MINNESOTA'S ANGEL TAX CREDIT

SMALL CORPORATE OFFERING REGISTRATION (SCOR)

A "Short Form" Registration Statement

Revised September 2013

A Collaborative Effort

Minnesota Department of Employment and Economic Development

Larkin Hoffman ATTORNEYS

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This booklet is available without charge from the Minnesota Department of Employment and Economic Development, Small Business Assistance Office, 1st National Bank Building, 332 Minnesota Street, Suite E-200, St. Paul, MN 55101-1351.
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Upon request, this publication can be made available in alternative formats by contacting (651) 259-7476.

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Minnesota Department of Employment and Economic Development
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Larkin Hoffman Daly & Lindgren Ltd.

ISBN 1-888-404-63-9

PREFACE

Minnesota's Angel Tax Credit, which first became available in 2010, helps Minnesota businesses raise funding by giving their investors a refundable income tax credit equal to 25 percent of their equity investment.

Not all businesses, investors and investments are eligible. Businesses and investors must comply with a number of requirements before an investment will qualify for the credit. In addition, there are a number of post-investment requirements that must be satisfied in connection with a qualified investment. Part 1 of this booklet lays out eligibility requirements for the credit, how the credit works, and other information about the credit.

Businesses seeking funding from investors must comply with numerous requirements and limitations related to sales of their securities. These requirements are particularly difficult for small and early stage businesses. The Small Corporate Offering Registration ("SCOR") helps many businesses raise capital by dramatically easing restrictions on public solicitation, removing limits on the number of investors and otherwise. Part 2 of this booklet explains how SCOR works, what businesses are eligible and when SCOR may be appropriate to use.

This booklet was prepared by the law firm of Larkin Hoffman Daly & Lindgren Ltd. Bradley J. Hennen, a shareholder at Larkin Hoffman, is the primary author. Special thanks to Michael W. Schley (retired) for his work on prior editions.

This booklet is an introduction to the matters discussed and is not intended to be, and should not be relied upon as, legal advice. Like all publications of this kind, this guide is not a substitute for the advice of your attorney on the complexities of the law.

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INTRODUCTION

Minnesota has a long tradition of supporting the growth of early stage businesses. Today's economy requires us, now more than ever, to provide business owners with the resources necessary to grow their businesses. One way to help businesses grow is to facilitate equity investments.

Minnesota's Small Business Investment Tax Credit (the "Angel Credit"), codified at Minn. Stat. § 116J.8737, is intended to encourage equity investment in early stage, technology-based businesses and encourage job creation by providing tax incentives to investors making investments in these innovative companies. The credit encourages investment in start-up companies that are focused on developing high technology or using new proprietary technology.

More than twenty-five states have established investment incentive programs similar to Minnesota's. The structure and operation of each program differs depending on the particular laws of each state. Minnesota's Angel Credit program is structured as a dollar-for-dollar reduction of the recipient's Minnesota income tax liability.

Before an investor can receive credits under the program, there are a number of eligibility requirements that must be met and a number of procedural steps that must be taken – both by the business and by the investors involved. Many of the requirements and steps are not intuitive. This booklet is designed to provide businesses and investors with a basic understanding of how the Angel Credit works.

The 2013 Legislature amended the credit program for 2014. The key changes are described below.

- To qualify for the program, a company must be "in operation" for less than a stated number of years. For businesses that are engaged in researching, developing or producing medical devices requiring US FDA approval, the Legislature has extended these years in operation limit. For those businesses, the limit has been extended from 10 years to 20 years. The 10-year "in operation" limit remains in place for all other businesses.

- A new data privacy exception has been added for 2014 that allows DEED to disclose a Qualified Small Business's basic contact information and a description of each QSB.

- The requirements for certification as a QSB have been slightly modified for 2014. In 2014, a business that has issued securities traded on a public exchange will not qualify as a QSB.

- The requirements for a Qualified Investment have also been slightly modified. An investment will not meet program requirements if: (1) the subject business has issued securities traded on a public exchange; (2) the subject business issues securities that are traded on a public exchange within 180 days after the date of the Qualified Investment; or (3) the subject business experiences a "liquidation event" within 180 days after the date of the Qualified Investment. A definition for the term "liquidation event" has been added to the statute.

The information provided in this booklet is not intended as, and should not be relied upon as, legal advice. Individuals and business entities should always seek the advice of qualified legal counsel in all matters relating to obtaining and using the Angel Credit.

CHAPTER 1 KEY DEFINITIONS

- Angel Credit: A tax credit issued to a Taxpayer for making Qualified Investments. The investments may be made directly by the Taxpayer as an Angel or indirectly, through a Qualified Fund in which the Taxpayer is an equity owner.
- Taxpayer: The individual receiving Angel Credits in connection with a Qualified Investment. A Taxpayer may be: (1) a natural person who is an Angel; (2) an equity investor in a Qualified Fund; or (3) an individual beneficiary of a revocable trust (but not the beneficiary of an irrevocable trust).
- Angel or Qualified Investor: A natural person who has been certified (or, in certain circumstances, will be certified) as eligible to make Qualified Investments. The terms Angel and Qualified Investor have the same meaning.
- Qualified Fund: An investment fund or other investment entity that is certified as eligible to make Qualified Investments because it (1) invests in, or intends to invest in, Qualified Small Businesses; (2) is recognized as a Pass-Through Entity for tax purposes; and (3) has at least three separate individual investors (and at least three of its investors intend to make use of Angel Credits in connection with its investment).
- Pass-Through Entity: An entity that is generally not subject to income tax but as to which any taxable income is taxable directly to its equity owners. These generally include a corporation that has elected to be treated as an S corporation, a general partnership, a limited partnership, an irrevocable trust, or a limited liability company that has elected to be treated as a partnership. Revocable trusts are not Pass-Through Entities.

- Qualified Small Business or QSB: A small business that meets the program's eligibility requirements (including requirements concerning the nature of its business, its operating history and its funding history) and that is certified as eligible to receive Qualified Investments from Angels and Qualified Funds.
- Qualified Investment: A cash investment in a QSB in exchange for equity in the QSB. The investment must meet a number of additional requirements.
- Unitary Group: Two or more entities that are required under the Minnesota tax laws to file a combined tax return based upon common ownership, operation or activities, or otherwise. Generally, related entities which are required to file consolidated tax returns are treated as a Unitary Group. Parent entities, subsidiary entities and "sister" entities are usually included.
- DEED: Minnesota's Department of Employment and Economic Development. DEED's website regarding the Angel Credit is http://mn.gov/deed/angelcredit.
- Intern: A student at an accredited institution of higher education, or a recent graduate within the past six months, who is employed (for nine months or less) at a small business in a temporary position that provides training and experience in business activities.
- Liquidation Event: Conversion of an investment for cash, cash and other consideration, or any other form of equity or debt interest.

CHAPTER 2 HOW THE CREDIT WORKS

Minnesota's Angel Credit is a refundable tax credit equal to 25 percent of a qualified investment in a Minnesota small business.

Qualified Investments may be made by an individual investor (sometimes referred to as an Angel or a Qualified Investor) or by a qualified investment fund (referred to as a Qualified Fund). When an Angel makes a Qualified Investment, the individual making the investment will receive the Angel Credits. When a Qualified Fund makes a Qualified Investment, the owners of the fund will receive the Angel Credits in amounts proportional to the individual's ownership of the Qualified Fund. Regardless of whether the investment is made by an Angel or by a Qualified Fund, the resulting tax credits are awarded to individual Taxpayers.

Angel Credits are applied against and reduce the Minnesota income tax liability of the recipient Taxpayer. If a Taxpayer's Angel Credits exceeds his or her Minnesota income tax liability, then the Taxpayer will be entitled to a tax refund equal to the difference. Taxpayers need not be Minnesota residents. The refundable nature of the credit encourages investment in Minnesota business by out-of-state investors.

An individual Taxpayer is eligible to claim up to $125,000 of Angel Credits each year (for up to $500,000 of Qualified Investments). Taxpayers filing joint tax returns are eligible to claim up to $250,000 of Angel Credits each year (for up to $1 million of Qualified Investment). Credits allocated to a Taxpayer for investments through Qualified Funds are included in calculating these annual maximums. Taxpayers are not subject to any lifetime maximum amount of Angel Credits.

Key Angel Credit Requirements

There are three key requirements for Angel Credits under the program:

- Qualified Small Business (QSB),
- Qualified Investor / Qualified Fund, and
- Qualified Investment.

Qualified Small Business (QSB)

Angel Credits are only available for investments in Qualified Small Businesses (or QSBs). A Minnesota small business that meets the program requirements may apply to DEED to be certified as a Qualified Small Business. There are a number of criteria that a small business must meet before DEED will be able to certify the business as a Qualified Small Business.

The foremost requirement is that the business must be engaged in, or committed to engage in, "innovation" by researching, using or developing proprietary technology in a qualified high technology field or in one of six other specifically designated fields.

The business must also meet criteria concerning its employees (location and pay), limits on how long the business has been in operation, limits on its prior equity funding history, and a number of additional requirements. QSBs are not subject to any annual maximum of Angel Credits generated. They are, however, subject to a lifetime maximum of generating $1 million of credits (equal to receiving a lifetime maximum of $4 million of Qualified Investments).

After a Qualified Investment is received, the QSBs is obligated to file certain reports and meet ongoing requirements for five years. Failure to comply with certain of these requirements will require the QSB to amend its Minnesota tax return within 30 days of a disqualifying event and pay a tax equal to all or a portion of Angel Credits allocated to its investors. The amount of tax is 100 percent of credits during the year of investment and the next calendar year, then is reduced by 20 percent each calendar year. A QSB's failure to meet its post-investment requirements does not affect the Taxpayer's receipt of credits.

Qualified Investors / Qualified Funds

Angel Credits are available to Taxpayers for person, direct investments or for indirect investments, made by qualifying funds that are owned by individual Taxpayers.

