Business Transactions Solutions § 152:170

Business Transactions Solutions
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Part VI. Finance
Chapter 152. Offering and Disclosure Documents
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# § 152:170. Executive summary for clients regarding offering documents and procedures

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OFFERING DOCUMENTS AND PROCEDURES

## I. OFFERING DOCUMENTS AND PROCEDURES

Financing is an important issue for all businesses and one of the most important steps in completing the financing of any business is the preparation and presentation of the materials, the so-called "offering" or "disclosure" documents, that describe the company's business and its owners as well as the required financing and the terms of the securities being offered. There are a number of issues and activities that arise during any securities offering and this executive summary highlights some of the key ones included the regulatory context and requirements for private placements; the role of counsel and offering advisors; transaction planning and scheduling; preparation and use of business plans and private placement memoranda; the engagement of finders; investor presentations, and finally, the preparation of subscription documents and purchase and investors' rights agreements.

## II. REGULATORY CONTEXT AND REQUIREMENTS

The offer and sale of securities is regulated at both the state and federal level. The definition of a "security" is quite broad and includes common stock and preferred stock, investment contracts, and in some cases, promissory notes or other debt obligations. The state securities laws are called "blue sky" laws and require all offers and sales of securities to be registered in each state in which sales are solicited or a purchaser resides. In some states, the nature of the securities being offered is reviewed by the state, and the offer or sale must meet certain standards and be qualified. As a general rule, all offers and sales of securities in the United States must also be registered with the Securities and Exchange Commission, generally referred to as the "SEC", but there are exemptions to those registration requirements that can be used to complete so-called "private placements" and small offerings to the general public.

Both state and federal securities laws impose penalties for noncompliance. For example, investors have the right to rescind purchases of securities sold in violation of law and to obtain a refund of the purchase price paid. If the noncompliance involves the failure to qualify for an exemption from registration requirements, it can cause the entire offering to lose its exempt status even if the failure involves only a single requirement or a single investor. Loss of an exemption for the entire offering means that all investors may have a rescission right. Penalties for noncompliance with the securities law can be imposed not only on the corporation issuing the securities but also on those who control the corporation. Criminal penalties can be imposed for willful noncompliance with the securities laws.

Most securities offerings are made pursuant to exemptions from registration requirements. The cost of an SEC registration is prohibitive unless a corporation is seeking large amounts of capital and wishes to take on the burdens of being a public company. Even the cost of registering or qualifying an offering with a state can be significant. While there are actually a number of possible exemptions, including exemptions for transactions involving offerings of securities in a single state and other transactions covered by § 3 of the Securities Act of 1933, the most frequently used federal exemption is that for offerings "not involving any public offering." This exemption is created by § 4(2) of the Securities Act, and while a public offering might seem like a relatively simple concept, determining whether a particular offering is public involves issues such as the number of investors to whom offers are made, their level of financial sophistication, and the information they have been furnished. The law relating to these issues has been developed by the courts and the SEC on a case-by-case basis and is sometimes inconsistent. Fortunately, the SEC has created a "safe harbor" exemption under § 4(2), which provides that if certain requirements are met, an offering not be considered a public offering. Regulation D imposes limitations on the manner in which investors may be solicited, the number of investors, the dollar amount of securities that investors may purchase and resale of securities purchased in the offering. The Regulation also sets standards for the financial sophistication of investors and the information they must be furnished. Prospective investors must be asked to complete a confidential investor questionnaire in connection with a Regulation D offering. The questionnaire provides detailed information about the investor, including the investor's education, previous investment experience, income, and net worth that is relevant to determining whether the investor is accredited or sophisticated.

There must be full and fair disclosure of the nature of the securities being offered and the corporation offering them. All disclosures must be true, and there may not be any omissions that would make the disclosures misleading. These disclosure and antifraud requirements apply whether or not the offering qualifies for an exemption from registration. Disclosures pertaining to a securities offering are typically contained in a "private placement memorandum", or "PPM", that is delivered to prospective investors. At a minimum, this document must disclose all "material" information concerning the investment. This encompasses any information that a reasonable investor would consider important in making a decision to invest in the offered securities. The length and content of a PPM depends on the business and ownership of the corporation issuing the securities being offered and the nature of those securities. It also depends on the sophistication of potential investors and their access to information. It is not uncommon for a PPM to be quite long and detailed.

## III. ROLE OF COUNSEL AND OFFERING ADVISORS

While the ultimate responsibility for the preparation and content of the offering documents and the conduct of the offering itself lies with the company and its senior officers, it is common for company counsel and any investment banker or finder involved in the offering to play important roles in the offering process. The primary job of company counsel is to ensure that the offering documents comply with the various information disclosure requirements under federal and state securities laws. For their part, investment bankers and finders will work to make sure that the PPM is an effective "selling" document; however, they will also have an interest in making sure that the document does not expose them to securities law liability. In addition, company counsel is the primary guide for the company with respect to compliance with the requirements for the specific type of exemption that is being relied upon to avoid the time and expense of registration and qualification with federal and state securities regulators. Finally, company counsel will assist the senior officers of the company with negotiating of the terms and conditions upon which the investors will provide capital for the company's use in continuing its operations.

