

PRIVATE EQUITY OFFERINGS

THE PRIVATE PLACEMENT

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

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

Individuals affiliated with the company and third party advisers play a significant role in making the private placement process a success. Depending on the size and type of offering, the players involved can include the founders, officers and directors of the

company, attorneys, accountants, other third party advisors, finders, brokers and, of course, the potential investors.

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

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

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

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

STRUCTURING THE OFFERING

Securities Law Considerations

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

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

General Considerations

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

Investors

There are generally three types of investors: accredited, non-accredited and sophisticated. The number and type of potential investor impacts the applicability of certain securities laws exemptions and their disclosure requirements. In addition, there are certain requirements to maintain a private offering, which are discussed below, that require the company or its broker to have pre-established relationships with the potential investors. The company should also evaluate whether it or its affiliates have those types of contacts, or if it will need to secure the services of a third party to assist in the process.

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

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

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

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

A company should consult with experienced legal counsel to stay abreast of changes to the definition of "accredited investor," and to other securities laws. At the time of this writing, the U.S. Senate and the House of Representatives each passed bills aimed at dramatic changes to the federal financial regulatory system. After a conference scheduled for the summer of 2010, the legislators are expected to deliver a final bill to the President. The outcome of the conference is unclear, but revisions to the bill may result in a decrease in the number of individuals who meet the definition of "accredited investor" by (1) excluding the investor's primary residence in the net worth calculation, (2) adjusting for inflation the net worth

calculation every four years, (3) authorizing the SEC to revise the “accredited investor” definition, and (4) requiring the SEC to revisit that definition every four years to make any adjustments it deems necessary.

Two exemptions that are closely linked to each other, the Section 4(2) exemption and Rule 506 exemption, deal with the concept that the potential investors must be “sophisticated” in nature. For example, Rule 506 requires the issuer to reasonably believe that each purchaser who is not an accredited investor have such knowledge and experience to judge the merits and risks of the prospective investment. Such factors as education, investment background, net worth and investment experience should be taken into account in making this determination. This information is typically solicited in a questionnaire and is clearly more subjective than the accredited investor standard. A careful record should be kept by the company showing its basis for determining that an investor is sophisticated in nature.

Amount of Capital

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

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

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

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

Type of Securities to be Offered

In general, securities that are offered are classified as equity, debt or a hybrid form of debt and equity, some of which may have conversion features. Section Three of this book entitled “Securities Law Considerations” contains a more detailed discussion of these alternative forms of securities.

Timing of Offering / Integration of the Offering

The timing of the offering is dictated by a number of factors. The company should allocate enough time on the front-end of the process to allow itself to undertake its own internal due diligence. This time should be used to organize and collect information that will be disclosed to potential investors. The actual duration of the offering should allow for a realistic timeframe to raise the amount of desired capital while still giving the company enough time to take advantage of the existing market opportunity and enabling the company to meet its business plan.

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

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

It should be noted that Regulation D contains a safe harbor from integration. This safe harbor excepts from integration any offers and sales made more than six months before the start of the Regulation D offering or made more than six months after completion of the Regulation D offering, so long as during either six month period there are no offers or sales of securities by or for the company that are of the same or a similar class as those offered in the Regulation D offering, other than offers and sales pursuant to an employee benefit plan.

ORGANIZING THE OFFERING

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

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

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

INTERNAL DUE DILIGENCE

Prior to preparing its disclosure document that will be distributed to potential investors, the company should conduct extensive due diligence of its current business operations. This due diligence is important for a number of reasons, but mostly because exempt transactions are still subject to the antifraud or civil liability provisions of federal securities law. This places a burden upon the company to never give false or misleading statements (whether written or oral) about the company or offering. Full disclosure is always the best way to prevent future liability. The company and its attorneys and accountants should make certain that facts are supported and opinions have a reasonable basis. It should be noted that the accreditation of an investor does not remove the need for this type of disclosure.