Qualified Investors

Angel Credits are available to individual investors (known as Angels or Qualified Investors) in connection with a Qualified Investment. Individual investors must apply for and receive a certification from DEED in connection with a Qualified Investment. When an Angel makes a direct Qualified Investment in a QSB, the individual Angel receives the corresponding Angel Credit.

There are no income or net worth tests that an individual investor must meet in order to be certified as a Qualified Investor. While many Qualified Investors will be obligated to obtain certification from DEED prior to making a Qualified Investment, Angels that are not accredited investors (within the meaning of the federal securities laws) may file certification requests (and pay the corresponding fee) either before making a Qualified Investment or within 30 days after making a Qualified Investment.

Qualified Funds

Certain investment funds may apply for and be certified by DEED as Qualified Funds under the program. When a Qualified Fund makes a Qualified Investment, the individual owners of the Qualified Fund receive the resulting Angel Credits (rather than the fund receiving the Angel Credits).

To be eligible for certification as a Qualified Fund, the investment fund (1) must be organized and treated as a disregarded or pass-through entity for tax purposes (a Disregarded Entity) and (2) must be owned by at least three individuals, who intend to make use of the resulting Angel Credits.

Qualified Investment

A Qualified Investment must be a cash investment made in exchange for equity in the QSB. Equity of the QSB may include: common stock, partnership or membership interests, preferred stocks or mandatorily convertible debt meeting certain specific requirements. In order for convertible debt investments to be treated as equity and qualify under the program, the debt must contain mandatory conversion provisions and be convertible without any further action by or consent from the Angel investor. These requirements are more fully discussed in Chapter 6.

Qualified Investments are subject to minimum investment restrictions. To qualify, an investment in a QSB must exceed the applicable minimum investment requirement.

- An Angel's investment in the QSB must be at least $10,000 in a calendar year.
- A Qualified Funds' investment in the QSB must be at least $30,000 in a calendar year.

The Angel Credit Process

Angels, Qualified Fund and QSBs must all meet the program's requirements and obtain certifications from DEED before Qualified Investments can be completed (with the exception that certain Angels may obtain certification post-transaction). Applications for certification are submitted to DEED. The certification process entails submitting an application form along with the applicable fee. Certifications will be granted or denied based on whether the applicant meets the program's requirements. Periodically, DEED will publish a list of the Angels, Qualified Funds, and QSBs that it has certified in that year. DEED publishes the list on its website. The list identifies Angels and Qualified Funds by name but does not provide contact information or any other information regarding these individuals or entities. For Qualified Small Businesses, DEED may include basic contact information and descriptions of each Qualified Small Business (as permitted by the statute).

Certification of the business and investors are only part of the Angel Credit process. Before a Qualifying Investment will receive credits, the business and investors must apply to receive an allocation of available Angel Credits for the subject investment.

Angel Credits are allocated by DEED to specific investment transactions, from a pool of available credits. For 2014, the Legislature has approved a pool of $12 million of available credits. Requests for an allocation of credits must be filed and approved by DEED prior to completion of the corresponding Qualified Investment. There is no fee required for allocation requests. Allocation requests may be filed only after QSBs, Angels and/or Qualified Funds have received the required DEED certifications. Allocation requests that are submitted before the date that required certifications are issued will be treated as though filed on the date that the required certifications are issued. DEED must approve or reject each allocation request within 15 days of its receipt. Credits

are allocated in the order that allocation requests are filed with DEED. All allocation requests filed on the same day are deemed filed simultaneously, and, if allocation requests filed on the same day exceed remaining available credits, the remaining credits are allocated on a pro-rata basis to those requests.

Qualified Investments must be completed within 60 days of the date Angel Credits are allocated. Failure to complete the transaction within this period results in cancellation of the allocation. Angels and Qualified Funds must promptly notify DEED after completing a Qualified Investment.

At the end of the year, DEED will issue a credit certificate directly to each Taxpayer. The Taxpayer credit certificate will including credits for direct investments by the Taxpayer as an Angel, along with the Taxpayer's proportionate share of investments made by the Taxpayer's Qualified Funds. Credit certificates will be filed with the Taxpayer's Minnesota tax return, together with a Form M1B "Business and Investment Credits."

Annual reports to DEED are required to demonstrate that eligibility requirements are being maintained. Failure to comply with post-investment requirements may result in a loss of the credit, requiring immediate repayment of the credits by the Taxpayer, or may result in a tax to the QSB equal to some or all of the credit received by its investors.

Angel Credits are subject to recapture. Qualified Investments must be held by investors for a three-year holding period. The three-year period is computed as (1) the remainder of the calendar year in which the investment is made plus (2) the following two calendar years. Failure to satisfy this requirement will result in the credits being revoked. If credits are revoked, each Taxpayer must file an amended Minnesota tax return for the year in which the credit was issued and the credit must be repaid by the Taxpayer within 30 days of revocation.

CHAPTER 3 QUALIFIED SMALL BUSINESSES ("QSBs")

A company seeking allocation of Angel Credits for its investors must be certified by DEED as a Qualified Small Business (QSB) before receiving the corresponding investment. QSB certification may be obtained by submitting an application to DEED along with a $150 application fee. The form of application is available on DEED'S website. Certification as a QSB only qualifies the business as eligible to engage in credit-generating transactions. It does not mean that any credits have been allocated for investments in the company. The credit allocation process is a separate step, discussed in Chapter 7.

Within 30 days of receiving an application for certification, DEED must grant certification, reject the application or request additional information. If DEED requests additional information, then DEED must certify or reject the application within 30 days of its receiving the requested additional information. The QSB application fee is not refundable (except that if an application is neither certified nor rejected within 30 days, then it will be deemed rejected and the fee may refunded). Rejected applicants for QSB certification may reapply.

Certification is valid for the calendar year in which the certification was obtained. A new certification is required for each calendar year that the company wishes to qualify investments for additional credits.

Once investment in a company results in the issuance of credits, there are a number of ongoing, post-investment requirements that the QSB must meet. Failure to remain in compliance with the ongoing, post-investment requirements could result in a tax on the company up to the amount of credits allocated to its investors. The QSB's failure to meet the ongoing requirements do not result in a tax on, or recovery of the credit from, Taxpayers.

In order to receive certification from DEED as a QSB, a number of conditions must be satisfied.

The Innovation Requirement

The company must be "engaged in" or "committed to engage in . . . innovation" in Minnesota with at least one of the following categories as its "primary business activity:"

Category A. Using proprietary technology to add value to a product, process or service;

Category B. Researching or developing a proprietary product, process, or service; or

Category C. Researching, developing, or producing a new proprietary technology.

Merely engaging in or committing to engage in innovation is not adequate. The innovation activities must be the company's primary business activity. While sources of revenue and the nature of a company's expenses are good indicators of a company's primary business activities, they are not the only factors to consider. Other factors that should be considered to consider include, without limitation: how the company holds itself out to the public, how the company characterizes itself in contexts other than the QSB process, the company's uses of investment proceeds, the number of personnel devoted to the activity, as well as other factors. The requirement that the company be engaged in innovation is an

ongoing requirement. Failure to comply with the requirement after credit-generating investments have been made, however, does not result in loss of the credit or require the QSB to pay any tax.

Companies whose primary business activities fall within Category A or Category B above must be operating or intending to operate in a qualified "high technology field." These fields consist of the following:

- Aerospace
- Agricultural processing
- Renewable energy
- Energy efficiency and conservation
- Environmental engineering
- Food technology
- Cellulosic ethanol
- Information technology
- Materials science technology
- Nanotechnology
- Telecommunications
- Biotechnology
- Medical devices
- Pharmaceuticals
- Diagnostics
- Biological
- Chemistry
- Veterinary science
- Similar fields

It should be noted that these fields are not defined in the statute. As a result, DEED must exercise its judgment when reviewing applications for certification. The "similar fields" designation is a recognition that technology changes over time.

Companies whose primary business activities fall within Category C, above, may be eligible for QSB certification if their new proprietary technology is for use in the following fields:

- Agriculture
- Mining
- Forestry
- Tourism
- Manufacturing
- Transportation

Companies engaging in the business described below are not eligible for certification under Category A and Category B, even if their primary business activities are in a qualified "high technology field."

- Real estate development
- Insurance
- Banking
- Lending
- Lobbying
- Political consulting
- Information technology consulting
- Professional services provided by attorneys, accountants, business consultants, physicians, and health care consultants
- Wholesale trade
- Retail trade
- Leisure
- Hospitality
- Transportation
- Construction
- Ethanol from corn

This ineligibility does not apply to a company whose primary business activities fall within Category C. For example, a company in the transportation industry would be eligible if its primary business activities fall within Category C but would be ineligible if its primary business activities fall within Category A or Category B.

Proprietary Technology

In order for a company to qualify as a QSB, its technology must be unique. "Unique" technology includes, without limitation, innovations that are patented, patent pending, the subject of trade secrets, or copyrighted. Additionally, the technology must be legally owned or licensed by the company. If the technology is used pursuant to a license from a third party, the license need not be exclusive.

Location Requirements

The company must be headquartered in Minnesota. There are no requirements concerning where the company was originally incorporated or formed (for example, a corporation formed under Delaware law with its headquarters and principal operations in Minnesota may qualify as a QSB).

Companies that receive credit-generating investments must maintain their headquarters in Minnesota for at least five years following the year of investment. Failure to comply with this requirement does not result in a tax on the company or recovery of the credit from Taxpayers.

The company must meet the following requirements regarding location of its employees:

- 51 percent of the company's employees must be employed in Minnesota; and
- 51 percent of the company's payroll must be paid or incurred in Minnesota.

The number of employees deemed employed in Minnesota (and other states) is computed on a "full-time equivalent" basis. For example, two employees, each working 20 hours per week, are considered one full-time equivalent and count as one employee. Similarly, three employees, who collectively work 40 hours per week, also count as one employee.