## IV. TRANSACTION PLANNING AND SCHEDULING

While the client sets the overall schedule for completion of the offering based on the capital requirements of the business, one of the jobs of company counsel will be to develop an acceptable plan for completing all of the key steps in the transaction process and making sure that those steps are carried out in a way that meets the needs and expectations of the client. While it is common to use a fairly detailed transactional checklist, it can generally be expected that the most important activities will include a preliminary planning meeting, due diligence, business plan preparation, establishing the proposed terms of offering, integration of the business plan with securities law requirements, review of proposed PPM by professional advisors,

  

preparation of subscription documents, identification of investors and presentations to investors, negotiation of final terms of offering and investment documentation, preparation of necessary federal and state securities law filings and the "closing".

## V. BUSINESS PLANS

A well-drafted business plan is obviously an important strategic and management tool; however, a plan that contains sufficient detailed information can also be used to comply with the information requirements of both federal and state securities laws as well as provide the company and its senior officers with protection against suits for fraud. Companies should create or update their business plan at the same time they are preparing their offering documentation, since this facilitates the development of a congruent and accurate package for prospective investors in a cost effective and time efficient manner. In addition, business plan preparation should be synchronized with the collection and organization of the information that investors are likely to request as part of their due diligence investigation. Elements of business plans include an executive summary, description of mission of company and current status, description of the company's current and proposed products and services, industry and competitive analysis, market analysis and marketing strategy, background of the company's managers and key employees and financial analysis.

## VI. PRIVATE PLACEMENT MEMORANDUM

As mentioned above, the most common offering document is often referred to as the private placement memorandum, or "PPM". The PPM includes the company's business plan, a description of the company's management and a description of the proposed offering terms. While each PPM is different it is safe to say that one will usually find that it covers most, if not all, of the following topics: summary information, risk factors, business and properties, offering price factors, use of proceeds, capitalization, description of securities, plan of distribution, dividends and redemptions, officers and key personnel, directors, principal stockholders, management relationships and remuneration, transactions between principal stockholders/managers and the corporation, litigation, federal tax aspects of the purchase of offered securities and financial statements.

It should be noted that companies that are willing and able to limit their investment group to persons or entities that meet the requirements of a so-called "accredited investor" under Regulation D can, in theory, reduce the size and detail of their offering document provided that they can demonstrate that investors had access to the company's facilities and financial information and records and access to management to ask questions relating to the investors' investment. However, because all securities transactions, even exempt transactions, are subject to the antifraud provisions of both federal and state securities laws, companies should provide sufficient information that is neither false nor misleading (i.e., statements that might contain a material omission that would make the statement made false or misleading), in order to avoid potential liability under the relevant securities law's antifraud provisions. Therefore, even if no specific disclosure requirements are mandated by law, companies should take care to provide sufficient information to prospective investors who are accredited so that the prospective investor can make an informed decision.

Initial drafting of the PPM should be done by the company, to save on attorney time. However, one of the purposes of drafting a PPM is to insulate the company from securities litigation in the event the company's plans go awry, so the company should expect significant input from company counsel on each word in the PPM and company counsel will typically focus on certain "special topics" including products and services, marketing and selling activities, intellectual property rights, regulatory compliance, plan of operations, financial information and projects and "risk factors".

## VII. PRACTICAL CONSIDERATIONS

There is no single method for producing a successful disclosure document, particularly since the attractiveness of the investment opportunity described in the document ultimately depends on the commercial viability of the company's products and services. Nonetheless, it is worth reviewing the final draft of the PPM against the following requirements and

suggestions:

- PPM should provide readers with a clear sense of what the company intends to accomplish over the typical investment period;

- PPM should describe the competitive advantages of the company products, services and/or operational methods;

- PPM should provide evidence of a market for the company's products and services and a roadmap regarding the strategies for penetrating that market;

- Financial projections should be believable (i.e., fall within accepted industry ranges) and fully explained and documented;

- Disclosures should be made with due regard to applicable "standard of care" imposed by federal and state securities laws;

- Distribution and presentation of information should be carefully managed to preserve confidentiality and provide foundation for claiming exemption from registration requirements;

- References to third parties in PPM should be fully supported and should not violate any contractual obligations.

