

ROBERT G. HUTCHINS – LEGAL ESSAYS

Private Placements - Part I - Financing the Start-Up or Development-Stage Company

Preliminary Note

Although accurate figures will never be available, it is clear that most capital held by United States companies is raised privately. The capital is contributed in exchange for a seemingly infinite variety of investment securities. These include common and preferred shares, promissory notes and other debt instruments, convertible securities having attributes of both equity and debt, plus warrants, options and other “derivative” instruments.

The transactions that induce private investment vary widely. At one extreme are doomed encounters between amateur promoters and naive purchasers characterized by little documentation, less thought and no chance for investment profit short of Divine intervention. At the other extreme are professionally orchestrated securities placements that finance a huge component of the United States economy and fuel every conceivable kind of enterprise. Regardless of their sophistication, however, all of these efforts share a common element; they involve unregistered securities.

This Essay is the first in a four part series that examines the offer and sale of securities, by the company that issues them, in a transaction that is *exempt* from the general registration requirement imposed by the securities laws. Such a transaction is called a “private offering” or “private placement.”

The Role of the Business Plan in Selected Financings

- **Seed Money Financings:** Although it may have been developed solely as a management tool, the company's Business Plan will usually be its primary disclosure document for obtaining seed capital. The Plan can be pressed into service for that purpose, with appropriate editing, if it is to be used merely to persuade a small group of family members or close friends to sponsor the company during its formative period. The Plan will probably be sufficient, in this context, if (a) it avoids exaggeration, (b) it discloses existing financial information about the company meaningfully, (c) it discloses basic investment risks forthrightly and prominently and (d) it contains a reasonably lucid blueprint for meeting the company's initial business and financial goals. At the practical level, the Plan should articulate a plausible strategy for obtaining liquidity for initial investors if the goals are actually achieved. The essential legal requisites are these: The company cannot contact prospective investors using mass media, cold calls or other forms of “general solicitation.” Each

prospect must be acquainted with a director, officer or other representative of the company *prior* to the time the solicitation begins. The representative must have a reasonable basis for believing the prospect understands the investment and can afford to invest. The Business Plan, taken as a whole, must not be misleading.

The Plan should be edited to ensure that it distinguishes supportable *facts* from mere *expectations*. Statements that are actually predictions of future events should be prefaced with phrases such as “we anticipate,” “we believe,” “we intend” or “we think.” Projected financial results should be identified as hypothetical outcomes that are dependent upon the accuracy of specific assumptions. The assumptions and the rationale for them should be explained.

- **Venture capital financings:** Venture capitalists see hundreds of Business Plans each year, but they discard most of them out-of-hand. Venture firms look for specific strengths in the companies they sponsor. A Plan addressed to them must fairly radiate overall competence, thoroughness and clarity. It should emphasize the relevant experience and deep commitment of the company's management team. It should explain the company's marketing studies, development timetable, strategic objectives and operating milestones in a way that highlights the company's distinctive features and demonstrates its ability to sustain aggressive growth if adequately capitalized. The Plan should also describe the amount and timing of the company's known capital requirements, the specific uses to which each infusion of capital will be put, the attributes of the securities that will be offered to venture investors and the basis on which the *current* value of the company, its so-called “pre-money” value, has been determined.

If the Business Plan survives initial scrutiny, the venture firm will open negotiations with the company respecting the terms on which the firm might provide financing. If the initial negotiations produce a workable consensus about the basic terms, the firm will begin a thorough “due diligence” investigation of the company while pursuing a final agreement. The firm will usually insist upon the right to negotiate on an exclusive basis for a period of 30 to 90 days. The preliminary documents will include reciprocal confidentiality undertakings, a letter of intent and a proposed term sheet for the investment.

The legal issues associated with venture capital financing are formidable. They center primarily upon the allocation between the venture firm and the company's existing security holders of the right to participate in the company's earnings, assets and management. The allocation will vary significantly with each negotiation. The common theme, however, reflects the venture firm's insistence upon the right to receive enormous returns if the company is successful. Typically venture firms want preferred shares that have full voting rights as well as priority claims to the company's earnings and assets. The preferred shares must be convertible to common shares using a formula that provides holders with both an “upside” right to lock in capital appreciation and “downside” protection against business reversals. The

shares must confer the power to veto or even initiate major business and financial decisions (including a decision to “go public” or sell out) plus the right to elect a majority of directors if the company does not perform well. Venture firms also demand contractual “co-sale” rights to participate in any resale transaction negotiated by the founders with third parties.

