery.** In 1998, the NASD notified its members that they may transmit documents to

their customers via electronic means in accordance with the standards set out by the SEC. However, pursuant to a 1996 NASD Regulatory and Compliance Alert, if a member is obligated to file information from its Web site with the NASD, and that site contains hyperlinks to a third party's site, then both the information from the member's site and that of the linked site must be submitted for review.

## **Hyperlinked Information**

The SEC has made clear that an issuer is "responsible for the accuracy of its statements that reasonably can be expected to reach investors or the securities markets regardless of the medium through which the statements are made, including the Internet." Whether an issuer is responsible for information on a third-party's Web site to which it has created a hyperlink depends on whether the issuer was either involved in the preparation of the information (the "entanglement" theory) or has somehow explicitly or implicitly endorsed it (the "adoption" theory). In determining whether an issuer has adopted such third-party information through the use of a hyperlink, the SEC considers the following factors to be relevant:

- The SEC will examine the context of the hyperlink by considering what the issuer says about the hyperlink or what is implied by the context of its use. When an issuer embeds a hyperlink to a Web site within a document to be filed or delivered under the federal securities laws, that issuer will be deemed to have adopted that information. In addition, when an issuer is in registration and establishes a hyperlink from its Web site to information that meets the definition of an "offer to sell," "offer for sale," or "offer," a strong inference is created that, for purposes of securities law liability, it has adopted the information. Therefore, it is important that an issuer only link to the home page of a third-party's Web site rather than to subsections within the site.



- Another factor the SEC will consider is the risk of confusion created in the minds of the investing public. Such risk is minimized if a message is prominently displayed on the user's computer screen notifying the user that he or she is being taken from the issuer's Web site to that of another. Also, the display of a clear and prominent statement made by the issuer disclaiming responsibility for, or endorsement of, the third-party's information can serve as an effective tool against investor confusion. On the other hand, the framing or inlining (i.e., importing through the use of a hyperlink) of information from a third-party's Web site tends to increase the risk of investor confusion. It must be stressed that, although the use of a disclaimer might afford some degree of comfort to an issuer, disclaimers by themselves are insufficient to protect an issuer from liability for fraudulent hyperlinked information. To be most effective, a disclaimer should:
  - be prominent, clear, concise, and easy to read;
  - provide the full text of the disclaimer on the same screen as the information to which the disclaimer is relating;
  - use an intermediate screen that pops up on the Web site that forces users to acknowledge that they have seen the disclaimer by requiring that they click a box before being allowed to move forward and access the information; or
  - create a hyperlink from the information to the disclaimer or to the Web site's "terms and conditions."
- How the hyperlinked information is presented on the Web site is also a consideration. An issuer should avoid attempts at directing the attention of investors toward particular information through the selective use of hyperlinks on its site. In addition, an issuer should refrain from using different colors and font sizes and types in such a way so as to draw the

attention of investors by making it appear that certain hyperlinked information is favored over other information on its site.

The gun-jumping prohibitions that apply to the general content contained on Web sites also apply to information on a third-party Web site to which the issuer has established a hyperlink. (Please see the “General Solicitation” section above for further information related to this issue.) Therefore, an issuer must be concerned about any hyperlinked information on a third-party’s site that meets the definition of an “offer to sell,” “offer for sale,” or “offer” as those terms are defined in Section 2(a)(3) of the Securities Act.

## **Avoid Selective Disclosure**

Information posted on a company’s Web site without being disseminated by other means creates selective disclosure concerns. This is the case because the SEC has not yet accepted the Internet as a medium of communication that satisfies the legal requirements for public dissemination of material information. The concern is that unlike with traditional news vendor services, not all investors have access to the Internet or choose to use it as a regular information source. Therefore, in order to avoid potential selective disclosure issues and to “ensure a level playing field for all investors,” it is imperative that issuers be certain that they have already released material information either via a periodic or special SEC filing or press release prior to posting it on their Web sites. Pursuant to NASD Interpretation IM-4120-1, Disclosure of Material Information, the “policy on disclosure of corporate information requires that the use of the Internet to disseminate material press releases is appropriate provided the information is not made available over the Internet before the same information is transmitted to, and received by, the traditional news vendor services.”

## **REGULATORY SCRUTINY AND INTERNET FRAUD**

In response to Internet fraud, the SEC and other regulatory agencies, such as the North American Securities Administrators Association (NASAA), are keeping a vigilant watch and closely monitoring the landscape. Below are just a few examples of measures that various regulatory bodies have taken to protect investors:

### **Fictitious Web Sites**

In recent years, the SEC launched a series of Web sites aimed at warning investors of the dangers involved with investing in online offerings without first fully researching the issuer and its claims. One site, whose address is [www.mcwhortle.com](http://www.mcwhortle.com), was set up by the SEC to appear as a genuine investment opportunity. The site incorporates a fictional company history, press releases, and even made up testimonials from the “CFO of [a] Fortune 100 Company” and an analyst of a “major investment banking firm.” McWhortle.com is a professionally designed Web site, and there is no way for a potential investor to know that it was put out by the SEC until he or she tries to make a purchase. At that point, the user is taken to a screen which prominently displays the following message: “If you responded to an investment idea like this . . . You could get scammed!” The SEC launched McWhortle.com in conjunction with a “spoof” press release intended to promote the site. By creating such Web sites, the SEC is attempting to show potential investors the telltale signs of fraud (i.e., promises of fast and high profits with little or no risk) and urging them not to make hasty and uninformed decisions.