Special care should be taken with regard to the manner in which the information is presented, as well as to the procedures for distributing the final version of the PPM. As a general rule, the PPM should be printed and bound, and the cover should include the name and address of the company, the date of the PPM, and a legend or statement to the effect that the information in the PPM should be maintained in confidence by the recipient. The number of copies of the PPM should be carefully controlled, and a record should be maintained regarding the distribution of copies of the PPM. If the terms of the proposed offering are included in the PPM, appropriate legends should also be placed on the outside and inside covers of the PPM to satisfy the requirements of federal and state securities laws.

## VIII. FINDERS

While companies know they need capital in order to survive and thrive, their founders and officers are often uncomfortable with soliciting capital. This is not surprising; the founders start up the company with the goal of doing the things the company was formed to do, not to spend the time and energy required in fund-raising. The reality is that company management must be able to do both, achieve the company's substantive goals and solicit money, in order for the venture to succeed.

Many companies will want to use a broker or a finder to do the money-raising, or at least to identify target investors. The activities of brokers, who deal in securities, are regulated by state and federal authorities. Finders are persons who hold themselves out as merely bringing investors and issuers together, and not directly dealing in securities.

The ability of the company to use the Regulation D exemption described above can be compromised by the use of finders, because the company could run afoul of the Regulation's "no general solicitation" requirement. Therefore, it is essential to establish procedures for carefully monitoring dissemination of the PPM and the finder's activities in connection with "publicizing" the offering. A company that is considering using a finder or other unregistered placement agent for its PPM should use consult first with counsel and should also request the finder to provide references and list successful experience, in order to see if the finder has a history of delivering on the promised performance. In addition, counsel should assist the

  

company in negotiating a finders' agreement that covers the services to be provided by the finder, remuneration for finder's services, restrictions on finder's activities and safeguards to ensure compliance with laws and regulations applicable to offering of securities.

## IX. INVESTOR PRESENTATIONS

Once the PPM has been drafted, the next step is the presentation of the information in the PPM to prospective investors. Just as the presentation of a resume, by itself, does not generally lead to a job offer, similarly, the presentation of a well-written business plan or PPM, by itself, will not lead to funding. The ability of a company and its principals to obtain investment funding depends on how the capital formation process is managed and the PPM only provides a written document that is used to generate interest in the investment opportunity and hopefully entice investors to take a harder look at the company and its business prospects. In addition to the PPM, the senior managers of the company must know when, how and to whom to present the information in the PPM, either orally, or in written form. Timing is critical.

Suggestions for companies about the presentation process included the following:

- Opportunities to make a presentation to potential investors may arise at any time and preparation is essential;

- Founders and other senior executives should be totally familiar with the key details of the business plan and the terms of the proposed offering;

- Companies should develop a plan for identifying and approaching prospective investors that taps into contacts of their outside advisors;

- Formal presentations to prospective investors should be carefully planned in advance with particular emphasis on articulating the contents of the executive summary and being prepared to answer questions regarding the summary;

- Companies should conduct due diligence on prospective investors before presentations in order to determine the investor's background and experience with respect to the particular market and technology;

- Each presentation should be seized as an opportunity to make changes and improvements to the business plan and supporting materials.

It is not typical for the attorney to attend every investor presentation so it will be difficult for company counsel to monitor exactly how clients handle face-to-face meetings with investors. However, if possible, companies should do a "dry run" of their presentation with their attorney so that counsel can provide input as to any statements or actions that may cause legal concerns, such as comments that strike counsel as being "excessively excited" about the future projected growth for the company's business.

## X. SUBSCRIPTION DOCUMENTS

The disclosure document is typically accompanied by subscription documents. If subscription documents are not used, the company and its counsel should obtain separate documentation confirming the eligibility of the investors to participate in the offering. This usually takes the form of a qualification questionnaire that collects specific information to verify that the investor meets the standards for the exemption from registration that is being relied upon in connection with the offering.

Subscription documents can take a number of different forms; however, they always serve several two important purposes: documentation of the agreement of the investor to purchase the offered securities and incorporation of the securities law compliance representations regarding disclosure requirements and applicable registration exemptions, which reduce the possibility that investors will bring legal action against the company. For example, the subscription documents should include representations from investors with respect to their "investment intent" and, in general, should serve as a record of the company's reasonable efforts to comply with requirements for private placement exemption from registration requirements.

## XI. PURCHASE AND INVESTORS' RIGHTS AGREEMENTS

While it is possible to complete the investment transaction using the subscription documents, which often are quite brief, in most cases the agreement to invest, which is the main purpose of the subscription documents, is formalized through the negotiation and execution of several purchase and investors' rights agreements which will cover the agreement of the parties with respect to purchase and sale of the offered securities, representations and warranties of the company (and founders), registration rights, affirmative and negative covenants, voting agreements and co-sale and other share transfer restriction agreements. The PPM should include a summary of the contents of each of these agreements as part of the description of the "terms of the offering".



Footnotes

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