- **Non-venture expansion financings:** If the company seeks expansion capital from persons who are not family members, close friends, venture capitalists or other seasoned investors able to fend for themselves, the typical Business Plan will not suffice as a selling document. At most it will be a guide for the preparation of a formal Private Placement Memorandum designed to comply with stringent disclosure standards imposed by the securities laws.

In approaching the subject of formal disclosure, it should be remembered that, regardless of its title, a document that is in fact used to solicit capital in an unregistered securities offering may not disclaim legal consequences. Recitations that the document is to be read “for informational purposes only” or that it “does not constitute an offer to sell or a solicitation of an offer to buy any security” are ineffective. A selling document is the functional equivalent (or will be an integral part) of a Private Placement Memorandum. To minimize legal risk, the Memorandum should describe the company, its business and the securities to be offered in detail. The subjects that should be addressed are extensive and they are set forth by line item in SEC regulations. Here is a brief overview of the suggested disclosure for three of them; financial information, risk factors and the proposed use of the offering proceeds:

- ⇒ **Financial information:** The company will have been in business for at least some period of time. It will have a financial history it must disclose to investors. The minimum disclosure, for offerings up to \$2 million, will include an audited balance sheet dated within 120 days of the offering. In addition, there should be a statement of income, cash flows and changes in stockholder’s equity covering all fiscal periods from inception to a date within 60 days of the offering. The income statement should be prepared according to generally accepted accounting principles. It should at least be “reviewed” by independent accountants, though it need not be audited. For offerings up to \$7.5 million, the company should furnish the audited balance sheet plus audited income statements for its prior two fiscal years. For offerings above \$7.5 million the financial disclosure will be equivalent to the disclosure that would be furnished in a registered offering of comparable size.

⇒ **Risk factors:** The risks associated with the proposed investment must be labeled conspicuously, described succinctly in descending order of importance and set forth in a special section near the beginning of the Memorandum. The following are basic risks commonly associated with companies that are still in the development stage. All remaining risks specific to a given company must, of course, be added.

- **Limited operating history:** Development-stage companies, by definition, have not engaged in operations long enough to permit an informed assessment to be made respecting their future prospects.¹
- **Unproven Concept, Product or Service:** Development-stage companies may be offering products or services, or using business methods, that have never been sold or used successfully and are thus unproven.
- **Inexperienced or thin management:** The management team of a development-stage company may be inexperienced and it may lack the depth to carry out the company's business plan. The company may be unable to attract competent personnel to fill the gaps.
- **Losses in prior periods:** Most development-stage companies incur significant losses in the initial phases of their operations. No assurance can be given on the basis of their financial history that they will be successful.
- **Inadequate offering proceeds:** The proceeds from an early private placement are rarely adequate to finance the operations of a development-stage company until it is self-sustaining. The company's failure to achieve forecasted unit sales within anticipated time periods, at predicted prices and for anticipated costs will leave it chronically short of capital.
- **Competition:** No matter how innovative their products or services may be, development-stage companies are uniformly confronted by intense competition, often from much larger and better capitalized entities. A company may

¹ The SEC definition of a development-stage company includes all companies that have not realized "significant" income from operations.

not believe that it faces significant direct competition if its product or service is unique, but the barriers to entering the company's market may be low. Moreover, the patent or copyright protection afforded the company may be limited. The possibility that another firm could lawfully exploit the company's intellectual property can be a serious risk.

- **Absence of a market for the securities:** A company cannot provide a *public* market for its securities without registering them with the SEC, a time consuming and extraordinarily expensive process well beyond the immediate reach of a company in the development stage. Further, the company's outstanding securities may not lawfully be resold by holders without registration, in *any* market, unless an exemption is available for the resale transaction. To be exempt, resales of unregistered securities must comply with SEC Rules 144 or 144A, or must satisfy less formal requirements known in the jargon of securities lawyers as the "4(1)(½)" exemption. The salient point here is that investors who purchase a company's unregistered securities may, as a practical matter, be required to hold them for an indefinite period, regardless of the fortunes of the company.²

- **Absence of experience in selling securities:** Officers and directors of companies still in the development stage often have little, if any, direct experience in selling securities. Purchasers in development-stage offerings thus assume the risk that all of the capital sought by the company may not be raised and the company may be cash short as a result. One hedge, discussed below, involves a so-called "contingency" offering. Investors' funds are held in escrow and will be returned to them unless the minimum amount of capital necessary for the company to achieve basic objectives is raised. A contingency offering provides some assurance that investors' funds will not be squandered needlessly while still permitting the company to seek additional proceeds that will enable it to satisfy more aggressive objectives.