Where payroll is deemed "paid or incurred" will be based on where the employees work, without regard to where they live. Wages paid to an Iowa resident working in Minnesota are deemed paid or incurred in Minnesota. Wages paid to a Minnesota resident working in Wisconsin are deemed paid or incurred in Wisconsin, even though subject to Minnesota income tax.

The payroll requirements are ongoing obligations and must be satisfied for periods following the investment. Failure to do so may result in a tax on the company up to 100 percent of the credit but will not result in a tax on or recovery of the credit from Taxpayers.

Limits on Operating History

To qualify as a QSB a company must be "in operation" for less than a stated number of years. There are two different years "in operation" limits: (1) a 20-year limit that is applicable to a select group of medical device and pharmaceutical companies, and (2) a 10-year limit that is applicable to all other companies. Determining which limit will applicable to a particular company depends on the nature of the company's business and operations.

20-Year Operating Limit – Medical Devices and Pharmaceuticals

A company that is engaged in the research, development, or production of medical devices or pharmaceuticals may qualify for a 20-year operating limit. In order to be eligible, for the 20-year limit, the company's medical devices or pharmaceuticals must require US FDA approval before they can be used in the treatment or diagnosis of a disease or condition. Such a company may qualify for certification as a QSB until it has been in operation for more than 20 years.

10-Year Operating Limit – Other Businesses

The default operating limit on QSB certification is a 10-year operating limit. That is, a company that has been "in operation" for 10 years or less can qualify for certification as a QSB. A company that has been in operation for more than 10 years will not qualify (unless it otherwise qualifies for the 20-year limit described above).

Prohibited Persons

A company seeking QSB certification cannot be subject to any of the disqualifications from eligibility to conduct a Small Corporate Offering Registration pursuant to the Minnesota Securities Act. These disqualifications limit the ability of certain persons and the businesses with which they are associated from conducting a simplified public offering of securities. A copy of these disqualifications is attached as Appendix A. Although these disqualifications are patterned after the disqualifications for Regulation A offerings under the federal securities laws, they are not identical.

Prior Equity Funding Limits

The amount of private equity raised by the company prior to applying for certification as a QSB must be $4 million or less. This amount is recalculated at the time of each year's application for certification as a QSB. All transactions in prior years are included, including those for which credits were issued, but transactions for which certification is currently being sought are not. Qualified Investments received after the date of certification but in the same year as the certification will not affect the company's status as a QSB for the remainder of that year. If the company submits an application for certification in subsequent years, then those investments will be included in assessing eligibility.

Each year's application for QSB certification continues to include equity raised in prior years, including equity for which Angel Credits were allocated.

In determining the amount of equity previously raised, funds received by the company from the sale of debt which is subject to mandatory conversion (i.e. automatically or at the election of the company without action by the debt holder) are included. This is true even if the mandatory conversion is subject to contingencies

and even if the debt holder has the option to convert such debt into equity prior to the mandatory conversion date.

Funds received from the sale of promissory notes and other debt where the holder has the right to convert such notes or debts into equity of the company but which are not subject to mandatory conversion are not treated as equity. Once such notes are actually converted, such funds will be included as equity previously raised.

DEED will determine compliance with the prior funding limitation based upon financial statements submitted by the company in connection with its application for certification as a QSB. Financial statements are required of all companies seeking certification. If the company has audited financial statements, they should be submitted. If the company does not have audited financial statements, its application should include a statement to that effect and the company should submit unaudited financial statements. If a company is newly-formed, and has conducted no operations, it should submit a balance sheet as of the most recent practicable date showing equity raised by the company.

A businesses that has issued securities traded on a public exchange will not be eligible for QSB certification.

Requirements Concerning Employees

The company must have fewer than 25 employees, measured on a "full-time equivalent" basis (in the same manner as determining the location of employment of the company's employees). All of the company's employees, including the company's officers as well as seasonal and short-term/temporary employees, are counted. If the company is a part of a Unitary Group, all employees of all members of the Unitary Group must be included in this calculation.

All of the company's employees, other than Interns, must be paid at a rate at least equal to 175 percent of the federal poverty guideline for a family of four. The poverty guideline is published by the Federal Department of Health and Human Services and is generally updated annually. Interns must be paid at a rate at least equal to 175 percent of the federal minimum wage. The federal minimum wage may be modified from time to time. Compliance with these requirements is determined on an employee-by-employee basis, not an average basis.

Once certified as a QSB, a company's eligibility will not be affected by changes in these guidelines or changes in its rate of pay during the remainder of the year for which certification was granted. The DEED website will be updated from time to time to reflect changes in these guidelines.

For purposes of this calculation, a company may include not only wages and salary paid to the employee but also other benefits deductible by the company and specifically allocable to the employee. For example, contributions to a 401 (k) plan and day care expenses may be included. Benefits such as medical insurance where the cost related to each individual employee is not known may not be included.

Payments to an executive officer, board member, or any employee who owns more than 20 percent of the company are exempt from this minimum rate requirement. Payments to family members of such persons are not, however, exempt. This requirement applies not only to the company seeking to be a QSB but also to other entities that are part of a Unitary Group with the applicant. It is an ongoing requirement but failure to comply with it, after certification, will not result in the QSB incurring a tax or other penalty.

There is no requirement of a minimum rate of pay to independent contractors that provide services to the company such as payroll services, computer services, and the like. Companies are cautioned, however, that payments to such services are exempt from this requirement only if the recipients are, in fact, independent contractors. The determination whether a recipient of payments is, in fact, an independent contractor is complicated. The courts, in assessing this issue in cases involving failure to withhold payroll taxes, rely upon numerous factors. Claims that individuals who are paid at an hourly rate less than the guideline will likely be suspect. Entities are urged to seek competent advice from their attorneys or accountants as to this determination.

Please remember that certification only qualifies a QSB to receive Qualified Investments. It does not mean that any Angel Credits have been allocated

CHAPTER 4 QUALIFIED INVESTORS ("ANGELS")

In order for a natural person to be eligible to receive Angel Credits for Qualified Investments, the investor must be certified by DEED as a Qualified Investor. Certification is obtained by submitting an application to DEED along with a $350 application fee. This form of application is available on DEED'S website.

Certification as an Qualified Investor (or Angel) must be obtained prior to making a qualified investment, with one exception: an Angel who is not an accredited investor under the federal securities laws may file an application for certification and pay the required fee before credits are allocated or the non-accredited Angel may elect to make a filing within 30 days after completing the investment.

Within 30 days of receiving an application for certification, DEED must grant certification, reject the application or request additional information. If additional information is requested, the application must be certified or rejected by DEED within 30 days of receiving the additional information. The application fee is not refundable (except that if an application is neither certified nor rejected within 30 days, it is deemed rejected and the fee is to be refunded). Rejected applicants may reapply.

Certification as an Angel is valid for the calendar year in which the certification is obtained. A new certification is required for each subsequent calendar year in which the Angel proposes to make Qualified Investments. Certification as an Angel only qualifies an investor as eligible to make Qualified Investments. It does not mean that any credits have been allocated for his or her investments. The credit allocation process is discussed in Chapter 7.

In order to be certified as an Angel, an investor must meet several requirements at the time the Qualified Investment is made. These requirements are not ongoing.

Natural Persons

The investor must be a natural person. Corporations, partnerships, limited liability companies and other entities are not eligible to be Angels but may be eligible to be Qualified Funds (if their owners are natural persons). Exception: If a revocable trust makes a Qualified Investment, the investment is treated as if made by the trust beneficiary and the trust need not be certified as a Qualified Fund.

There is no requirement that investors be residents of Minnesota or that they receive taxable income in Minnesota. In order to receive the Angel Credit, however, investors will be required to file a Minnesota tax return for the year of investment even if they would not otherwise be required to do so.

Required Holding Period

After an investment has been made, the Angel must continue to hold the investment for the remainder of the year of investment and the following two calendar years.

Please remember that investor certification only qualifies an Angel to make Qualified Investments. It does not mean that any Angel Credits have been allocated to a particular investment.

CHAPTER 5 QUALIFIED FUNDS

Angel Credits are available for investments in QSBs by Qualified Funds. In order for an entity to be a Qualified Fund and eligible to make investments for which its owners will receive Angel Credits, the entity must be certified by DEED as a Qualified Fund prior to making such investment. Certification is obtained by submitting an application to DEED along with a $1,000 application fee. This form of application is available on DEED's website. Certification as a Qualified Fund only qualifies the entity as eligible to make Qualified Investments. It does not mean that any credits have been allocated for its investors.

Within 30 days of receiving an application for certification, DEED must grant certification, reject the application or request additional information. If additional information is requested, the application must be certified or rejected by DEED within 30 days of receiving the additional information. The application fee is not refundable (except that if an application is neither certified nor rejected within 30 days, it is deemed rejected and the fee is to be refunded). Rejected applicants may reapply.

Certification as a Qualified Fund is valid for the calendar year in which the certification is obtained. A new certification is required for each subsequent calendar year in which the entity proposes to make Qualified Investments.

Only a Pass-Through Entity is eligible to be a Qualified Fund. When a Qualified Fund makes a Qualified Investment, the credits are not allocated to the fund but, instead, are allocated directly to the Taxpayers who are the equity owners of the fund.

A Qualified Fund must have at least three owners who are natural persons. It may have owners which are not natural persons but they are not eligible for the credit and do not count toward the "three investor" minimum. A Qualified Fund may make a Qualified Investment in a QSB only if the Qualified Fund has at least three owners who would be eligible to receive Angel Credits for their direct investment in the QSB.