### **Investor Alerts**

In January 2002, the SEC released a press release entitled “‘High Yields’ and Hot Air” in which it alerted potential investors to the

“red flags” associated with “too good to be true” investment offers. In this release the SEC again urges investors to thoroughly research and understand the issuer and the investment before writing out a check. “‘High Yields’ and Hot Air” can be located at [www.sec.gov/investor/pubs/investorfraud.htm](http://www.sec.gov/investor/pubs/investorfraud.htm). The SEC has also published a document titled “Internet Fraud: How to Avoid Internet Investment Scams,” which tells prospective investors how to spot different types of Internet fraud, what the SEC is doing to fight Internet investment scams, and how to use the Internet to invest wisely. This document can be found at [www.sec.gov/investor/pubs/cyberfraud.htm](http://www.sec.gov/investor/pubs/cyberfraud.htm).

## **Public Warnings**

The NASAA has issued a number of public warnings alerting investors to various cyberspace schemes it deems to be illegal and abusive. Such Internet schemes include stock manipulations, pyramid scams, and Ponzi schemes.

## **METHODS OF PUBLICLY RAISING CAPITAL ONLINE**

The advent of the Internet has brought about a number of innovative methods designed to harness the technological advances and provide alternative methods for public offerings of securities.

### **The Direct Public Offering (DPO)**

In a DPO (i.e., a self-underwritten deal), the traditional underwriting process is completely bypassed because the shares are directly offered by the issuer to the prospective investors online. This is an attractive alternative to smaller investors who are often unable to attract traditional underwriters because of the

fact that they are either relatively unknown and/or lack the necessary resources. In a typical DPO, the company offers its shares directly to potential investors. Those individuals who request further information about the investment are then sent a prospectus.

The DPO is more geared toward established companies with loyal customers who have a firm belief in the company and its products or services. Those persons likely to get most involved in the DPO are devoted customers who lack experience in investing. In fact, the majority of individuals who invest in DPOs do not use the services of a broker and have never purchased shares directly from an issuer. Because a company involved in a DPO typically draws investors from its customer base, a DPO is not generally an acceptable financing tool for start-ups. In addition, since a successful DPO can be expected to take about one year to complete and requires the infusion of considerable time and money, it is best that the issuer be established with a track record of success.

## **The Online Public Auction**

Online public auctions use an auction method termed the “Dutch auction.” In a Dutch auction, prospective investors submit bids for the amounts that they are willing to pay for the securities. After the bidding process has been completed, the offering price is set at the highest price at which all of the offered shares can be sold. All investors pay the same amount for their shares regardless of the size of their orders. Furthermore, because in the typical Dutch auction all bids are blind, no preference is given to those customers who would normally be considered “preferred.” The end result is that whoever is willing to pay the highest price for the securities being offered will ultimately be the owner regardless of who they are or who they know, thus ensuring that the shares are allocated in an equal and impartial way. Purported advantages of the Dutch auction include:

- Decreased costs of the underwriting process (among other savings, underwriting and brokerage fees are effectively eliminated);
- Maximization of proceeds for the issuer (in a traditional initial public offering (IPO) the investment bank takes seven to nine percent of the proceeds);
- A more accurate gauge of market demand for the securities; and
- The “democratization” of the IPO process by allowing for the most equitable distribution of shares possible by virtue of the fact that the underwriter lacks the discretion to select the price of the shares and cannot unfairly favor one prospective purchaser over another.

Only a few years ago, the online auction format was touted as a viable alternative to the traditional IPO process. It was anticipated that revolutionary changes would level the playing field and bring about a more efficient and equitable method of raising capital and investing. Proponents of the auction process offered a myriad of reasons for such changes:

- The widespread knowledge and use of the Internet by both retail and institutional investors;
- Standardized hardware and software technology to facilitate the mechanics of an electronic offering;
- The inability of many small companies to raise capital via the traditional IPO;
- The unavailability of quality purchasing opportunities to those prospective buyers who lack close ties with the underwriting community; and

- The advent of online brokerage firms in search of new products to offer their customers.

### **The Pros and Cons of Internet Offerings**

Using the Internet to make an offering can bring tremendous advantages and cost savings to the issuer, thus significantly reducing its cost of capital. The following are the major benefits inherent in such an undertaking:

- Greater control by the issuer over the offering process;
- Rapid dissemination of information over Web-based technologies giving issuers direct access to large pools of investors;
- The use of the Internet allows issuers to reach the broadest range of potential investors possible without regard to their location;
- Continuous access to large amounts of up-to-date financial and investment information;
- Savings in costs associated with the capital formation process including reduced printing, binding, distribution, advertising, and promotion expenses; and
- A more efficient and economical method of supplementing and updating offering materials.