² For a discussion of the resale requirements, see this Website, Publications, Essays, *Private Placements Part II, Finding Investors, Selling Constraints Applicable to Unregistered Securities Offerings*. The lack of a ready market for them also makes it important to enhance the attractiveness of the securities by devising an *ultimate* liquidity or exit strategy that is carefully articulated. See below.

- **Conflicts of interest:** The founders of the company usually will be executive officers as well as majority stockholders after an initial offering is complete. They may have interests that conflict with those of minority investors who are not also insiders. As one example, a favorable opportunity for outside investors to realize capital appreciation may be presented through a negotiated sale of the company to an acquirer intent on installing its own management team. The founders may be tempted to oppose the transaction to protect their jobs.

The duty to disclose risk should not be viewed as an onerous burden. All business is associated with financial risk and experienced investors are leery of executives who do not seem to recognize that basic fact. Proper disclosure of risk shows that management will take steps to combat those factors that might threaten the success of the company.

- ⇒ **Use of Offering Proceeds:** The Memorandum should disclose specifically the use to be made of the offering proceeds. If a substantial amount of money is to be reserved for some general purpose such as "working capital," the resulting wide discretion vested in management may even be a separate risk. Apart from legal requirements, a tabular presentation of the anticipated use of proceeds is an important selling tool, demonstrating to investors that management has thought carefully about the deployment of company resources.

A Private Placement Memorandum is a critical disclosure document that has important legal consequences. Purchasers of company securities who suffer a loss on their investment can sue the company itself, its officers, directors and other selling agents if the Memorandum is misleading. The Memorandum will be judged with the benefit of hindsight *after* the loss has occurred. It will be treated as misleading if it is perceived in court as having misstated or omitted a fact about the investment that a reasonably prudent investor would have considered "material" (significant) at the time the investment was made. It is therefore important to follow the SEC's disclosure regulations when organizing the Memorandum and to distinguish carefully between facts and beliefs when drafting it. Restrained language should be used throughout the text. As a practical matter, experienced investors are accustomed to reading carefully worded Memoranda and they are suspicious of broad, unqualified claims. Measured understatement has its own selling impact.

Devising and articulating a Liquidity Strategy

The objective of any investor is to realize capital appreciation through a “liquidity event” or “exit.” If the company cannot provide liquidity through cash distributions, investors will be intensely interested in its prospects for a registered public offering, a refinancing, a management buyout or a negotiated sale to a third party. Nevertheless, despite the importance of this subject, a consistent weakness of Private Placement Memoranda is their failure to articulate a liquidity strategy beyond a meaningless statement of general intent. When developing such a strategy, and preparing to disclose it, the company should be aware of the following:

- **The Role of the Underwriter in an IPO:** In most cases, an initial public offering or “IPO” will not be completed successfully without an “underwriter.” An underwriter is a securities broker-dealer engaged by a company as an intermediary to purchase all securities included in the IPO, as soon as they have been registered, at a discount from the public offering price. To complete the IPO, the broker resells the securities at the public price to the broker’s customers. The company retains only the net purchase price paid by the underwriter. The underwriter’s profit is measured by the discount. The underwriter’s customers then trade the securities in the after-market.

Underwriters vary widely in their approach to small companies, some disdaining them, others tolerating them, still others specializing in them. Underwriters often develop a focused interest in and comprehensive knowledge about particular industries. Some underwriters have strong retail distribution systems and others place securities with financial institutions. Retail distributions are often touted as favorable for initial public offerings because individual investors tend to be loyal and to stick with newer companies through the inevitable ups and downs, while institutional investors will abandon a company quickly if its stock does not perform well. On the other hand, institutional investors may have the sophistication to see merit in a small company that an individual investor might overlook. A company bent on “going public” should begin contacting investment bankers a full year in advance. It should not hesitate to interview a number of them, asking for and checking references to determine the track record of each. Attention should be paid to the post-offering performance of the bankers as market makers for the companies they have taken public, and to the quality of the working relationships that existed during the underwriting process.

