ROBERT HUTCHINS – LEGAL ESSAYS

Private Placements - Part IV – Pre-IPO and post Sarbanes-Oxley Act Placements

Preliminary Note

In the frenzied days before the dot.com bust, "emerging growth" companies would finance their pre-IPO operations by placing securities having registration rights with venture capitalists or "private equity" funds. It was not unusual for such placements to raise $20,000,000. The company would agree that, within eighteen to twenty four months, it would file a registration statement for its IPO that would include the securities sold in the placement. If the company faltered, or its IPO window closed, the alternative exit was a sale of the company itself. The VCs wanted short-term liquidity, not portfolios cluttered with restricted securities.[1]

During the same period, startups would begin with seed money in the $500,000 range obtained from family, friends and the occasional "angel." The initial investors would have the right (or the obligation) to participate in later financing rounds if the startup achieved negotiated milestones. Those rounds would be divided into tranches of from $2,000,000 to $10,000,000. If funded at all, they would include VCs and equity funds as well as the initial investors. Again, the planned liquidity event was an IPO, scheduled in this instance for registration within three to five years. Again, the backup was a sale of the enterprise.

The stock market, however, was rising on the naïve assumption that the technological revolutions underway in computing, data processing and the life sciences were triggering a "new economy" in which, for the participating companies, traditional valuation criteria were irrelevant. The "enthusiasm" for this assumption was sufficiently strong among underwriters that companies in prosaic "old economy" businesses found it difficult to go public, and thus difficult to attract private investment. Since the acquisition market was driven by the same enthusiasm, old economy companies were hamstrung even when they tried to sell out.

By April of 2000, it was clear that the enthusiasm was misplaced and that real demand for the new technologies would fall far short of expectations. A huge inventory of internet related products, developed largely on speculation, was left unsold. Stock prices plummeted, stranding some IPOs in mid-registration. Employment contracted sharply and the economy ground to a halt. With a moribund IPO market, VCs and equity funds found themselves holding extensive portfolios of restricted securities after all. They devoted their capital to the intravenous feeding of the few portfolio companies that showed promise of weathering the storm. They abandoned the rest or sold them off at fire-sale prices.

In 2001, a nascent economic recovery was frustrated by the September 11 nightmare and a series of corporate financial scandals some of which linger to this day. In July of 2002, Congress weighed in with the Sarbanes-Oxley Act, a clumsy attempt to improve corporate governance and financial "transparency." The only *certain* effect of this statute will be to raise exponentially the cost, complexity and risk of being public, eliminating the IPO as a liquidity vehicle for most entrepreneurs.

The problem looming for 2004 and beyond is that, with the economy at last recovering (and with the notion that there is anything "new" about it hopefully behind us) companies seeking risk capital face the prospect of being hamstrung again, this time by chastened financial markets and burdensome new regulations. This Essay examines their options.

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[1] They also knew that an outright sale, with its control premium, could yield a greater return than an IPO.

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Going Public in the post-dot.com era

The after-market acceptance afforded newly public companies has always been fragile. Even during the dot.com bubble many companies that succeeded in going public found afterward that there was little trading in their securities. The reasons for this phenomenon vary widely. In many cases, the company is clearly to blame because it fails to meet earnings targets, but at times the reasons are frustratingly

obscure. The company's securities might be included in a sell-off triggered by institutional program trading. The company might lose its panache in response to a general shift in investor sentiment, or suffer a minor setback that depresses its stock price irrationally and disproportionately for reasons no one can articulate. Whatever the cause, a newly public company that falls out of favor will be unable to maintain the IPO price for its securities. As a consequence, it will be unable to raise additional capital in the public markets or use its securities as currency to make acquisitions or attract executives. Yet, as a reporting company, it must continue to expose its financial condition and internal affairs to the world at large, including competitors, shareholder activists, unions and hostile acquirers. Such a company will be a stock market "orphan" having the entire burden, but none of the benefits, of complying with complex rules governing periodic reporting, insider trading, proxy solicitation and financial disclosure. After the dot.com bust, most of the 17,000 public companies in the United States could fairly be classified as "orphans." Orphans that managed to stave off bankruptcy are now "going private" in droves.

In the current environment, mature companies still contemplating an IPO (to say nothing of those preparing to be acquired) will find that their financial track records are more important than their technical or marketing prowess. Valuations for both IPOs and acquisitions are based increasingly upon trailing rather than projected cash flow. Investors and acquirers are focused primarily upon the quality and strength of a company's balance sheet, its procedures for revenue recognition, its cost controls and the empirical data supporting its business model. There is, in short, a return to fundamentals.

This trend leaves startups, for which any fundamental attribute is probably illusory, dependent as never before upon the perceived competence of their founders and the faith of their founders' friends and families. Startups can no longer devise a credible exit for outside investors with nothing more than a dazzling business plan and a potentially exciting product. They must make a convincing case that their fundamentals will be in place when their product is ready for the market. As a result, the capital commitments startups must require of initial investors are likely to increase substantially in both amount and duration, together with the associated investment risk. To compensate investors for assuming that risk, startups may be forced to sell significantly more equity in early rounds than previously.

The impact of the Sarbanes-Oxley Act of 2002

On the regulatory side, the Sarbanes-Oxley Act of 2002 has made a difficult situation much worse. The Act vests regulatory jurisdiction over public company audits and auditors in a new "Public Company Accounting Oversight Board," yet another bureaucracy whose pronouncements will be a part of corporate life. The Act creates ambiguous new standards for "Auditor Independence," "Corporate Responsibility" and "Enhanced Financial Disclosures," including arcane mandatory disclosures respecting "off-balance sheet" financing and "pro-forma" earnings. The Act imposes upon directors who serve on audit committees direct responsibility not merely for the basic integrity of the *company's* financial disclosure process (their traditional role), but also for the "appointment, compensation and *oversight*" (emphasis supplied) of the *auditor's* work. That, of course, subjects audit committee directors to increased risk of personal liability for errors made by outside accountants. The Act also requires that chief executives and chief financial officers certify personally the accuracy of each annual or quarterly report and state affirmatively that *they*, not the auditors, have designed internal procedures to *ensure* that they have knowledge of all information necessary for the certification. The certification will make it difficult for executives to defend against frivolous misrepresentation claims. To me, liability for misleading financial disclosure lies first with the company. In the absence at least of negligence, if not willful fraud, I see no benefit in increasing the personal exposure of corporate executives. That simply impairs the ability of public companies to recruit and retain them.[2]

[2] By contrast, the Securities Act of 1933 imposes personal liability for misrepresentations in a registration statement upon all persons who sign it, including a majority of the directors, the chief financial officer, the controller and the

The Act requires that companies make "real time" disclosure on a "rapid and current basis," in "plain English" no less, of unspecified "additional information." The SEC is to adopt Rules categorizing this information and they will be read in conjunction with Rules already adopted that accelerate the filing dates for annual and quarterly reports, expand the subjects to be disclosed in current reports and tighten the requirements for reports of transactions by insiders in company securities. The cost to public companies, in time and money, of complying with what amounts to a continuous reporting obligation will be substantial. Whether the result will be a net gain in the quality of corporate disclosure or a confusing avalanche of minutia is an open question.