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

PREPARATION OF PRIVATE PLACEMENT MEMORANDUM

Purpose of PPM

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

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

Disclosure Requirements

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

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

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

Non-financial Information

It is up to the company and its attorneys to figure out the proper amount of disclosure for the potential investors. For discussion purposes, this chapter will focus on the most detailed disclosure that would be required under a Regulation D, Section 4(2) or Section 4(6)

exemption, which is an offering to non-accredited investors under Rule 505 or Rule 506 of Regulation D. Private companies using this exemption are required to provide the same kind of business and non-financial information the issuer would be required to provide if it registered securities or if it utilized Regulation A. This information is required to be delivered to the purchaser within a reasonable time before the sale and would include such things as:

- Description of the Company
- Risk Factors
- Business and Properties
- Financial Information
- Offering Price Factors
- Use of Proceeds
- Capitalization of the Company
- Description of the Securities Offered
- Plan of Distribution
- Dividends, Distributions and Redemptions
- Officers and Key Personnel of the Company
- Directors of the Company
- Principal Stockholders
- Management Relationships, Transactions and Remuneration
- Litigation

- Federal Tax Aspects
- Management’s Discussion and Analysis of Financial Condition and Results of Operation

In addition, the PPM should include a cover page, offering summary, details regarding the administration of the offering and a list of documents available for inspection. These areas of information are only provided as a guide, and are not a checklist. The company should always disclose all material information to potential investors regardless of whether it is in one of these categories. A detailed discussion of each section is outside the scope of this publication, however, several of the key sections are described further below.

Risk Factors

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

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

- cash flow and liquidity problems;
- inexperience of management;
- dependence upon key employees;
- dependence on a single product;
- dependence on certain suppliers, license agreements or other material relationships;
- lack of commercialized product;
- lack of market acceptance of product;
- significant regulatory hurdles;
- absence of operating history;
- company is currently unprofitable;
- nature of business opportunity;
- conflicts of interest with management;
- lack of protection for intellectual property;
- highly competitive industry;
- need for additional capital;
- arbitrary determination of offering price / nominal book value;
- restrictions on transfers of shares or lack of market for shares;
or
- potential for dilution from future equity issuances.

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

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

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

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

Financial Information

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

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

Projections

The company is not required to include projections of potential revenues as part of the PPM, unless its omission would be considered material to the potential investor's understanding of the business. The tendency is to provide projections under the assumptions of the best possible outcome. Such a tendency leads to significant legal risk, especially if the projections are never met

and investors become upset. Even though there is no requirement to include projections, most companies feel that it is necessary to show investors the potential gain or return on their investment. The benefits of including projections needs to be weighed against the potential risk of providing a permanent record of the returns that the company “promised” to potential investors.

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

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

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

Other Important Disclosures

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

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

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

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

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

and those persons retained to advise prospective investors, and that any reproduction of the PPM, in whole or in part, or any disclosure of any of its contents without the company's prior written consent is prohibited.

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

THE OFFERING

Organizing the Offering

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

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

- offers should only be extended by the PPM; and
- the company and its counsel should monitor deadlines for state and federal filings required under securities laws.

Investor Due Diligence

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

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

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

Ancillary Documents

In addition to the PPM, a company will need a subscription agreement and investment letter, which will be executed by the potential investor once they have made their investment decision.

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

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

General Solicitation and General Advertising

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

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

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

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

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

prior relationship is not the only way to show absence of a general solicitation, but it is definitely one of the safest.

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

Self-Managed

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

Finders

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

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

A company should carefully evaluate the use of a finder. In addition to the risks under federal securities law, the use of a finder may implicate some state securities laws, which may limit the role of finders. Some states, including Minnesota beginning in August 2007, require finders to file an application before they can assist companies in their capital raising efforts. Many states securities laws provide that any sale through an unregistered agent, like a finder, is voidable at the purchaser's election. Because there are often many participants involved in every capital raising transaction, a company should check with its legal counsel to determine whether these state laws are implicated.

Placement Agents

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

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

Use of the Internet

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

THE CLOSING

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

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

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