- **IPO Valuations:** There are various ways to value a company, of course, but however it is done the company should have a *perceived* enterprise value that takes account of some basic dynamics:

- ⇒ **The size of the after-market for the securities:** Underwriters, who after an IPO function as market makers for the company, look for additional profits from transaction fees earned during post-IPO trading of the company's securities. The company itself needs sufficient market capitalization that its securities can be used as currency to attract employees, energize executives, finance new business acquisitions and raise additional capital. To establish a sufficient pool for those activities, the company should have at least 300,000 to 500,000 shares in the after market when the IPO is complete. The company should assume 500,000 for planning purposes.
- ⇒ **The taint of "cheap stock:"** There is a bias in the public markets against so-called "cheap" stock. Stock that is offered to the public initially at less than \$10 per share is viewed with suspicion. It brings to mind the frauds associated with "penny stock." A company selling 500,000 shares at \$10 per share must necessarily be worth at least \$5 million before other factors are considered.
- ⇒ **The necessity of retaining substantial equity:** Public markets do not readily accept large blocks of equity in initial primary offerings and they are wary of fixed-price secondary offerings in which insiders are reselling securities acquired privately at an earlier date. These transactions have the appearance of a "bail out." They suggest that something may be wrong with the company. Underwriters, accordingly, are reluctant to let a fledgling company go public for more than 25% to 35% of its equity, or to let its existing holders resell in the public offering more than a nominal amount of their previously acquired securities. Insiders are usually required to sign agreements prohibiting them from reselling their shares on the open market for six months or so after an initial public offering is complete. In any case, if we multiply our hypothetical \$5 million by 4 (assuming the offering is for 25% of the company's equity securities), the company must be perceived as being worth at least \$20 million for the IPO to be feasible.³

³ For a further discussion of this subject, see this Website, Publications, Essays, "*Risk Capital For 'Middle Market Companies.'*" With the passage of the Sarbanes-Oxley Act of

- **The high cost of “Going Public:”** Transaction costs, even for a small IPO in the \$10 million range, are very high, particularly when the underwriting discount of 6% to 8% of the public offering price is taken into account. The necessary professional work stubbornly resists scale economies. Legal fees will range between \$150,000 and \$225,000 and can be much higher for complex offerings. Accounting and printing fees are also substantial. Furthermore, after a company is publicly held, its management is often shocked at the continued administrative, accounting and legal cost associated with such things as filing periodic reports, communicating with analysts and the general public, and devising compliance programs respecting prohibited market manipulation and insider trading. To make things worse, the pressure to perform well can induce management to sacrifice long-term objectives in favor of short-term earnings. Finally, many smaller public companies, even those with NASDAQ listings, find that there is no active trading in their securities after their IPO is complete so that the securities are of little ongoing benefit either to the company or to their holders. When total costs are considered, the best course of action for a company emerging from the development stage may well be to stay private for as long as possible.

- **Internal Valuation Methods and Pricing:** For a company starting the capital-raising process, it is important that the pricing dynamics of each round of financing be understood from the outset. Investors in a private placement should be told how their securities have been priced in terms that compare the underlying valuation of the company with the valuation that later may be used for subsequent placements, for an IPO or for a disposition of the company structured as a merger or sale of assets. For example, if the planned exit were an IPO, the price to investors in a pre-IPO *private* offering might be pegged to a multiple of projected net earnings one year out. The theory would be that later, if the company were successful, the *public* markets might accept the company's securities at a *higher* multiple, while the company's earnings *level* will have *increased*. A trading market might be established for the company's public securities at a level exponentially above the original private offering price. Interim recapitalizations featuring non-taxable stock dividends or splits would align the holdings of insiders, on a per share basis, with the securities to be sold to the public. An explanation of the valuation methods and pricing used by a development stage company can quantify the financial incentive for early investors, framing their “bet” for them.