The Act strengthens the role of "independent" directors at the expense of management and it imposes whistle-blowing obligations upon attorneys who advise public companies, factors that increase the potential for boardroom tension and corporate inefficiency. Finally, the Act expands the definitions and escalates the penalties for "Corporate Fraud" and "White Collar Crime" despite the absence of any evidence that those actions will have a deterrent effect. [3]

Inevitably, this statute will increase substantially the complexity and cost of being a public company and the personal risk associated with serving one. The compensation demanded by public company executives, auditors and other outside advisers will rise precipitously, along with the premiums for directors' and officers' liability insurance. The enhanced regulatory burden will be prohibitive for the vast majority of private companies that, in other times, might readily have gone public. Under the circumstances, the typical privately held company is well advised to stay private. Its challenge will be to attract investment without the lure of an IPO by substituting another means of achieving liquidity.[4]

Current Late Round and Pre-IPO Financings

Financings using Registration Rights

Despite Sarbanes-Oxley, there will be no shortage of private companies anxious to go public. Some of these companies, their fundamentals in place, will persuade underwriters to take them on. The capital structures used by these companies for their initial and follow-on placements will mirror those used during the dot.com bubble, although newly conservative VCs and equity funds will probably demand substantially more equity than previously for each dollar of contributed capital. A major problem that has not changed will arise during the 6 months preceding the IPO. The run up to an IPO can be financially draining. The company's operations are apt to deteriorate because its senior executives will be preoccupied with accountants, lawyers and investment bankers throughout the preparation of the registration statement and their schedules will be dominated by road shows after the statement is filed. The direct cost of this effort is substantial. The company often needs a supplementary injection of capital

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chief executive officer, but those persons may defend by showing that, after a reasonable investigation, they had "reasonable ground to believe and did believe" that the challenged disclosure was materially accurate.

[3] To be "independent" under the Act, a director must be independent of *management*, which begs two important questions: first, can a company *ever* be governed effectively by directors who, by definition, are divorced from management? Second, are directors who owe their seats to, say, venture capitalists or unions any more capable of objective oversight than those who sit as senior executives? As for the penalties, breathes there anywhere a corporate executive who would feloniously have filed a false statement with the SEC when the maximum penalty was $1,000,000 and ten years, but who will now refrain because the maximum is $5,000,000 and twenty years?

[4] The Act requires that funding for the Oversight Board and for additional SEC staff be provided, through special assessments, by the public companies themselves and their "registered public accounting firms." As with all costs, the assessments will be passed to consumers in the form of higher prices and to investors in the form of reduced capital appreciation. See also, this website, *Public Company Reporting and Disclosure/Evolving trends in Financial Disclosure – Part III – Congress Intervenes - The Sarbanes-Oxley Act of 2002.*

to tide it over until its registration statement is declared effective. With the concurrence of its underwriters, the company will place a limited amount of securities having registration rights with private investors who will purchase and pay for them at a discount from the anticipated public offering price. These investors will be identified in the registration statement as reselling security holders. Their shares will be purchased by the underwriters then resold to the public as a secondary component of the IPO. The placement must be complete before the registration statement is filed because the filing constitutes a public solicitation. SEC Rule 152 is helpful in this context because it provides that a pre-planned IPO will not, as such, taint a private placement that does not involve a public offering *at the time it is made.*

Financings using Participation Rights

In addition to registration rights, late round and pre-IPO financings often feature "participation rights." Participation rights are actually allocation rights, the right of existing investors, exacted as a condition of their original investment, to purchase additional securities in the company's IPO at the same price and on the same terms as other IPO investors. Participation rights are thus distinguishable from the "registration rights" discussed above i.e., the right to have the company register privately placed securities for public resale if an IPO goes forward. The SEC staff has taken the position that IPO participation rights granted within 12 months prior to the IPO involve an advance "offer" of the securities included in the IPO registration statement. The offer is unlawful because securities covered by a registration statement may not be offered until the statement is filed (or sold until the statement is effective). The practice, accordingly, is to condition the participation rights upon the expiration of a 12 month period or to substitute registration rights if the registration statement will be filed within 12 months.

Private Placements by Public Companies

In general

Publicly held companies routinely use private placements to fund short-term capital requirements. If the company has registered a class of equity securities with the SEC and the securities are listed on an exchange or NASDAQ, it can raise capital by placing securities of the same class (sold with registration rights) or derivative instruments tied to the registered securities (options, warrants or convertible securities). These securities are restricted upon issuance, but the company can satisfy its contractual obligation to private investors by filing a simplified resale registration statement for them. If the company's securities are registered but not listed, they may be quoted on over-the-counter bulletin boards maintained by the NASD. In that case, purchasers for the company's privately placed securities are harder to find, and the transaction costs of any placement that does close may be significantly higher though still much lower than the cost of a registered offering.