> *Example:* Assume that John Q. Taxpayer has been certified as a Qualified Investor. Also assume that John Q. Taxpayer is an equity owner in Great Investments Minnesota LLC which has been certified as a Qualified Fund. If John Q. Taxpayer received more than half of his gross income from Smart Ideas, LLC, he is disqualified from receiving Angel Credits related to investments in Smart Ideas. This is true both as to his direct investments and as to any investments by Great Investments Minnesota. Great Investments Minnesota is eligible to make Qualified Investments in Smart Ideas and credits will be allocated to its owners (other than John Q. Taxpayer). Great Investments' owners, other than John Q. Taxpayer, may also be allocated Angel Credits for their investments in Smart Ideas other than through Great Investments Minnesota (that is, directly as Angel Investors or indirectly as owners of another Qualified Fund).

The Qualified Fund need not be organized under Minnesota law and owners of the fund need not be Minnesota residents.

After the investment is made, the Fund must continue to hold the investment for the remainder of the year of investment and the following two calendar years.

Please remember that certification only qualifies a Qualified Fund to make Qualified Investments. It does not mean that any Angel Credits have been allocated. The credit allocation process is discussed in Chapter 7, Allocations and Timetable.

CHAPTER 6 QUALIFIED INVESTMENTS

In addition to the Angel, Qualified Fund and QSB certification requirements previously discussed, the investment must be a Qualified Investment. Certain requirements must be met in order for an investment to be treated as a Qualified Investment. These requirements relate to the nature of the security received by the investor, the nature of consideration given by the investor, the minimum size of the investment, the maximum credits that can be allocated for investments in each QSB, the maximum credits that may be claimed by each Taxpayer, and the required status under Minnesota securities laws of issuances of securities eligible for the credit.

Restriction on Investors' Sources of Income

Even though certified as an Angel, an investor may not be eligible for credits in connection with certain investments. An Angel may not be allocated credits for a proposed investment if the Angel receives more than half of his or her gross income from the QSB. This includes salaries, wages and other payments to the Angel as compensation, such as fees paid to the Angel as an independent contractor. The amounts do not include amounts that are not taxable to the Angel, such as reimbursement of bona fide out-of-pocket expenses. For purposes of this calculation, DEED will look only to items includable in the Angel's "gross income" as reported on IRS Form 1040.

An Angel will not be eligible to receive credits if a "family member" of the Angel receives more than half of his or her gross income from the QSB. In making this determination, the term "family member"

is defined by reference to the Internal Revenue Code and includes the Angel, the Angel's spouse, their parents, siblings, children and the spouse of any of such persons.

Although eligibility to be allocated credits is limited based upon gross income received from the QSB, there is no limitation based upon the Angel's ownership interest in the QSB.

Equity Investment Requirements

Only equity investments in QSB are eligible for the credit. Eligible forms of equity include common stock, preferred stock, interests in general partnerships, interests in limited partnerships, membership interests in limited liability companies and membership interests in limited liability partnerships. Status as an eligible form of investment is not affected by whether the QSB is a Pass-Through Entity.

Many companies have more than one classes of preferred equity. Preferences can include differences in voting rights, dividends, liquidation, appointment of directors or managers, approval of certain transactions, among others. So long as the securities being issued are equity securities, class preferences and differences will not affect eligibility for the credit.

Treatment of Certain Convertible Debt Investments as Equity

Some promissory notes and other debt provide that they are, or will become, convertible into equity. If the terms and conditions of such conversion meet certain requirements, these promissory notes and debt investment may be treated as equity investments. In order to be a Qualified Investment, such promissory note or debt investment must be subject to mandatory conversion into equity within three years of its issuance, without any further action or consent by the Angel. The mandatory conversion must not be subject to any conditions. For example, a promissory note that provides that it

will automatically and mandatorily convert into common stock on the third anniversary of its issuance will be eligible for the credit. Some promissory notes and other debt are convertible into equity, but conversion is solely at the election of the holder. Because there is no obligation to convert, these debt investments will not be eligible for the credit.

Some promissory notes and other debt are not immediately convertible but become subject to conversion (either mandatory or at the election of the Angel) only upon satisfaction of defined contingencies. Typical contingencies are receipt by the QSB of a minimum amount of funding, achievement by the QSB of financial or operational goals, and similar conditions. Because there is no unconditional obligation to convert, these debt investments will not be eligible for the credit. This is true even if the obligation to convert may become mandatory.

If a promissory note or other debt contains both a mandatory conversion provision and an optional right to convert earlier than the automatic conversion date (where the optional rights may be immediate, deferred or contingent), the debt investment will be is treated as equity – so long as the mandatory conversion, by its terms, must occur within three years of issuance.

Important Note: The 2013 amendments to the program add additional complications for those seeking to structure convertible debt investments as Qualified Investments. Under the amendments, an investment cannot be treated as a Qualified Investment if a Liquidation Event occurs with respect to the investment within 180 days after its issuance date. The new definition of a Liquidation Event includes any "conversion of qualified investment for cash, cash and other consideration, or any other form of equity or debt interest." The conversion of a qualified, convertible debt investment into equity in the company is not excluded. As a result, conversion of an otherwise qualified debt instrument into the company's equity within 180 days of the investment date, for any reason,

will trigger the Liquidation Event prohibition and disqualify an otherwise qualified mandatorily convertible debt instrument from being treated as a Qualified Investment.

Comment: Businesses that seek to have convertible debt treated as equity under the program are strongly encouraged to submit their proposed forms of convertible debt instruments for review by to DEED before finalizing terms of those investments.

In addition to the types of securities specifically identified, DEED is authorized to consider other forms of investment and, if appropriate, treat them as eligible.

Cash Consideration Requirements

The Angel's or Qualified Fund's investment in a QSB must be a cash investment. Services rendered to the QSB do not qualify nor do assignments of assets, whether tangible (such as real estate and equipment) or intangible (such as patents).

If promissory notes (or other debt) of the QSB are converted into equity of the QSB, such conversion does not qualify. This limitation applies both where the debt holder has a right to convert the note into equity and where the conversion into equity is negotiated at the time of conversion. (Note: Cash paid to a QSB to purchase equity is an eligible form of consideration without regard to the source of the cash. If a QSB repays a note owed to an Angel and the Angel immediately uses that cash to purchase equity securities in the QSB, this requirement will be satisfied.)

Minimum Investment Requirements

In order for an investment to be treated as a Qualified Investment, the amount invested must be above a stated minimum.

Angels - $10,000 Minimum Investment

The minimum investment requirement for Angels is $10,000 per QSB investment. This requirement applies to each investment in each QSB. Separate investments by an Angel of $5,000 in two separate QSBs will not be a Qualified Investment.

Qualified Funds - $30,000 Minimum Investment

The minimum investment requirement for Qualified Funds is $30,000 per QSB investment. Note that Qualified Funds are not required to receive a minimum level of funding from each of their owners. This means that an equity owner of a Qualified Fund is eligible to receive his or her proportionate share of credits generated by investments by the fund even if the Taxpayer's underlying investment in the Qualified Fund is less than $10,000.

Maximum Qualified Investments and Angel Credits

The total amount of Qualified Investments in each QSB may not exceed $4 million. This equates to $1 million of Angel Credits. This limitation is a lifetime maximum and there is no annual maximum limitation.

Caution: Depending upon the timing of Qualified Investments and other investments, a company that is eligible to be a QSB in one year may become ineligible to be a QSB in a later year based upon issuances of equity (both eligible and ineligible for the credit).

The maximum Angel Credits a Taxpayer may receive in any calendar year is $125,000 which relates to Qualified Investments of $500,000. The maximum amount of Qualified Investments for each Taxpayer includes investments directly by the Taxpayer and the Taxpayer's proportionate share of investments through a Qualified Fund for which the Taxpayer is allocated credits.

Taxpayers who are married and file a joint return may receive up to $250,000 of credits each year which relates to Qualified Investments of $1 million. This is without regard to who made the investments. The following examples illustrate this limitation. If a husband and wife separately make Qualified Investments of $500,000, each is entitled to $125,000 of credits which may be claimed without regard to whether they file a joint tax return or separate tax returns. If, instead, one spouse makes Qualified Investments of $1 million, the maximum credit available will depend upon their filing status. If they file a joint return, they can receive $250,000 of credits. If they file separate returns, the spouse making the investment will receive $125,000 of credits and the non-investing spouse will not receive any credits.

Securities Law Status of Qualified Investments

The Minnesota Securities Act requires that all offers and sales of securities must be registered unless such offers and sales are made pursuant to valid exemptions from registration. This requirement is in addition to federal securities registration requirements. The Angel Credit is available only if the securities issued to the Angel and/or to the Qualified Fund are offered and sold pursuant to two specified exemptions from registration or pursuant to a short-form registration. Each is discussed in turn.

The Minnesota Securities Act provides an exemption for sales of securities to "accredited investors," "institutional investors," and certain other persons. The term "accredited investor" is defined under the federal Securities Act of 1933, as amended. Although there are several other categories, the most commonly relied-upon categories are natural persons who have a net worth of $1 million or more (not including their principal residence), individuals with a $200,000 net income for the past two years and reasonably expected in the current year, married couples with joint net income of $300,000 in each of the last two years and reasonably expected in the current year, and directors, executive officers (as defined) and

general partners of the company. (Note: The number of persons who qualify as accredited investors was significantly reduced by Congress in the Dodd-Frank Wall Street Reform Act which was enacted in July 2010. Investors previously could include the value of their principal residence in determining net worth but now may not include such value.)

The Minnesota Securities Act also provides an exemption from registration for sales of securities made as part of a "private placement." This exemption limits the number of investors, prohibits general solicitation, limits commissions, sometimes requires a filing to be made, and is subject to other conditions.

The Minnesota Securities Act provides for a "mini public offering" registered as a Small Corporate Offering Registration ("SCOR"). SCOR does not limit the number of investors and public solicitation of investors is permitted. An issuer may sell up to $1 million of its securities, subject to certain reductions. Issuers are required to file a "short-form" registration statement which is subject to minimal review, to provide each investor with a simplified offering document and to meet certain other conditions and requirements. SCOR is not available to certain types of issuers nor to issuers engaged in certain types of business. SCOR is subject to "bad boy" provisions identical to those of the Angel Credit.