On the other hand, there exists a number of potential drawbacks to engaging in direct capital financing online. Some major concerns include the fact that:

- There is often a lack of liquidity due to the relatively small number or entire absence of market makers and researchers;

- There is a small “float” because the offerings are typically quite small;
- Internet offerings have sometimes been viewed as the “option of last resort” for companies that are perceived to be too “inferior” to obtain capital financing via the more traditional methods; and
- Many states have yet to make their positions on Internet offerings clear, thus creating possible “Blue Sky” compliance issues.

## **INTERNET RESOURCES FOR RAISING CAPITAL**

Unfortunately, neither the DPO nor the auction format have met with the kind of success that was envisioned only a few years ago. The “dot com crash” has been responsible for the demise of a great many Web sites geared toward the sale of equity shares via self-underwritten offerings over the Internet. The majority of Web sites that have survived largely play a “matchmaking” role in connection with private placements by providing information about companies to high net-worth investors and matching these investors with companies that fit their investment criteria. Most of the services require individuals to certify that they are accredited investors and screen company business plans before listing them on their sites. Only after individuals have qualified as accredited investors can they access information via a password protected area of the Web site.

Without serving as an endorsement by the Minnesota Department of Trade and Economic Development or Oppenheimer Wolff & Donnelly LLP, the following is a brief listing of Web sites that, at the time of publication, were among the more prevalent sites related to capital raising. Although most are of the



“matchmaking” variety, WR Hambrecht & Co.’s OpenIPO stands out from the rest of the firms appearing in the following list in that it continues to offer equity securities via an auction format.

**WR Hambrecht & Co.**  
([www.openipo.com](http://www.openipo.com))

- Via its OpenIPO process, WR Hambrecht & Co. brings investors and companies together by way of its online securities auction. The transactions consummated on its online auction run the investment spectrum as WR Hambrecht hosts IPOs, secondary offerings, and corporate debt offerings. Although the companies that participate in the online auctions are not required to operate in a select number of industries, they typically do operate within industries in which WR Hambrecht has developed expertise (i.e., software, Internet, and branded consumer products).

**OffRoadCapital.com**  
([www.offroadcapital.com](http://www.offroadcapital.com))

- Seeks to bring together high net worth investors and emerging growth companies in a variety of industries.
- Initially screens corporate referrals. After this preliminary screening, OffRoadCapital follows-up with an assessment of the company, its business, products and services, and the competitive landscape in which it operates. In addition, OffRoadCapital performs due diligence and enlists the help of attorneys and accountants, if necessary, to perform such analysis and review of the company’s books, records, and reports.

- During OffRoadCapital's "OffRoad Show," the Company presents its offering memorandum, provides an inside look at its products and services, and answers questions. There is also a live studio event and simultaneous webcast in which company principals personally present the business to investors. Investors can participate via phone and e-mail and can ask the companies questions.
- Once a company receives funding through OffRoad participants, it is required to provide regular updates online to its investors.

### **Garage.com**

([www.garage.com](http://www.garage.com))

- Uses its web-site to match venture capital, corporate, and angel investors with companies in the communications, infrastructure, software, and wireless sectors that seek to raise between \$2 million and \$15 million in a first or second institutional financing round. Although not officially set, the minimum investment is generally between \$50,000 to \$100,000.
- Focuses its efforts on early-stage companies that it perceives have the greatest growth and business potential.
- When an investor expresses interest in a listed company, Garage.com releases the investor's profile to the company in order to enable the company to decide whether to proceed with that particular investor. In addition, investors are notified via e-mail when the profile of a newly-listed company matches the investment criteria they previously selected.

## **EarlyBirdCapital**

([www.earlybirdcapital.com](http://www.earlybirdcapital.com))

- Provides financing for early-stage companies, typically within the range of \$3 - \$10 million. EarlyBirdCapital's corporate clients operate in high-growth industries such as e-commerce, information technology, Internet infrastructure, media, entertainment, telecommunications, and medical technology.
- Works with only accredited investors and provides them with a wide range of information concerning potential investments, including company overviews, data received in connection with road shows, due diligence summaries, private placement memoranda, and subscription documents.
- Configured to allow investors to engage in question and answer sessions with companies and their management.
- Offers immediate e-mail notification to investors of new postings that match their investment criteria.

## **NVST**

([www.nvst.com](http://www.nvst.com))

- Provides investors with prospects that meet their investment criteria.
- Provides entrepreneurs with direct access to angels, venture capitalists, corporate venture funds, and investment bankers.
- Advises companies as to how they may obtain capital financing and the ways in which they can formulate effective capital raising strategies and approaches.
- Investors must be accredited to participate.



Recycled paper with a minimum of  
10 percent post consumer waste