Moreover, even for a holder without registration rights there is an ultimate re-sale market for securities of a class already registered with the SEC. If a public company is in compliance with its reporting obligations, securities of the registered class that it sells privately can eventually be resold in the relevant public market in accordance with Securities Act Rule 144. That assurance of eventual liquidity is an important advantage that public companies have over private ones. Placements by public companies must, of course, satisfy all of the requirements for an exemption.[5]

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[5] There are millions of securities sold daily in the public markets that have never been included in a registration statement. Typically the securities were sold originally to founders or early investors in private placements completed before the selling company went public. Rule 144 allows holders of these securities to re-sell them without including them in a new registration statement if the resales are conducted through brokers' transactions after the expiration of a 1 year holding period and certain volume limitations are satisfied. After a holding period of 2 years, the securities can be resold without registration and free of other restrictions by holders who are not

Rule 144A Financings

If the company's debt is rated by a recognized agency such as Standard & Poors, it can place that debt privately and effectively by selling short or medium-term notes to a brokerage firm that immediately resells the notes to "qualified institutional buyers" under SEC Rule 144A. A "qualified institutional buyer" is a bank, insurance company, investment company, employee benefit plan, registered investment adviser or registered broker-dealer that owns and invests on a discretionary basis at least $100 million in securities other than securities issued by the company. A broker that acts as an intermediary to distribute securities to such a buyer will not face liability as a statutory underwriter. The company will not face liability for violating the registration requirement of Section 5 of the Securities Act. Securities sold in reliance upon Rule 144A cannot be part of a class of securities registered with the SEC, but they are freely tradable among qualified institutional buyers without registration. The institutional market for Rule 144A securities is huge. The Rule was adopted originally to permit foreign companies unwilling to comply with US registration requirements to gain access to US capital markets by placing securities with very large and very sophisticated US buyers. The Rule has far outstripped its original purpose and is used regularly by both US and foreign issuers.[6]

"PIPE" Financings

"PIPE" is an acronym for "private investment in public equity." PIPE offerings are complex financings completed in two phases. In phase-one, a public company engages in a private placement of securities of a class registered with the SEC. The private offering price is discounted from the trading price for the registered securities. The inducement for private investors is the ability to resell their securities in the public markets at the prevailing price within a short time after purchasing them, thus locking in an attractive profit. The company, by accepting the discount, is assured of raising needed capital quickly.

PIPE offerings must take account of a number of legal principles of which three are structurally critical. First, as already indicated, the filing of a registration statement, without more, constitutes a public solicitation of buyers that is prohibited for private placements. Second, securities covered by a registration statement cannot be *offered* until the statement is filed or *sold* until the statement is "effective." Third, allegedly separate offerings of securities that in fact are components of the same plan of financing will be "integrated" (combined and treated as a single offering) for securities law purposes. Given those principles, if a company files a registration statement covering a given class of securities while simultaneously conducting an allegedly separate and private placement of securities of the same class, it will ruin both financings. The two events will be "integrated" and the "private" placement will be treated as part of the "public" offering. It follows that the placement cannot proceed lawfully because general solicitation, the filing of the registration statement, was used to promote it. The public offering cannot proceed lawfully because some of the securities covered by the registration statement were offered in the placement prior to the filing date.[7]

"affiliates" of (persons in a control relationship with) the issuer. See also, this website, Legal Essays, *"Private Placements – Part II –Finding Investors. Selling Constraints Applicable To Unregistered Securities Offerings"*

[6] Debt securities sold under Rule 144A are to be distinguished from short term commercial paper (notes with maturities of 9 months or less) sold to finance "current transactions." These notes are exempt securities under Section 3(a)(3) of the Securities Act.

[7] If any of the securities were actually sold, purchasers would be entitled to recover the full price plus interest against tender of the securities or damages if the purchasers no longer owned the securities.

PIPE offerings must thus be structured so that the phase one private placement is deemed complete for legal purposes prior to the filing of the registration statement for the phase two public offering. That means purchasers in the placement must have accepted the risk that the public offering might be delayed, abandoned, or unsuccessfully prosecuted. It is not strictly necessary that purchasers actually have paid for the placed securities when the registration statement is filed, and PIPEs are occasionally devised so that payment occurs simultaneously with the IPO, but that strategy is risky because the payment obligation must be free of any condition that is dependent upon the outcome of the IPO. For example, the placement will be illegal if purchasers can withdraw unless the actual IPO price reaches a specified level. The placement will also be illegal if it includes preferred shares convertible to IPO common shares at a ratio that varies with the IPO price. SEC Rule 152 and several SEC no-action letters provide guidance to avoid these pitfalls, but the conservative view is to require that private investors pay for their securities in full prior to the filing of the registration statement.

Raising capital without an IPO - Private placements of self-liquidating investment securities

Obviously, a private company whose current owners are willing to part with control can raise capital without an IPO simply by contracting with investors to put itself in play on agreed terms and within an agreed time frame and to negotiate in good faith with potential acquirers. If the company is to remain both private and *independent*, however, it must rely upon exempt placements of securities on which holders realize profit in the form of distributions from the company itself. The current financial environment can be seen as receptive to placements of this kind once it is realized that companies will have to provide more value per investment dollar than previously in any offering they attempt, private or public. Prevailing low enterprise valuations will depress prices for both registered and privately issued equity securities. Prevailing low interest rates will bolster resale prices in all markets for outstanding debt previously issued at higher rates, but will do nothing to improve the attractiveness of new issues relative to other investments. These conditions permit companies to devise private investments featuring returns from internally generated cash or recapitalizations that are competitive with publicly traded alternatives. As discussed below, private companies can also provide a limited secondary market for financings up to $5,000,000 by issuing securities, without registration, in compliance with SEC Regulation A and Rule 415, then maintaining an online or "desk drawer" resale bulletin board for them. Regulation A securities may be offered to the public and are not encumbered by resale restrictions. Though not a substitute for a public market, a resale bulletin board will enhance the value of these securities.

Preparing the company

To sell any securities without registration, a private company must convince investors it will have sufficient cash flow at the appropriate time to provide the promised return. To do that, the company must develop more than a potentially lucrative product or service. It must also have a capable management team, reliable financial statements and viable systems for financial forecasting and corporate governance.

The management team

Established private companies often have sophisticated management teams able to carry out financial transactions as complex as anything seen in the public markets. Early stage companies, by contrast, tend to focus primarily upon product development and marketing. They may lack the business sophistication and infrastructure associated with mature firms.

When a management team must be expanded to round out its capabilities, the first and most important outside hire is usually the Chief Financial Officer. Few things discourage investment more than a history of missed sales targets, budget overruns or revised financial projections. To prevent those disasters, the Chief Financial Officer must have, in addition to basic financial literacy, a thorough understanding of the

interplay between the company's present and future capital requirements, revenue sources and operating expenses. As gatekeeper to the company, this officer must also be able to communicate effectively with the company's customers, suppliers, employees and investors.