CHAPTER 7 ALLOCATIONS AND TIMETABLE

After required certifications have been obtained (with one exception), the QSB together with an Angel and/or a Qualified Fund may jointly submit a tax credit request application to DEED requesting allocation of Angel Credits. (Exception: An Angel who is not an accredited investor under the federal securities laws may choose to file his or her application for certification and pay the required fee within 30 days after completing his or her investment.) The form of such request is available on DEED's website. The request for allocation will identify and provide information regarding Angels (both certified and uncertified) and/or Qualified Funds, the QSB, prior issuances of the QSB's equity for which Angel Credits have been allocated and information about the proposed investment transaction.

The request for allocation needs to identify each Taxpayer to whom credits will be issued, both directly as an Angel and as an equity owner of a Qualified Fund, and information about the Taxpayer's prior credits and the related transactions. No fee is required in connection with filing a request for allocation.

DEED will review the request for completeness, eligibility, and compliance with the limitations as to the maximum allocation of Angel Credits, both as to the QSB and each Taxpayer. Requests must be approved or rejected by DEED within 15 days of receipt. Credits will be allocated in the order that the applications are filed with DEED. The dates that required certifications are obtained is irrelevant in determining the amount of credits to be allocated except that applications for allocation of Angel Credits are not deemed filed until all required certifications have been obtained.

All requests for allocation filed on the same day are treated as having been filed simultaneously. If two or more requests are filed on the same day and fewer credits remain unallocated than requested, the available credits will be allocated pro-rata among the requests filed on that day.

Once credits have been allocated, the Qualified Investment must be made within 60 days of the date of allocation. The investment must also be made prior to December 31st. If these time limitations are not satisfied, the allocation will be canceled and the credits will become available for reallocation for other investments.

Angels, Qualified Funds and QSBs can make multiple requests for allocation during each year. Each is reviewed separately as to completeness and each allocation of credits is made based upon the date the request was filed. The determinations of Angel, Qualified Fund and QSB eligibility are made only at the time of the application for certification and are not reconsidered upon submission of a request for allocation of credits.

CHAPTER 8 REPORTING

After an investment has been completed, Angels and Qualified Funds must notify DEED of the closing of the investment. An Angel or Qualified Fund that fails to complete the proposed investment must notify DEED within five business days of the expiration of the 60-day investment period. There is no provision for extension of these time periods.

At the end of each year, DEED will issue a tax credit certificate to each Taxpayer for the total amount of credits allocated to the Taxpayer. The Taxpayer will receive one certificate relating to all Qualified Investments including those made directly by the Taxpayer as an Angel, those made by a Qualified Fund of which the Taxpayer is an owner, and those made by a revocable trust of which the Taxpayer is the beneficiary. Certificates will not be issued to Qualified Funds.

By February 1st of each year, each QSB that received a credit-generating investment and each Angel and each Qualified Fund that made a credit-generating investment during the year must submit an annual report to DEED and pay a $100 filing fee. Failure to file a report will result in a fine of $500.

Angels and Qualified Funds must submit a report for the year in which they made a Qualified Investment for which credits were issued and for the following two years. The report must certify that the investor (i.e. an Angel or a Qualified Fund) remains invested in the QSB.

QSBs must submit a report for each year in which they received investments for which credits were issued and for five years thereafter. The reports must certify that the QSB continues to satisfy the following requirements:

- The QSB has its headquarters in Minnesota;
- At least 51 percent of the QSB's employees are employed in Minnesota;
- At least 51 percent of the QSB's total payroll is paid or incurred in Minnesota; and
- The QSB continues to be engaged in, or remains committed to engage in, innovation in Minnesota as required under the conditions of certification.

A company that ceases all operations and becomes insolvent must file an insolvency report documenting its insolvency. Insolvency of the company does not relieve Taxpayers of their obligations to file annual reports.

CHAPTER 9 POST-INVESTMENT REQUIREMENTS: REVOCATION AND REPAYMENT

Revocation and Repayment by the Taxpayer

The Angel Credit is subject to revocation if the Angel or Qualified Fund fails to hold the securities until after the end of the second calendar year after their investment. For example, securities acquired on any date in 2013 must be held until at least January 1, 2016.

If the Angel or Qualified Fund fails to hold the securities for the requisite period of time and no exemption is available, the credits are revoked and must be repaid. The amount required to be repaid is not affected by the period between the investment and the date of revocation. If the credits are revoked for failure to hold for the required period, the Taxpayer must file an amended Minnesota tax return for the year of investment and must repay the entire amount of credits received, both within 30 days of the date of revocation. If the securities were purchased by a Qualified Fund, the fund must notify its members of the revocation. Such members must file amended tax returns and repay the credit. The fund is not required to file a return or pay any tax or penalty.

Under certain circumstances, revocation is not appropriate. The revocation does not apply in any of the following circumstances:

- The securities become worthless;
- The QSB sells 80 percent or more of its assets;
- The QSB is sold; or
- The QSB's common stock begins trading on a public exchange.

Tax on the Qualified Small Business

A QSB that receives Qualified Investments that result in the issuance of Angel Credits to Taxpayers must continue to employ at least 51 percent of its employees in Minnesota. The QSB must also continue to pay or incur at least 51 percent of its total payroll in Minnesota. These requirements must be met in the calendar year the Qualified Investment was received and for five years thereafter.

If the employee and payroll requirements are not met, the QSB must pay a tax equal to a percentage of the Angel Credits:

Year after investment	Percentage
Year of investment and first year after investment	100%
Second	80%
Third	60%
Fourth	40%
Fifth	20%
Sixth or later	0%

In addition to the employee and payroll requirements, *QSBs* are required to meet other requirements. They must continue to be engaged in or committed to engage in innovation in Minnesota with their primary business activities within one of the permissible categories. Additionally, they must maintain their headquarters in Minnesota, continue to engage in innovation, and continue to comply with the minimum rate of pay requirements. Failure to comply with these additional requirements, however, does *not* result in loss of the credit or require the QSB to pay any tax.

Even if the QSB fails to comply with its ongoing requirements, the Angel Credit received by the Taxpayer is not subject to revocation or repayment.

APPENDIX A DISQUALIFICATION PROVISIONS

Disqualification Provisions
[Minn. Stat. § Chapter 80A.50 sec. 302(b)(3)]

(3) **Disqualification**. Registration under this section is not available to any of the following issuers:

(A) an issuer subject to the reporting requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934;

(B) an investment company;

(C) a development stage company that either has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies or other entity or person;

(D) an issuer if the issuer or any of its predecessors, officers, directors, governors, partners, ten percent stock or equity holders, promoters, or any selling agents of the securities to be offered, or any officer, director, governor, or partner of the selling agent:

(i) has filed a registration statement that is the subject of a currently effective registration stop order entered under a federal or state securities law within five years before the filing of the small corporate offering registration application;

(ii) has been convicted within five years before the filing of the small corporate offering registration application of a felony or misdemeanor in connection with the offer, purchase, or sale of a security or a felony involving fraud or deceit, including, but not limited to, forgery, embezzlement, obtaining money under false pretenses, larceny, or conspiracy to defraud;

(iii) is currently subject to a state administrative enforcement order or judgment entered by a state securities administrator or the Securities and Exchange Commission within five years before the filing of the small corporate offering registration application, or is subject to a federal or state administrative enforcement order or judgment in which fraud or deceit, including, but not limited to, making untrue statements of material facts or omitting to state material facts, was found and the order or judgment was entered within five years before the filing of the small corporate offering registration application;

(iv) is currently subject to an order, judgment, or decree of a court of competent jurisdiction temporarily restraining or enjoining, or is subject to an order, judgment, or decree of a court of competent jurisdiction permanently restraining or enjoining the party from engaging in or continuing any conduct or practice in connection with the purchase or sale of any security or involving the making of a false filing with a state or with the Securities and Exchange Commission entered within five years before the filing of the small corporate offering registration application; or

(v) is subject to a state's administrative enforcement order, or judgment that prohibits, denies, or revokes the use of an exemption for registration in connection with the offer, purchase, or sale of securities,

(I) except that clauses (i) to (iv) do not apply if the person subject to the disqualification is duly licensed or registered to conduct securities-related business in the state in which the administrative order or judgment was entered against the person or if the dealer employing the party is licensed or registered in this state and the form BD filed in this state discloses the order, conviction, judgment, or decree relating to the person, and

(II) except that the disqualification under this subdivision is automatically waived if the state securities administrator or federal agency that created the basis for disqualification determines upon a showing of good cause that it is not necessary under the circumstances to deny the registration.

SMALL CORPORATE OFFERING REGISTRATION (SCOR)

A “Short Form” Registration Statement

SMALL CORPORATE OFFERING REGISTRATION (SCOR) TABLE OF CONTENTS

INTRODUCTION

This booklet discusses the Small Corporate Offering Registration, commonly known as "SCOR."[1] SCOR is a simplified ("short form") method of registration which allows certain small businesses to offer and sell their securities free from prohibitions on public solicitation of investors and from limitations on the number of investors. This prohibition and this limitation, which are conditions of most exemptions from registration, are often a major roadblock to small business financing.

Both federal and state securities laws require registration of securities[2] before they can be offered or sold to investors. Some offerings must comply with the requirements of more than one state's laws. (State securities laws are commonly known as "blue sky" laws.) Registration is an expensive process requiring disclosure of detailed and extensive information about the company, its business or planned business, its management, its capitalization, its financial statements, and much more.

There are various exemptions from these registration requirements if certain conditions are met. The requirements of the exemptions are strictly enforced. A sale of securities which is neither registered nor

1 SCOR is unrelated to the Small Business Administration's Service Corps of Retired Executives, commonly known as "SCORE."