- **Selling the company as a liquidity strategy:** A negotiated sale of the company to a strategic acquirer can potentially yield greater value to shareholders than an IPO and is often more readily achievable. Here again, it will be important for the company to engage investment bankers early. It will also be

2002, the expense and risk of becoming and remaining a public company have increased exponentially. See, Essays, “*Special Reports- Evolving Trends in Financial Disclosure – Parts I, II and III.*”

necessary for the founders to accept emotionally the proposition that the company will not remain independent.⁴

Devising and Selling a Private Placement

Here are some additional practical tips for devising a private offering or placement and preparing the Memorandum:

- **Corporate cleanup:** The company should begin by directing its general counsel to conduct a corporate "clean-up" to confirm that the company's Articles of Incorporation and Bylaws create a capital structure appropriate for its offering and that the company's employment agreements, loan documents and major third-party leases or contracts for facilities, supplies, product development and initial orders are enforceable as written and can be explained clearly.

- **Organization and Capital Structure:** The company's form of organization and tax status, the rights and duties associated with its capital stock, the precise arrangement by which it will be managed, and its employment or other agreements or arrangements with insiders are all critical to investors and must be discussed thoroughly in the Memorandum.

- **Financial forecast and projections:** The Memorandum should include a unit sale forecast and related financial projections prepared in an "ABC" format, with A representing the base case, B the optimum case and C the worst probable case for unit sales. There are at least two reasons for this:

⇒ First, SEC Rule 175 creates a safe harbor for financial forecasts if they are provided in good faith, have a reasonable basis in fact and are accompanied by warnings sufficiently cautionary that investors are not gulled into accepting them at face value. The safe harbor is limited currently to filings by public companies, but the concept will spill over inevitably into the exempt offering arena. The safe harbor builds upon a judicial doctrine providing that forecasted financial results will not support a securities fraud lawsuit if accompanied by warnings that would "bespeak caution" to a reasonable investor. An ABC forecast demonstrates graphically the proposition that projected earnings are based upon estimates subject to both error and change.

⇒ Second, the overwhelming probabilities are against the company achieving the optimum results predicted for it. Promoters of development-stage companies simply do not recognize all the variations of "Murphy's Law" that

⁴ For observations on the purchase and sale of private companies, see this Website, Publications, Essays, Cumulative Index, "Mergers and Acquisitions."

can impede their progress. Material shortages, labor difficulties, canceled or delayed purchase orders, test failures, the denial or delay of critical permits and the unanticipated loss of key employees are only a few examples of the barriers to the delivery of products or services that a company may encounter. Investors will be more receptive to the company if its forecast recognizes that fact.⁵

- **Definitions:** A Private Placement Memorandum should minimize arcane jargon and technical terms. Those that must be used should be defined in the text or in a glossary. Investors should not be forced to master a new language to understand the company's business.

- **Key personnel:** The biographical sketches for key personnel should be prepared with attention to unintended impressions that may be created by them. The proposition that the founder spent many years developing the company's products and "vision," for example, should be phrased carefully. The founder spent that time attempting, without success, to achieve the company's objectives.

- **Screening and selection of offerees:** The company should keep a permanent record of the name, address, telephone number and relationship to the company of every person with whom its representatives have discussed the company's offering. Since exempt offerings are not to be "public," the cardinal sin in attempting them is a general solicitation of investors. Securities regulations impose a blanket prohibition on attracting investors by general solicitation if the offering is not registered. Cold calls, mass mailings and seminars whose attendees are invited by general means must scrupulously be avoided. The company should not use finders, "friends" or other intermediaries to tout its offering without the advice of counsel. Instead, the company should limit its solicitation to persons who already have a relationship with one of its representatives that can be called "substantive." A substantive relationship can be business, professional, or social but, whatever its origin, it must provide information permitting the reasonable conclusion that the person can assess the merits and risks of the offering, can afford to invest and will review relevant information about the company.

⁵ In carelessly prepared disclosure documents an unqualified claim is occasionally made that the company's first-year forecasted revenues are covered by "purchase orders," "letters of intent," or "letters of interest." Since the company, by definition, cannot continue operations without raising capital, its "purchase orders" are necessarily conditional until the capital is at hand. "Letters of Intent" and "Letters of Interest" are expressly made "non-binding" to avoid a premature purchase commitment. It would be misleading, and actionable if sales do not materialize, to infer that the company has pre-sold its products to any significant degree.

- **Contingency offering:** An exempt offering or placement can be so structured that investors' funds will be held in escrow and returned unless sufficient capital has been raised (the "Minimum Proceeds") to provide the company with a reasonable opportunity to complete its financial plan. If the Minimum Proceeds are raised, they are released immediately to the company. The company can then continue the offering until the maximum desired capital is raised or the offering period expires.

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