Occasionally, the founders' talents are so concentrated in the technical or marketing areas that the company will stagnate unless, in addition to a Chief Financial Officer, it also hires a Chief Operating Officer or even a Chief Executive Officer. Clearly, the founders' egos can frustrate any decision to delegate the day-to-day management function to outsiders. Without dwelling on the subject, I suggest that all founders will benefit from an early and frank discussion with their advisers respecting the composition of their company's management team.

The financial statements

Private companies should, as soon as practical, engage accountants to provide full audited financial statements for each fiscal year. Startups that are serious about raising capital on optimum terms should engage auditors from inception, so that their internal controls and accounting procedures are adequately developed when their operations become complex. Even though these companies are not reporting entities they will inevitably apply for bank financing, solicit private capital or prepare to be acquired at some point. Commercial lenders, equity investors and acquirers all react most positively to financial statements that bear an auditor's assurance of fair presentation. It does not matter that lenders have accepted reviewed statements or even compilations in the past, that reviewed statements would be permitted for a "mini public offering" under SEC Regulation A, or that limiting the audit to a recent balance sheet might be sufficient for a safe harbor exemption from registration under SEC Regulation D. Corporate finance and fiscal management are not practiced successfully by making do with the minimum and the events of the past several years have raised the standards for financial disclosure comprehensively. Even if a financial transaction is not imminent, the audit process will discipline a company to tie up loose ends, clean up internal controls and identify areas that need attention.

The forecast and projections

Any company bent on raising capital should prepare a financial forecast showing what it would expect to accomplish with the capital at hand. A company with a history of operations should base its forecast upon at least two years' of full audited financial statements or statements from inception if it has not operated for two years. There should be detailed forecast schedules showing anticipated sales volumes, costs of sales, unit prices, operating income and capital expenses, plus a detailed description of the forecast assumptions. Those schedules should be accompanied by projected "pro forma" balance sheets and statements of income and cash flow for the following two years. The forecast and projections should be prepared on an "A, B C" basis with "A" being the base case, "B" the optimum case and "C" the worst probable case. When preparing these analytical tools, management should focus on free cash flow, the sum derived by subtracting debt principal payments and capital expenses from the company's operating cash flow. No matter how a self-liquidating investment is actually structured, the ultimate source of return on the investment is the company's free cash flow.

The forecast should take account of all anticipated financing rounds and the company should raise as much capital as possible in each round rather than capping the size of the offering to minimize dilution. Accordingly, it is imperative that the company communicate clearly to investors the dilutive impact of subsequent rounds. The company's relationship with existing investors is as important as its relationship with new ones, particularly if consent must be obtained from all investors for any exit.

The forecast of a startup should be based upon an audited balance sheet dated within 120 days of the start of the solicitation. If nothing else, such a balance sheet will confirm the existence and extent of the

startup's initial assets, proprietary technology, if any, and debt. It will also align the financial disclosure to investors with the minimum requirements of Regulation D, a wise precaution if the solicitation is to be exempt from registration. Startups find it extraordinarily difficult to predict financial results accurately. By examining established companies in the same industry, consulting trade journals and conferring with experienced business advisers, it is usually possible for startup managers to forecast their initial price points, operating expenses and capital costs with reasonable accuracy *on a unit basis*, i.e., so much per widget, per month, per production line, etc. There is an almost universal tendency, however, for startups to underestimate substantially the *time* it will actually take to overcome each initial hurdle and achieve each initial objective. At least in the worst case version of the forecast, startup managers should double or even triple the time originally allotted for such things as obtaining operating permits, product development, beta testing and the achievement of initial sales levels. They should then re-calculate the projections against the extended schedule. Delays in the implementation of an untested business plan are inevitable due to the operation of "Murphy's Law." The increase in the "burn rate" of a new company imposed by such delays can be stunning. A startup should provide investors with graphic evidence, in the form of alternative projections, that it is aware of this phenomenon.

Corporate governance and the rights of investors

When thinking about governance rights in the context of a specific financing, it is helpful to segregate those rights that are *essential* from those that are merely advantageous for the protection of a given class of investors. The purchaser of a secured note, for example, has an acute interest in the preservation of the collateral and in the company's cash flow, but may have only a secondary interest in the company's overall strategic plan. By contract, an equity investor may have the opposite inclination. As a result, the governance rights granted purchasers in the two types of offerings may be markedly different. Nevertheless, the following basic rights will probably be important in any placement:

Information and Board Visitation rights

Corporate statutes provide shareholders with a right of access to the shareholder lists, organizational documents and published financial reports of their companies, but not to budgets, monthly financial reports, sales reports or similar management information. The statutes also require that shareholder meetings be held at least annually and that holders be permitted to vote their shares for the election or removal of directors and for the approval of major corporate actions. In addition, companies, their directors and their controlling shareholders are fiduciaries who have an enforceable obligation to disclose significant facts coming to their attention that affect all shareholders in ways not expressly contemplated by the statute. The statutes, however, do not protect debt holders and they do not provide equity holders of a private company with assurance of receiving sufficient current information to monitor their investment effectively. Moreover, there is no statutory right to attend directors' meetings for any holder.

Private investors can bargain for a contractual right to be provided with most if not all of the inside information that would normally be reserved for directors and a right to attend and even participate in board meetings, though unless they were directors themselves they would not have the right to vote. Information and board visitation rights can be valuable complements to financial rights found elsewhere in the investment contract. The fact that investors have access to inside information on a continuous basis can have, without more, a constraining influence upon potentially adverse board action.

Voting rights

If the company is incorporated, its daily affairs will be managed by a board of directors elected by those shareholders who have voting rights. With respect to most issues, the corporate statutes provide for "straight voting," one vote for each share. When applied to the board elections, straight voting can lead to

distortions because 51% of the voting shares will always elect 100% of the directors. To provide minority holders with roughly proportionate board representation, the statutes permit all holders to "cumulate" their votes when electing directors if there are no contrary provisions in the corporation's charter. To cumulate, shareholders multiply the number of shares they own by the number of directors to be elected and cast the *total* for any one or more directors. With all holders cumulating, the majority runs out of votes before it can elect a complete slate.

In a *negotiated* placement, influential investors often have enough clout to insist upon the right to nominate and elect directors regardless of whether they would have that right under the statutory voting scheme. The statutes accommodate this by authorizing proxies, voting trusts and flexible voting contracts all of which can be adapted to the exigencies of a given negotiation.