2 The definition of "securities" is very broad and extends beyond the commonly recognized securities such as stock, debt and interests in limited partnerships and limited liability companies. This booklet does not address the scope of this definition. Businesses are urged to consult counsel before seeking or receiving any sort of equity funding or proceeds of debt from any source other than well-recognized lenders such as banks, governmental agencies, and commercial lenders.

made pursuant to a valid exemption can lead not only to enforcement action by the applicable agency(ies) but usually gives the investor a right of "rescission." Rescission means that the investor has the right to be paid back the full amount invested (often with interest) based *solely* upon failure to register the securities. No fraud need be shown. This rescission right exists whether the failure to register was intentional or was the result of ignorance or misunderstanding.

Officers, directors and other "control persons" of an issuer share responsibility for compliance with these requirements and, very often, are liable for the issuer's rescission obligations. Usually, such liability is "joint and several," which means that the investor has a right to recover his entire lost profit from any one of the issuer and the other responsible parties with no obligation to attempt to recover from other responsible parties.

Two of the most common conditions of the exemptions from registration are that (i) there is no public solicitation of investors and (ii) the securities are offered and sold only to a limited number of investors. Both of these can severely limit the funding ability of small business.[3]

- Public solicitation is prohibited. Whether a particular offering involves "public solicitation" is a complicated question. The existence or non-existence of public solicitation has been the primary issue in many government enforcement actions (both civil and criminal), in many private lawsuits by investors and has been the subject of Supreme Court decisions. The factors

3 Exemptions also exist based upon the relationship of the investor to the issuer (e.g. "rights offering" where only existing owners are offered the securities), the purpose of the issuance (e.g. securities issued as compensation), the characteristics of the issuer (e.g. non-profit entities), the location of the issuers and investors (e.g. the intrastate offering exemption) and numerous others. These exemptions impose widely varying requirements as to the number of investors ("body count"), the categories of permitted investors (e.g. "accredited investors"), the notice filings required to be made, whether those filings are reviewed and the nature of such review, and other matters.

that determine whether public solicitation is involved are beyond the scope of this booklet. Fraud need not be shown for this liability to exist. Issuers and their principals may become liable based *solely* upon violation of these no-public-solicitation prohibitions. These persons may become liable not only based upon their own actions but also based upon actions by brokers, agents and finders.[4]

- The number of investors is limited. Most exemptions are conditioned upon a limited number of investors (*i.e.* a "body count," often 35). Investors with high net worth or high net income (and certain other investors) may be excluded from the applicable body count. Nonetheless, because the number of non-counted investors is unknown at the beginning of the offering, companies typically require each of their investors to invest no less than a minimum amount, often $25,000 or $35,000. The interaction of the "no-public-solicitation" limitation with the "body-count" limitation is particularly problematic for entrepreneurs who do not have relationships with a significant number of non-counted investors (*i.e.* persons with high net worth or high net income). These limitations also increase the proportionate risk to less wealthy investors. A $25,000 investment poses a greater risk to the less-wealthy investor because a higher percentage of his or her total portfolio is concentrated in a single investment.

4 The scope of actions that finders are permitted to perform and the nature and amount of compensation that finders may receive without becoming subject to registration as a broker-dealer (and without the issuer becoming subject to claims for rescission based upon the finder's unregistered status) are among the most misunderstood limitations of the securities laws. These misunderstandings are held both by issuers and purported finders (as well as many of their lawyers). Issuers should not rely upon assertions by finders as to their permitted activities (no matter how ardently made) but should seek advice from competent legal counsel with experience in this area and who represents the interest of issuer (not the interests of the finder) before using a finder.

This booklet relates to SCOR as it is available for offers and sales in Minnesota. The conditions and requirements of SCOR in other states vary and are not addressed herein.

CHAPTER 1 WHEN SCOR SHOULD BE USED

As discussed elsewhere, there are limitations that affect a company's eligibility for SCOR offerings. Examples are the "bad boy" prohibitions and the "domestic entity" requirements described in Chapter 2, Eligible Issuers. If those conditions are not met, SCOR *may not* be used.

SCOR is a hybrid type of offering. It has characteristics of a public offering and has characteristics of a private placement in which some key conditions and requirement are eased. It is designed to allow smaller businesses (often early-stage businesses) to have access to capital when more traditional private placements are not feasible. It helps address the funding problems of companies that do not have access to a net work of accredited investors. It also may be appropriate for companies that could raise funding through a private placement but want a broader base of owners.

SCOR is most appropriate for companies:

- Whose officers, directors, managers and control persons do not have access to a significant number of persons eligible or willing to make sizeable investments but who do have access to a significant number of investors willing to make smaller investments, either based upon personal relationships, location of the company, customer loyalty, or other factors. The manner of offering is discussed in Chapter 4, Qualified Investors (Anges);

- Whose prospective investors are not willing to invest by purchasing "restricted securities". See Chapter 9, Additional Considerations; and
- Whose prospective investors are not willing to make large enough investments to allow the company to comply with "body-count" limitations. See Chapter 5, Number of Investors (Escrow of Proceeds Until Minimum Amount Raised).

Companies conducting SCOR offerings are required to give their investors thorough and carefully documented and drafted information in order to:

- Allow their investors to make intelligent investment decisions;
- Comply with requirements set forth in the registration statement. See Chapter 7, Information to Investors; and
- Avoid liability under the "antifraud rules". See Chapter 8, Liability to Investors/Civil Enforcement/Criminal Enforcement.

SCOR may also be appropriate for some companies that would be able to raise the needed amount of capital by complying with the private placement restrictions. Some companies use SCOR to enhance their relationships with persons such as customers. For example, SCOR has often been used by microbreweries, wineries, and locally based businesses who want to offer community members an opportunity to become owners of the company.

Companies considering SCOR offerings, and their officers, directors and similar persons, need to consider the risks of personal liability based upon the sale of securities. (These risks also exist as to provide placements of securities.) Status as a corporation, limited liability company, or similar entity does not provide protection against personal liability of its promoters, officers, directors, management and similar persons in the same way or to the same extent that such protection is provided as to most corporate obligations and liabilities.

Companies considering a SCOR offering need to recognize that prior sales of its securities (whether as part of a formal private placement or otherwise) may affect its eligibility for SCOR for the amount it is eligible to raise in a SCOR offering and should conduct this assessment early, before incurring significant costs.

The company is required to use an attorney in order to provide a legal opinion to be filed as part of its application. See Chapter 6, Filing Requirements. The company must use a certified public accountant to audit or review its financial statements. See Chapter 7, Information to Investors. Companies should also seek the assistance of attorneys and accountants as to the SCOR offering generally and, when engaging such persons, should consider these persons' experience with SCOR offerings and similar transactions.

Nearly all SCOR offerings are conducted without the engagement of a broker/dealer but many companies (both in SCOR offerings and private placements) use the services of a "finder". Companies should seek competent counsel prior to engaging or using a finder. The activities of a finder may put the company and its control persons at risk of liability based upon the finder's status as an unregistered broker/dealer or based upon the finder's dealings with investors.

The Minnesota Securities Act, including provisions related SCOR, are administered by the securities division of the Minnesota Department of Commerce. Although the staff may be helpful in obtaining information and guidance, a company should not expect the staff's participation in preparation of required documents. In addition to the fact that this is not the role of the staff, the number of staff persons has been reduced over the past several years and such persons are not able to devote significant time to any particular company or transaction.

CHAPTER 2 ELIGIBLE ISSUERS

Not all businesses are eligible to use SCOR. In order to be eligible, a business must meet all of the following requirements:

- Issuer only. Only issuers can register securities under SCOR. SCOR cannot be used for registration of securities for resale by shareholders, partners, members, etc.
- Not already public. The Securities Exchange Act of 1934 requires certain companies to register and to file annual, quarterly and other reports with the SEC. Typical of these forms are Forms 10-K, 10-Q, and 8-K. This obligation usually arises because the business has significant revenues, a significant number of owners, or because it has conducted a registered initial public offering. These companies may not use SCOR.[5]
- Rule 504 federal exemption. Rule 504, which is part of federal Regulation D, is an exemption from the federal securities registration requirements which allows companies to raise up to $1 million without registration. Only offerings federally exempt pursuant to Rule 504 are eligible to use SCOR.
- Not subject to "bad boy." Some companies are not eligible to use SCOR because they, their predecessors, officers, directors, 10 percent equity holders, promoters, selling agents or any officer, director, governor or partner of the selling agent have

5 There are some companies who voluntarily make Exchange Act filings and whose securities are publicly traded even though they are not registered under the Exchange Act. Although this ineligibility provision does not apply to these companies, they are not likely users of SCOR because of other limitations.

previously been sanctioned for certain activities involving fraud or deceit or violations of federal or state securities laws. This disqualification can be waived by the authority whose actions caused the disqualification. The text of Minnesota's bad boy limitation is Appendix A.[6]

- U.S. company. The business must be organized in a U.S. state or territory. It need not be organized under the laws of Minnesota. For example, a Delaware corporation is eligible. Companies organized outside the United States are not eligible.

- Not a "blank check" or "blind pool" company. Some development stage companies either have no specific business plan or purpose or have indicated that their business plan, after they raise capital, is to identify and merge with another company seeking financing. This allows the other companies to obtain their needed funding more quickly and inexpensively and is often seen as a "back door" way to "go public." Because of significant problems with these offerings and a high incidence of fraudulent transactions, these offerings are not SCOR-eligible.

6 Although the federal Securities Act contains a similar bad boy prohibition, only state limitations apply to SCOR offerings. The Minnesota list of disqualified persons is very similar to, but not identical to, the federal list.

CHAPTER 3 AMOUNT ELIGIBLE TO BE RAISED

Because SCOR offerings must be made pursuant to Rule 504 of Regulation D, they are limited to $1 million (the Rule 504 maximum). Proceeds from multiple rounds of financing may be treated as a single offering (i.e. "integrated") for purposes of computing compliance with this $1 million limitation. This means that proceeds from some sales of securities prior to the SCOR offering will be deemed integrated with the SCOR offering and will limit the size of the SCOR offering. For example, if a company has previously sold $250,000 in an offering which is deemed integrated, it may raise only $750,000 in its SCOR offering.