Once elected, the authority of the directors is comprehensive, but not absolute. Major transactions, such as mergers, consolidations, restructurings and liquidations require the approval of shareholders, usually by a two thirds vote. Here again, influential investors can alter the statutory result by contract and often bargain for special rights. Examples include the right to veto a merger, or to force one if the company fails to meet performance targets within a specified time period. Those rights can be combined with the right to nominate and elect a controlling number of directors to ensure that the forced exit is carried out.[8]

Rights respecting transfer restrictions

Securities may not be offered or sold in the US without registration unless the seller can claim an exemption for either the securities themselves or the sale transaction. There are various categories of exempt *securities.* Only one, for securities issued in an intra-state offering, is relevant here and it is largely ignored because of the difficulty of confining an offering to a single state. The exemptions for *transactions* in securities are *all* relevant and include trades executed on an exchange, non-public offerings by companies that comply with Section 4(2) of the Securities Act, offerings by companies that comply with SEC Regulation D and resales that comply with SEC Rules 144 or 144A or with SEC no-action letters that create something called the "4 (1½)" exemption.[9]

Companies engaged in private placements are at pains to find an exemption for the deal, typically by structuring the placement to comply with Regulation D. Subsequent resales by purchasers that are *not* exempt threaten the legality of the original placement by creating the impression that the company was complicit in a creeping public offering. Accordingly, the subscription agreement for any placement will obligate purchasers to notify the company in advance of any proposed resale, and will permit the company to block the transaction if it appears an exemption is not available for it. The mechanics vary. Sometimes the company has an unfettered right to determine whether the resale is legal. At other times, the company will accept a written opinion of legality provided by counsel to the seller. In any case, the subscription agreement (and legends placed on the certificates for the securities) will restrict resales. Where the investment incentive lies in the self-liquidating nature of the securities, resale restrictions may not be fatal to the placement, but the restriction is onerous and some relief from it will be important to investors. Since the restriction, as such, reflects a legal prohibition, investors will not be able to bargain successfully for its outright removal but, in an appropriate case, the company may agree to assist reselling investors at its expense. For example, the company may agree to engage counsel for investors respecting

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[8] The statutes governing limited liability companies and partnerships provide for majority rule based on capital accounts if there is no contrary provision in the applicable contract. The contracts, however, can be quite flexible.

[9] For an extensive discussion of the intrastate and transactional exemptions, see this website, *Publications/Corporate Finance/Private Placements/Parts I, II and III.*

compliance issues, to provide investors with current information that is important to resale purchasers and will help secure an exemption, or to maintain a resale bulletin board as discussed below.

Financial and Structural rights

Investors are preoccupied in the first instance with the price, earnings or liquidation preferences and expected total return on the securities they purchase. Entrepreneurs are concerned about the prospect of losing control over their enterprise prematurely, before they are ready to "cash in" their own investment. The allocation of financial and structural rights between a company and its security holders plays a dominant role in the design of any capital plan and those rights are affected by complex factors including the dynamics of the deal and the company's obligations to third parties such as its lenders, lessors and employees. Each round of financing will involve an element of compromise between these conflicting interests. Here are summaries of the rights most commonly negotiated:

Preemptive Purchase and Anti-Dilution rights

The risk of a company's financial failure can usually be evaluated by a careful reading of its financial statements and business plan, supplemented by some affirmative due diligence and close questioning of management. However, the risk that early investors might be deprived by later financing rounds of a substantial component of their participation in the company's earnings, assets and management can only be evaluated by an analysis of the company's charter documents and capital structure.

State statutes provide shareholders of an incorporated company with a limited "preemptive" right to maintain their percentage equity interest by purchasing, to the exclusion of others, their ratable share of any new issue of the same class of securities. To exercise the right, the shareholder must purchase and pay for the securities preempted at the price and on the terms set out by the company. Otherwise the right is waived. The details are supplied by the company's charter document and can vary widely. [10]

Unless altered by charter documents or binding contracts, statutory preemptive purchase rights have significant limitations. They do not apply to shares issued as compensation or to satisfy conversion or option rights. They do not apply to non-voting preferred shares or to debt instruments. They do not entitle holders of voting shares without preferences to purchase preferred shares. To assert them investors must purchase their preempted shares at the going price regardless of the circumstances. The notion of having to pay again to retain a percentage interest already purchased will be disquieting, particularly in a "down round" when incoming investors are paying less per share than their predecessors.[11]

Some investors minimize dilution by bargaining for the right to purchase preferred shares that are convertible to common shares on the basis of a formula. In the basic formula, the number of preferred shares owned by each holder is multiplied by a fraction the numerator of which is equal to the *original* common share price. The denominator, called the "conversion" price, is equal to the *current* common share price. The product, or conversion ratio, is the number of common shares the holder would receive on converting one preferred share. That number bears an *inverse* relationship to the conversion price.

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[10] For example, the Washington statute provides that a corporate preemptive right exists unless and to the extent it is denied in the relevant "Articles of Incorporation." The Delaware statute takes the opposite position; the right will exist only to the extent affirmatively set forth in the "Certificate of Incorporation." There is no statutory preemptive right for members of a limited liability company or partners of a general or limited partnership, but investors in such entities can acquire the right by contract if they have sufficient bargaining power.

[11] A "down" round occurs when a company has lost enterprise value in the opinion of its investors and must issue new shares at a lower price to raise additional capital.

Immediately after the initial round, both the numerator and the denominator will equal the price for the common shares issued in that round. The conversion ratio will thus be 1 and preferred holders converting prior to the next round would receive one common share for each preferred share. If the common share price in a subsequent round *increases* by 50%, the conversion price, the denominator in the fraction, will *also increase* by 50%. Since the numerator or original common share price remains constant, the conversion *ratio* will *decrease* by 50% and the preferred holders will receive on conversion only half the common shares they would have received after the first round. That result is deemed justified by the company's presumptively higher enterprise value. A down round produces the *opposite* result. The conversion price will *decrease* and that will *increase* the conversion ratio proportionately. That too is deemed justified because it compensates preferred holders for the company's presumed loss of value.

The foregoing discussion, however, ignores the effect upon the company and its investors of the *size* of the financing round at issue. If the company has outstanding 100,000 common shares and 100,000 preferred shares each issued at $10.00 per share, it makes little difference to any holder that the price per common share for the current round has increased to $15.00, or decreased to $5.00, if only 100 common shares are sold. On the other hand, if another 100,000 common shares are sold, the distortions are severe. A conversion formula that does not take account of the number of shares in the dilutive round is called a "full ratchet" formula. Full ratchets are demanded of companies without a strong bargaining position by investors who want to capitalize on a down round by increasing their equity position disproportionately. Thus, if the common share price in the down round has decreased by half, and a full ratchet formula is in effect, preferred holders can receive twice the number of common shares on conversion, even if only a few common shares are sold.

To counteract this, companies try to negotiate a weighted formula in which the conversion price is reduced in a down round only in proportion to the number of common shares sold in that round. They can also try to blunt the impact of an anti-dilution formula by insisting that preferred holders actually purchase common shares in a down round before invoking it, a so-called "pay to play" provision. Finally, companies can try to cap the number of common shares issuable on a full ratchet basis.

Anti-dilution formulae add an unpredictable and potentially disproportionate element of risk and reward driven solely by a company's early stage bargaining power to the long-term risks and rewards already inherent in the company's business model. It is imperative that the consequences be fully disclosed, preferably with examples, so that investors will realize not only that the company may seek additional equity at a time when its perceived value has changed, but also that the impact of the change can be affected profoundly by whatever anti-dilution mechanisms are in place.

"Drag Along" and "Tag Along" resale rights

Even though a company will not go public, its holders can resell their securities privately if the transaction is exempt. If the sellers own a majority of the voting securities, the resale will result in a change of control of the company and the sellers will realize a control premium in the price, factors that can disadvantage minority holders. On the other hand, would-be sellers may find it difficult to consummate *any* transaction (or to consummate one at an adequate price) unless the buyer is *assured* of acquiring control. To grapple with these issues, investors can negotiate for a "drag along right," the right to compel other holders to join in a resale transaction and/or a "tag along" right, the right to join in a resale transaction initiated by other holders. The major terms on which such rights are granted address the minimum included securities, the minimum price and the timing of the sale.

Put/Call redemption rights

A common means of exiting a self-liquidating investment is to force the company to redeem (repurchase) the investment securities. In the usual format, investors can "put" their securities (deliver them to the company) for redemption at a specified price after the expiration of a negotiated time period, subject to obvious conditions such as the company's financial ability to pay. For its part, the company can "call" the securities (demand their delivery) on the same dates at the put price plus a premium. If these rights are structured properly, investors have some assurance of an exit. The company has some assurance that it can buy back its outstanding securities on terms that may be less costly or burdensome than allowing them to remain outstanding, e.g., with extraordinary preferences or governance rights.

Common Self-liquidating Investments

A capital plan dependent upon self-liquidating investments will tend to be complex, because it must allocate returns that reflect fairly the varying degrees of risk assumed by initial and follow on investors without relying upon an IPO, jeopardizing the stability of the company, disenfranchising its founders or unduly constraining its management. The securities sold to finance a given project might include one or more "series" of preferred stock, some convertible debt and assorted stock purchase options, rights, or warrants, plus garden-variety common stock. Despite that complexity, though, the following self-liquidating placements can be devised quickly and inexpensively compared to a registered offering:

Cash flow placements

Securities with dividend, "preferred return" or liquidation preferences are commonly used to provide self-liquidating investments. In the typical case, the payment of dividends or priority distributions in specified amounts is mandatory, subject to the availability of earnings or operating cash flow. Preferential distributions can also be made to preferred holders from the proceeds of a merger or liquidation of the company. State laws permit wide latitude in the crafting and payment of dividend and liquidation preferences so long as the company's ability to satisfy its creditors is not impaired. Any company that has high operating cash flow is a good candidate for a placement of this kind. Successful retailers and companies with established franchises, technology licenses, or fully leased commercial real estate are examples. The total return on investment (preferred dividends plus capital appreciation realized on liquidation) can compare favorably with the total return on publicly traded equities.

Debt placements

If the company has stable earnings, it may be able to complete a debt offering at rates comparable to those prevailing in the public credit markets for high yield or "junk" bonds. If the financial covenants are well prepared and the debt is secured, investors willing to hold their securities to maturity may view the transaction as relatively safe. Variable rate secured notes are popular vehicles. Mezzanine financings featuring junior debt can bridge the gap between equity and senior secured debt used to finance a specific project. It is also possible to structure an attractive unit offering comprised of both debt and equity securities. As the debt is paid down, the value of the equity securities increases proportionately, even without any increase in the overall size of the company.

Bootstraps and Leveraged buyouts – in general

A company's growth plan may involve the acquisition of competitors, suppliers or distributors. In the 1960s and 70's, a financing technique for such a plan, called a "bootstrap acquisition," gained prominence. "Bootstraps" are a form of acquisition in which the acquirer buys the target using its post-closing cash flow not only to justify the price but as a direct source of payment. Structurally, the acquirer

purchases some of the target's securities at closing and the target redeems the rest over time. In other forms of leveraged buyout, the acquirer obtains debt financing from senior secured lenders and perhaps mezzanine investors, but in either case, the deal is driven by the parties' perception of the target's cash flow. Accordingly, the companies suitable for a leveraged buyout will have a strong cash position, sufficient cash flow to cover acquisition debt and a sustainable market share in a basic industry.

Manufacturing and distribution companies are classic examples of leveraged buyout candidates. If the transaction is not a management buyout funded completely by the managers themselves, the buyer or buying group should provide equity investors with an exit opportunity in five or so years. The downside is that investors may be required to contribute up to 30-40% of the cash price to obtain acquisition financing from commercial banks or asset based lenders given the prevailing conservative bias in the credit markets. [12]

Management buyouts – special considerations

At first blush, a management buyout is simply a leveraged buyout in which the acquiring group has experience in managing the target and a built-in motive for doing the deal. There can, however, be significant differences. When a private company is the target, the transaction may arise solely because the founders have not found a family member or a third party willing to pay what the founders believe to be a fair price for the business. The management team may have little equity to contribute to the deal because its members have spent their careers as salaried employees. That may increase the pressure for some form of seller financing. At the same time, the founders may have less than complete confidence in the managers, whom they have always viewed as employees rather than equals. The founders may thus approach the transaction with unrealistic expectations about the price and a disinclination to provide financing. For their part, the managers can be blinded by their own hubris, which can cause them to be irrationally optimistic respecting their ability to generate post-closing cash flow sufficient to cover operations and also pay down acquisition debt. Accordingly, negotiations for a management buyout often fail to survive the clash of the parties' egos. Both the founders and the managers should put aside any thought that their experience, as such, qualifies them to value the company or to structure its acquisition. They should always consult investment bankers or other financial experts before proceeding.