The integration period is not limited to one year or any other time period but includes all sales factually determined to be part of the same offering. The determination of which sales must be integrated is a complicated, highly fact specific analysis. In order to provide certainty and predictability, Rule 504 provides a "safe harbor." If an issuer has a six-month "gap" prior to the SCOR offering during which no sales of its securities occur (other than pursuant to two very limited exceptions[7]), the transactions before that gap will be treated as separate offerings, not subject to integration.

Even if not subject to "integration," some prior sales of securities must be counted against the $1 million limitation. The limitation

7 One exception relates to offshore sales to non-U.S. residents which are not subject to U.S. laws. The other exception relates to issuances which are not intended for capital-raising but are intended to compensate employees and certain others for service to the business.

is reduced by the proceeds from certain sales of securities within one year before the SCOR offering begins, even if those sales are not subject to integration with the SCOR offering. A company determining the maximum amount it is eligible to raise in a SCOR offering should (i) start with the $1 million maximum, (ii) deduct the amount of all securities (debt and equity) it has sold since the last 6-month gap in its sales of securities, then (iii) deduct all sales in the 12 months before the offering will start.[8] If this initially computed eligibility is too low, the company should consult with an attorney familiar with SCOR. Upon a more detailed analysis, the company may be able to exclude some of the reductions of (i) and (ii). For this initial analysis, the company should treat all funding, both equity and debt, as the sale of securities except funds borrowed from banks, governmental agencies and commercial lenders such as lenders affiliated with dealers of vehicles, computer equipment and software. Other borrowings may, in fact, not cause a reduction in eligible funding but, for this initial analysis, should be deducted.

Businesses whose financing plans include a possible SCOR offering should seek the advice of counsel familiar with Regulation D as far in advance as possible. By making certain changes in financing plans (particularly by insuring a six-month period with no sales), a business may be able to increase the amount eligible to be sold in a SCOR offering.

8 Sales which fall into both categories (ii) and (iii) need only be deducted once.

CHAPTER 4 PUBLIC SOLICITATION PERMITTED

Nearly all exemptions from securities registration limit the manner of solicitation of investors. Essentially, they prohibit "public solicitation" of investors. One of the primary benefits of SCOR is that the public solicitation prohibition does not apply. The determination whether "public solicitation" is involved depends upon numerous factors and is an often-litigated question.

Public solicitation includes not only traditional advertising but may also be involved if the company contacts a large number of prospective investors or publicly announces its offering. Even if a only small number of investors is contacted, a public offering may be involved, depending upon the relationship of the company and its principals[9] to the prospective investors. Public solicitation is broadly interpreted and includes direct mailing, door-to-door solicitation, announcements on product labeling, seminars, and other methods of contacting prospective investors.

Rule 504 of Regulation D (pursuant to which SCOR offerings are made) includes a prohibition on public solicitation, but this prohibition does not apply and public solicitation is permitted for *state registered offerings*. The public solicitation prohibition is not waived if the offering is made pursuant to *state exemptions* from registration. Minnesota adopted the short-form SCOR registration specifically to make public solicitations available to young businesses.

9 Primarily officers, directors and founding shareholders.

State registration removes the federal prohibition on public solicitation only if the securities are registered in all jurisdictions in which the offering is being made. For example, if a business intends to raise capital in Minnesota and other states, the business can use public solicitation only if it registers its securities both in Minnesota and all of the other states. If the business registers the securities in Minnesota pursuant to SCOR but offers the securities in even one state pursuant to an exemption from that state's registration requirements, the federal prohibition on public solicitation continues to apply. There is one exception to this requirement. Recognizing that not all states require registration of securities, sales in those states do not prevent the use of public solicitation so long as the securities are registered in at least one state and are registered in all states where registration is required.

CHAPTER 5 NUMBER OF INVESTORS (ESCROW OF PROCEEDS UNTIL MINIMUM AMOUNT RAISED)

Like many other exemptions, Rule 504 of Regulation D contains a limitation on the maximum number of investors. Because of this "body count" limitation, investors are typically allowed to invest only if they make a sizeable investment, often $25,000 or $35,000 or more. This minimum-investment limitation poses a much greater roadblock for entrepreneurs with less access to "deep pocket" investors. Because SCOR does not have a limitation on the number of investors, companies are free to accept investments without regard to the amount invested by each investor. This makes SCOR particularly useful for companies with a large number of potential investors such as a large base of customers. Elimination of this limitation is one of the primary benefits of SCOR.

SCOR offerings which are not subject to Rule 504's limitation on public solicitation (see the previous chapter) also are not subject to the "body count" limitations of Rule 504.

CHAPTER 6 FILING REQUIREMENTS

A SCOR registration begins with filing of a registration statement with the Securities Division of the Minnesota Department of Commerce. Only the company can file a registration statement. The registration statement must be submitted on Form U-7 which is published by the North American Securities Administrators Association ("NASAA"). Form U-7 consists of a series of questions seeking information about the company. Form U-7 and its instructions may be downloaded from the North American Securities Administrators Association at www.nasaa.org.

In addition to filing the registration statement with Minnesota, the company must also file a Form D with the Securities and Exchange Commission. The Form D gathers primarily identifying information and information about the exemptions claimed. It does not require filing of the form of disclosure document or a consent to service of process, and does not require a fee. The SEC now accepts filing of Forms D only electronically. In order to make such filings, issuers must obtain identifying numbers (similar to user IDs and passwords) from the SEC. Issuers are cautioned to obtain these numbers in advance so that the Form D can be timely filed.

Businesses that choose to provide information about themselves using Form U-7's question and answer format are cautioned to carefully consider whether there is information that prospective investors should be told which is not explicitly requested by these questions.

Instead of completing Form U-7 by answering all of its questions, companies may provide the information and complete some or all items by referencing an offering document to be delivered to investors. That document would present information about the business in a manner similar to a more traditional private placement memorandum or prospectus. If all items on Form U-7 are addressed in the offering document, the company need not deliver the Form U-7 to investors. If the company makes disclosure in this manner, it must file with its Form U-7 a cross-reference sheet showing where the information called for by the Form U-7, item-by-item, is included in the offering document. This cross-reference sheet need not be delivered to investors.

As discussed below, in Chapter 8, Liability to Investors/Civil Enforcement/Criminal Enforcement, companies conducting a SCOR offering are subject to the anti-fraud provisions of both the Minnesota Securities Act and federal securities laws.

Here are some of the categories of information that must be provided:

- What is being offered. The registration statement must set forth what type of securities are being offered, the total amount being offered, and the amount being offered in Minnesota. Typical types of securities are common stock, preferred stock, limited partnership interests, membership interests in limited liability companies, promissory notes, and similar instruments.

- Consent to be sued in Minnesota. The registration statement must include a consent to service of process. The form of such consent, Form U-2, is available at www.nasaa.org. By filing this document, the company agrees that an investor suing the company related to his or her investment may sue the company in Minnesota courts even if the company is not otherwise subject to jurisdiction of the Minnesota courts.

This consent does not affect the jurisdiction of Minnesota courts as to matters other than claims by investors related to their investment. This consent is required so that companies located elsewhere cannot avoid lawsuits brought by Minnesota investors in Minnesota courts by claiming that they are outside Minnesota courts' jurisdiction. This consent must be filed by all companies, including those located in Minnesota.

- Other states where offered. The registration statement must identify all states in which the company proposes to offer the securities, must identify in which states a registration statement or similar filing has been made, must set forth the status of each such application and, if any state has issued a "stop order" prohibiting the company from proceeding with the offering or has taken any similar action, must disclose that information.

- Articles and bylaws. The company must file a copy of its articles of incorporation and bylaws (if a corporation), partnership agreement (if a partnership), member control agreement (if a limited liability company), or other similar documents. The copies submitted should be copies of signed documents and should include all amendments. There is not a requirement to file amendments or revisions that are adopted after the SCOR offering is complete.

- Specimen certificate. The registration statement must include a specimen or form of the securities being registered. This might be, for example, a form of stock certificate, a form of partnership ownership certificate, or a form of promissory note. Many smaller companies, particularly limited partnerships and limited liability companies, do not issue certificates to their owners but, instead, keep track of ownership only by the company's official member register or similar records. SCOR registration does not require companies to change this practice but if this is the case, the registration statement must say so.

- Opinion of counsel. The registration statement must be accompanied by an opinion of counsel addressed to the company as to issuance of the securities. The opinion must state that equity securities, when sold to investors, will be "validly issued, fully paid and non-assessable" or, if debt securities are being issued, that they will be "binding obligations" of the company. Counsel's opinion does not speak to the accuracy or completeness of the information being provided.

CHAPTER 7 INFORMATION TO INVESTORS

When a company raises capital by offering its securities to investors, it has an obligation to provide the investors with material information about itself so that investors can make an informed investment decision. The company's offering document must be given to each investor prior to sale of the securities to that investor. The company must also file a copy of its offering document with the Department of Commerce and, if it amends that document, must file all amendments. In addition to the items addressed in the previous chapter (and similar items) for which the company can usually provide specific information, the answers to other questions and the company's assessment of what other information should be provided involves judgment as to relevancy, materiality, and importance to investors.

In traditional public offerings registered with the Securities Exchange Commission and made by broker dealers on behalf of issuers, investors are provided extensive and detailed information about the company by means of a prospectus. Preparation of such detailed information is complicated and expensive. In many cases, early-stage companies which are SCOR-eligible do not have as much reliable information as do more mature companies. SCOR and the Form U-7 recognize that this type of detailed disclosure is a significant hindrance to smaller companies raising funds. They also recognize, however, that investors should receive adequate accurate information about the company to enable them to make

intelligent investment decisions.[10] SCOR balances these conflicting factors by prescribing specific categories of information to be disclosed in a question-and-answer format. The company must respond to each question in the Form U-7 even if the answer is stating that the question is "not applicable."