Recapitalizations and Redemption Loans

As a company without current cash flow completes a construction, expansion or R&D project it can acquire a sizable collateral base and ample capacity to service debt. A point is often reached at which the company could induce a senior lender to participate in a debt recapitalization the proceeds of which can be used to redeem the company's investment securities. In a variation, an interim cash distribution or partial redemption financed by a lender is followed by a full redemption and final liquidating distribution when the company's assets are sold. Here are two categories of recapitalization financings:

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[12] Bootstraps gained some notoriety in the 60s and 70s because swashbuckling entrepreneurs like James J. Ling (LTV), Royal Little (Textron), Tex Thornton (Litton Industries) and Charles Bluhdorn (Gulf & Western) were occasionally using them in combination with the post World War II stock market boom to buy unrelated businesses and combine them into "conglomerates." They attracted sellers by agreeing to pay inflated prices with inflated shares. If the transaction was bootstrapped, they used the publicly traded shares of their own companies as currency to purchase directly a controlling block of the outstanding shares of the target. All parties assumed there would be a synergistic run-up in the post-closing cash flow of the target's business that would enable the target to redeem the rest of its shares. The assumption was flawed because it ignored the fragility of the boom and it underestimated the difficulty of managing disparate businesses. Inevitably, the boom ended, stock prices collapsed and the conglomerates failed, sold off unproductive units or were themselves acquired. Sound familiar?

Real Estate Development Financings

Commercial and residential real estate projects are strong candidates for a recapitalization because investors can profit from a sale or refinancing of the project without reselling their securities. While each project is different, most share certain common elements:

Real estate developers are likely to be involved in several projects at once and are thus confronted with conflicting demands upon their management time and financial resources. The conflicts must be disclosed to investors in detail. Because the developer will provide management and other services to the project, its financial position may also be material. If so, the developer should add its balance sheet, and perhaps full audited financial statements, to its disclosure of fees, "carried interests" and other forms of compensation. The developer's track record for completed projects with similar investment characteristics must also be disclosed with attention to the amount raised for each, the acquisition and sale or refinancing dates for the project real estate, the tax effects and the cash distributions to investors.

Real estate transactions have complicated tax characteristics. Real estate tax shelters have been a fruitful source of abuse in the past and regulators and sophisticated investors are acutely conscious of that fact. The developer should include a formal tax opinion of counsel in the offering materials. Guide 5, adopted by the SEC as a supplement to the registration form for real estate offerings, contains a detailed format for disclosure of tax and other material factors associated with real estate investments. Though written for limited partnerships, the Guide should be consulted regardless of the form of the investment entity.

Real estate projects are financed by a senior secured lender, with the developer and its investors providing initial project equity. The lender's requirements must be compatible with those of investors and securing that compatibility can be a frustrating exercise. For example, a lender not accustomed to transactions in which equity is provided by outside investors will often demand that each investor guaranty 100% of its loan, whereas outside investors will refuse to guaranty more than an amount proportionate to their ownership interests. The developer should negotiate with several prospective lenders and identify the minimum project equity each would require without investor guaranties, plus the minimum equity and aggregate net worth of investors as a group that would be required if investors guaranty the loan in proportion to their interests in the project. The developer must also align its time frame for soliciting investments with the lender's time frame for underwriting and due diligence, a precaution regularly overlooked. As part of this, the developer must pinpoint as closely as possible the date by which each lender would expect to issue a formal loan commitment letter.

Finally, the developer should acquaint the project architects, engineers and builders with the basic disclosure that must be made to investors, including possible disclosure about the experience and financial position of entities that provide critical services to the project. The cooperation of all project participants will be necessary if a real estate placement is to be carried out smoothly.

Forward Commitment Financings

If a private company has proven cash flow, it may be able to provide an exit for investors in the form of a pre-arranged redemption of their securities financed by an institutional lender. Structurally, the company would obtain a conditional forward loan commitment from the lender under which the loan would be funded if the company completed a defined construction or expansion project successfully, increased its tangible net worth and debt service capacity and satisfied specific underwriting criteria at closing. The loan proceeds would be used to redeem company securities purchased by investors to help finance the project in the first instance. The forward commitment would be feasible and credible to both investors and lenders if the project milestones and underwriting criteria were clearly articulated.

The risk to investors that the company could not satisfy the conditions for the redemption loan would be no greater, might be substantially less, and in any case would be easier to analyze than the risk that the company could not satisfy the conditions for a future IPO. The factors impacting a discrete construction or expansion project can be anticipated in advance and are limited to the company and its business. By contrast, an IPO can be postponed or abandoned for any number of unanticipated, market-based reasons having nothing to do with the success of the company or any of its projects. The risk to lenders that a forward commitment might trap them in a bad loan can be managed by careful drafting to ensure that the loan would not be funded unless specified underwriting criteria were satisfied at the closing.

Foreword commitment financing is designed for seasoned, private companies and sophisticated lenders. The return to investors inherent in the redemption price would be equivalent to the yield on junk bonds, perhaps with an additional premium. In most cases, the redemption loan would constitute the second phase of a two-phase financing that began with a senior secured project loan supported by existing assets of the company, enhanced by the investors' capital. The capital would be raised through an exempt private offering of the company's preferred equity or subordinated debt securities.