As to financial statements, generally the company is required to file audited financial statements as of its most recent year end, and unaudited financial statements covering the period since the last year end until a recent month end. Minnesota allows those financial statements to be unaudited if they are "reviewed"[11] by independent certified public accountants. A company may not rely upon this exception and must furnish audited financial statements if it has previously conducted a public offering (registered, SCOR or intrastate), has not previously been required to provide audited financial statements in connection with the sale of its securities, and prior sales of securities have not exceeded $1 million.[12]

One of the most important and most difficult to draft sections of the offering document is disclosure about the risks to investors. They play a key role both in informing investors and in protecting the company and its management against claims by investors that they were misled. There are some risks that face nearly all small

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10 A few examples are its business or planned business, its products or proposed products, whether it intends to manufacture products itself, where and to whom it has marketed and intends to market its products, its management, its funding to date, its operating history, its licenses as to matters such as technology, and its ownership. (This list of examples is far from complete.)

11 "Reviewed" refers to a professional standard adopted by the American Institute of Certified Public Accountants. In connection with reviewed financial statements, the accountant provides assistance to the issuer as to preparation of the financial statement but does not perform any testing of the company's financial records.

12 Note that this $1 million limitation is not limited to sales made pursuant to SCOR or public offerings, but includes all securities sold by the issuer. If the company has previously raised $500,000 in private offerings and is now planning to raise additional funds in a SCOR offering, the company will be required to furnish audited financial statements if it files to register more than $500,000.

and early stage companies.[13] Other risks vary significantly based upon the company's business, management and other factors. Identifying risks can be a challenging task both because of the energy necessary to consider possible events and circumstances and, as importantly, to articulate risks which management, because of its familiarity with the company's business, generally assumes and normally would not need to articulate. After identifying potential risks, drafting risk factors also involves judgment as to which risk factors need to be included. While it is important that material risks be disclosed, there is sometimes a temptation to include every possible risk including, sometimes, risks that face businesses generally or which are clearly not applicable to the company. While risks that may, in fact, face the company should not be excluded, judgment must be exercised because inclusion of remote risks may dilute the disclosure value of real risks.

In assessing disclosures to be made, the following may be helpful:

- The information needs to be the most accurate known to the company.
- The company should clearly explain the reliability of the information.[14]
- Estimates and opinions should be clearly distinguished from factual information.
- The information needs to be thorough without burdening the prospective investor with unnecessary detail.

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13 Examples are need for additional funding, lack of management experience, lack of a market for the company's products, patent and license risks, and conflicts of interest between the company and its management. (This list of examples is far from complete.)

14 For example, the company should identify the source of information that it does not know directly by clearly identifying the source of such information (perhaps by citing industry or governmental studies or reports). It should make clear what information is factual vs. what information represents management's opinions based on experience in the area of business.

- Unless obvious, the company should explain why the information provided is important to its business.

When making choices about disclosures, keep in mind two overriding principles:

- Prospective investors are entitled to adequate and accurate information to allow them to make the best possible decision about whether to invest in the company.

- The company and its management can protect themselves from investors' claims that they were misled or not given full information if the company carefully prepares its offering documents.

In addition to the offering document, the company may provide other documents to prospective investors. These might include letters of introduction, advertisements, handouts, or PowerPoint or similar presentations. Companies are required to file a copy of each of these with the Department of Commerce. This includes not only documents which are hand-delivered, mailed or emailed but also those which are made available on the company's (or another) website.

Prior to beginning a SCOR offering, a company should consider that some or all of its website might be deemed to be an offering document and may be required to be filed. Even if the company determines that its website (or portions of its website) would not be deemed to be an offering document, the company should carefully review its website to ensure that it is up to date and consistent with the disclosures the company is making in its offering documents.

CHAPTER 8 LIABILITY TO INVESTORS/ CIVIL ENFORCEMENT/ CRIMINAL ENFORCEMENT

Liability to investors can arise in two manners. If the securities are not registered and an exemption is not available for their offer and sale, investors have a right of rescission. As discussed earlier, claims for rescission do not require any showing of fraud or bad intent. Failure to comply with the registration requirement is, *by itself*, the basis for liability. Note that compliance is required under both federal and state law. SCOR offerings are exempt under federal law if they comply with Rule 504 and have been registered under state law.[15]

There may be fraud liability to investors if they were not provided complete and accurate information. These claims arise under the "anti-fraud" provisions of both Minnesota law and federal law. Whether the offering is SCOR registered or is exempt does not affect the determination whether investors were defrauded. Liability exists where the company intentionally or negligently provided inaccurate information or failed to disclose information that was known to it. This liability does not require an intention to defraud investors. All that is required is to show that the inaccurate information was known (or should have been known) to be inaccurate or that the undisclosed information was known (or should have been known) to be material. Note that investors' claims are usually assessed with the benefit of "20/20 hindsight."

15 Although this booklet discusses only the requirements for SCOR offerings conducted in Minnesota, note that compliance with SCOR may be required in multiple states depending both upon the location of investors and the location of sales activities.

In assessing antifraud liability, the courts (as well as the Minnesota Department of Commerce and Securities Exchange Commission) understand that companies and management do not have the ability to know and foresee all facts and circumstances. Liability may be avoided if the courts (or agencies) can be persuaded that the disclosure was made in good faith after "due diligence."[16] The accuracy and completeness of information that is provided and the efforts made to make full disclosure are often persuasive as to this issue and can serve a significant role in avoiding liability even when disclosure is imperfect. An offering document that evidences careful preparation also may influence lawyers representing investors to advise their clients (*i.e.* the investors) that the cost of litigation makes litigation inadvisable or may lead the lawyer to decline representation on a contingent fee basis. This would, in turn, increase the investor's risk of proceeding with the litigation and may therefore avoid the litigation.

Although status as a corporation, limited liability company or certain other types of entities generally provides protection against personal liability for the company's officers, directors, and others, this status is irrelevant to the determination of those persons' liability under the anti-fraud provisions. Their liability may arise based upon the role they play in the offering, their status as an officer, director or similar status, or their status as "control person"[17] of the company.

Individuals may be able to avoid personal liability (even if the company is liable) if they can show their due diligence. The defense that the defendant exercised due diligence is assessed

16 Liability for failure register is not avoided or mitigated by due diligence.

17 The imposition of liability of persons found to be "control persons" prevents the defendants from avoiding liability that claims they were not officers or directors (or similar titles) of the issuer. Status as a control person is a factual determination not dependent upon such status. Multiple persons may be found to be control persons; sole control is not required.

on a defendant-by-defendant basis. One person may be found to have exercised due diligence and thereby be free from liability while another defendant may be found to have been negligent in preparing or assessing disclosures and, therefore, liable. Although the responsibility for preparing disclosure is often split among members of management based upon their management responsibilities (e.g. the chief financial officer usually takes the lead as to financial statements and financing plans), each participant should review the entire disclosure document and assess whether his or her reliance on others is reasonable.

Unfortunately, the costs of defending claims of liability are significant and defendants who may have been able to successfully defend against liability often settle in order to avoid the risk of liability and the cost of litigation. In the end, each participant's action to ensure that the company makes thorough and appropriate disclosure is that person's best defense.

Liabilities are almost always assessed on a "joint and several" basis. This means that a plaintiff can recover his or her loss from any defendant found liable. There is no requirement that liability be imposed based upon percentage of ownership or relative fault. Provisions in the company's articles of incorporation or similar documents excluding directors and officers (or persons playing similar roles) from personal liability are not effective to protect such persons from liability for securities law violations. Additionally, obligations to indemnify have been stated to be against public policy and are, generally, not enforceable as to securities law claims. This is true both as to provisions in articles of incorporation, bylaws and similar documents and as to provisions in contractual agreements.

CHAPTER 9 ADDITIONAL CONSIDERATIONS

Resale Status. Unlike securities purchased in a private placement or exempt offering which are restricted from transfer, securities purchased by investors in a SCOR offering are freely tradable. This status continues indefinitely under federal law except as to securities reacquired by the company or its affiliates. Under Minnesota law, the general rule is mat a registration statement must be effective in order for sales (including resales) to take place. Eligibility for resale will continue to exist so long as the company maintains effectiveness of its registration statement with the Minnesota Department of Commerce by filing annual reports. Even if the company fails to maintain effectiveness, investors who are not affiliates of the company will usually be able to resell their securities so long as the number of their transactions is limited. Resale of securities purchased in a SCOR offering need not comply with Rule 144 under the Federal Securities Act because, for federal law purposes, they are free trading.

The company may be able to assist investors as to resale by matching prospective buyers and prospective sellers. The requirements for the company to be able to do so are complex and are not addressed here.

Merit Standards. Until a few years ago, registered offerings in Minnesota were required to comply with certain "minimum equity," "cheap stock" and "lock up" requirements. When Minnesota revised its securities laws in 2006, these requirements were eliminated.

Minimum Offering Size; Proceeds Escrow. SCOR offerings should be structured so that funds will be accepted from investors only if a minimum amount of funding is raised. This amount is set forth in the offering document. It would be unfair to the investors to allow the company to accept subscriptions unless this minimum amount is raised. The company should set this minimum at an amount that will let it engage in its planned operations as described in the offering document.

In order to protect investors, investors' funds must initially be deposited in an escrow or impoundment account with a bank. The company may not accept the subscriptions or receive any of the proceeds unless the stated minimum amount offering document is received. While the funds are in that account, the company may not access the funds and its creditors may not seize those funds to enforce judgments against the company. If the company's offering document indicates that it is attempting to raise funding beyond the minimum, escrow/impoundment is not required after the minimum is satisfied.

ISBN 1-888-404-63-9

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Department of Employment and Economic Development