The company would become the primary obligor on the initial project loan, which would be paid in installments. The company would support the loan with its accounts receivable, its inventory, its fixed assets and the capital contributed by investors. The funding of the project loan would be subject to obvious conditions requiring that the company have sufficient current assets (including the capital contributed by investors) and current cash flow to comply with prevailing collateral and debt service requirements. As stated, the phase two redemption loan would be conditioned upon the company's tangible net worth and cash flow having *increased* because of the completion of the project and the intervening pay-down of the project loan. From the lender's perspective, the increase in the company's net worth would offset the elimination (through the redemption) of the equity provided originally by investors. The interest rate for the redemption loan would be tied to the market.[13]

The lender's forward commitment would be renewable annually in exchange for a fee if the company was in compliance with all covenants imposed by the project loan. The satisfaction of the conditions for *funding* the redemption loan would be confirmed as of the closing by current appraisals of company assets, audited financial statements and an agreed-upon procedures report reflecting an accountant's review of post-closing financial forecasts. The lender would insist on a catchall satisfaction clause, but the clause could not be invoked in bad faith and might even be subject to a reasonableness requirement depending upon the negotiating strength of the company.

Indirect precedents for forward loan commitments can be found in agreements between a real estate developer, a construction lender, and a take-out mortgagee. There an office building or shopping center must be constructed on time and within budget, pre-lease and occupancy requirements must be satisfied, the interim construction loan must have been funded and the valuation posited by as-built appraisals must be confirmed before the permanent loan is made, but these conditions are objective and permanent financing will be available if they are satisfied. Here, a single lender would provide both the project and the redemption loan, but the conditions for the latter can be articulated as clearly, and measured as objectively, as the conditions long since accepted as satisfactory for take-out mortgages.

[13] In a typical model, the project loan would be paid over a 5 year term and the redemption loan would be paid over a 10 year term. The cost of capital to the company over the 15-year duration of the financing would be competitive.

Sale and Leaseback Financings

A company's office building, manufacturing plant or retail store is certainly an essential productive asset, but it also is a form of inert capital. A properly devised sale and leaseback transaction can free up that capital for a company willing to substitute a long-term tenancy for outright ownership. Structurally, the company's investors would form and capitalize the purchaser/lessor. The company's disclosure, and the investors' due diligence, would focus on asset valuation and the company's ability to pay rent over a period of 10 years or longer. In the purchase phase of the transaction, the price would reflect the current market value of the assets. The company would claim a federal income tax deduction for the rent payments while the lessor would claim a depreciation deduction for tangible personal property included in the assets. Over the term of the lease, the rent payments would return the full purchase price to the lessor plus a negotiated profit. The lessor would also benefit from any residual value of the assets at the end of the lease. The company would realize needed liquidity without compromising its core business. The investors would realize attractive long-term returns. The transaction would require the approval of the company's lenders and other holders of its secured debt, but if the transaction were properly devised, the interests of those creditors would be protected with junior liens. The current markets are conducive to all forms of asset-backed finance of which sale and leaseback transactions are common examples.

Tax incentives

On occasion, the Congress has attempted to encourage investment in "small" business by providing tax incentives always subject, of course, to a barely comprehensible array of exceptions and technical refinements that provide a trap for the unwary and full employment for tax experts. Nevertheless, these incentives can be quite valuable. I recommend that companies consult with their tax advisers about them at the beginning of any project requiring invested capital. Here are two sometimes overlooked examples:

50% Exclusion for gain on "qualified small business stock" - Section 1202 IRC

Section 1202 of the Internal Revenue Code provides an exclusion from gross income of 50% of the gain realized by an investor on "qualified small business stock" if the investor has held the stock for at least 5 years and the company has been engaged in the active conduct of a qualified trade or business during that period. The company must be organized as a "C" corporation, cannot have more than 50 million in assets (as defined), cannot be in a service business, is prohibited from certain anticipatory redemptions and must meet other requirements. Despite its technical overlay, however, Section 1202 can enhance the internal rate of return on a private investment dramatically. The Section is scheduled to expire in 2014. Unless Congress extends the deadline, the Section will be unavailable for small business stock issued after 2009.

"New Markets" tax credit

The Community Renewal Tax Relief Act of 2000 provides tax credits for equity investments in "Community Development Entities" that, in turn, loan or invest money in businesses located in distressed inner cities or rural areas. The credit, called a "New Markets' Tax Credit," is equal to 5% of the investment for each of the first three years and 6% for each of the ensuing 4 years. Any individual or corporation can be an investor. A Community Development Entity can be organized as an institution that provides mortgage or business loans, as a profit subsidiary of an established Community Development Corporation, or as an SBA licensed "New Markets Venture Capital" company or a standard SBA licensed Small Business Investment Company. The businesses that qualify for these investments need not be poor or redlined credit risks, but they must be located in an area with a poverty rate of 20% or with a median income that does not exceed 80% of the median income for the relevant statistical area or state. Astute promoters can make use of this credit in industrial areas that have become a refuge for undercapitalized manufacturing, distribution or technology companies with untapped potential.

Secondary market incentives for restricted securities

Regulation A "mini-public" Offerings

Section 3(b) of the federal Securities Act of 1933 authorizes the SEC to exempt "any class of securities" from full registration if, among other things, the "aggregate amount" of the offering does not exceed $5,000,000. The SEC adopted Regulation A on authority of Section 3(b). Regulation A permits non-reporting US and Canadian companies to offer *to the public* up to $5,000,000 in securities during any 12 month period if the company is not in the "development stage," neither the company nor its directors, officers or other affiliates has a history of securities law violations, the company files an "offering statement" with the SEC that substitutes for a registration statement and the company furnishes investors with an "offering circular" that substitutes for a prospectus. The narrative disclosure requirements parallel those for a registered offering, but are not as stringent. In deference to the small size of the offering, substantial relief is provided under Regulation A in the area of financial disclosure. The result is a "mini-public" securities offering that eliminates legal restrictions on resales and paves the way for the effective creation of a secondary market.

Resale Bulletin Boards

Holders who are able to resell their restricted or Regulation A securities lawfully must still find buyers. Since there is no public market for these securities, the companies that issue them often maintain a resale bulletin board accessible to would be purchasers or sellers. Sometimes the bulletin board consists merely of an informal list of persons who have expressed interest in a resale. At other times the list is posted electronically, e.g. in a password-protected "shareholder information" section on the company's website. The list is occasionally supplemented with bid or asked prices. There are several legal issues presented by these devices. Is the company engaging in an unregistered and non-exempt public offering by maintaining a bulletin board? Are persons listed as "sellers" statutory underwriters? By facilitating resales is the company acting as a broker-dealer that should be registered with the SEC? The SEC has stated that if the company merely introduces potential buyers and sellers, and does not participate in negotiations, suggest prices, facilitate closings or handle funds, its bulletin board will be lawful.

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