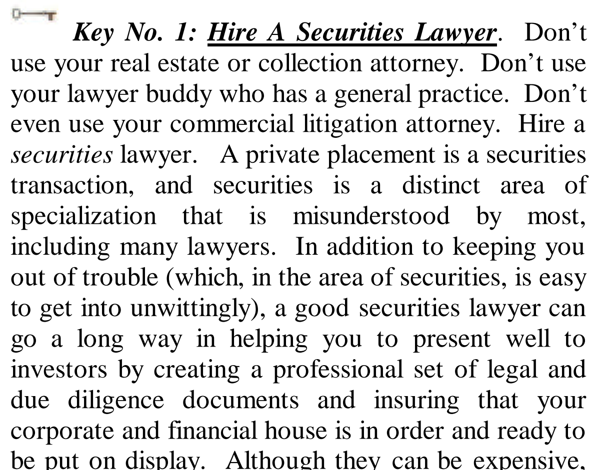
Private Placements on Main Street:

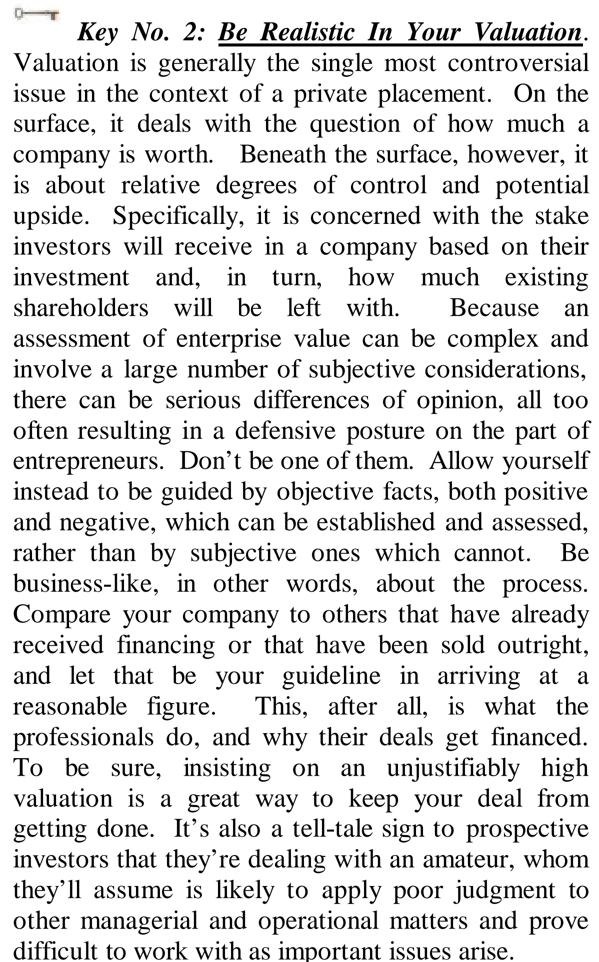
14 Keys to Getting Your Deal Done and Avoiding Traps

While many naively believe that their company will be amongst the chosen few, the fact remains that only an *extremely* small percentage of companies are able to attract institutional venture capital or the attention of Wall Street. The overwhelming majority of emerging companies in need of capital have to rely on private placements involving friends and family, initially, and high net worth investors the next few times around. In other words, it's life on *Main Street* for most small companies, *not* Wall Street, and although a private placement is probably the single best answer for a small company in need of equity financing, actually getting a deal done, and managing to avoiding the many not-so-obvious traps along the way, is a big challenge for most. This is particularly true for those that have not been through the process before and have not had the benefit of actually seeing how seemingly unimportant considerations on the front end of a deal, if not managed properly, can end up having very material negative consequences on the back end.

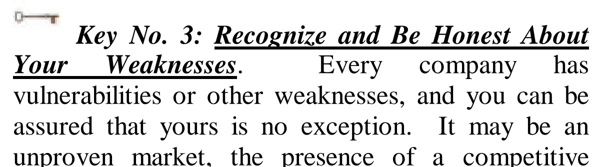
While navigating the private placement process is by no means intuitive, and there is no substitute for experience, by understanding and following a few key recommendations, your likelihood of success can be greatly enhanced. What follows, therefore, are 14 key recommendations that, if observed, will serve you well in getting your deal done and avoiding many of the traps along the way.



Key No. 1: Hire A Securities Lawyer. Don't use your real estate or collection attorney. Don't use your lawyer buddy who has a general practice. Don't even use your commercial litigation attorney. Hire a *securities* lawyer. A private placement is a securities transaction, and securities is a distinct area of specialization that is misunderstood by most, including many lawyers. In addition to keeping you out of trouble (which, in the area of securities, is easy to get into unwittingly), a good securities lawyer can go a long way in helping you to present well to investors by creating a professional set of legal and due diligence documents and insuring that your corporate and financial house is in order and ready to be put on display. Although they can be expensive, the money spent on a good securities lawyer will undoubtedly end up saving you a lot of time and money in the long run. And note, in this regard, that you can save yourself a substantial amount in legal fees by initially showing up at your counsel's office with a well-conceived, thoroughly researched and carefully written business plan.



Key No. 2: Be Realistic In Your Valuation. Valuation is generally the single most controversial issue in the context of a private placement. On the surface, it deals with the question of how much a company is worth. Beneath the surface, however, it is about relative degrees of control and potential upside. Specifically, it is concerned with the stake investors will receive in a company based on their investment and, in turn, how much existing shareholders will be left with. Because an assessment of enterprise value can be complex and involve a large number of subjective considerations, there can be serious differences of opinion, all too often resulting in a defensive posture on the part of entrepreneurs. Don't be one of them. Allow yourself instead to be guided by objective facts, both positive and negative, which can be established and assessed, rather than by subjective ones which cannot. Be business-like, in other words, about the process. Compare your company to others that have already received financing or that have been sold outright, and let that be your guideline in arriving at a reasonable figure. This, after all, is what the professionals do, and why their deals get financed. To be sure, insisting on an unjustifiably high valuation is a great way to keep your deal from getting done. It's also a tell-tale sign to prospective investors that they're dealing with an amateur, whom they'll assume is likely to apply poor judgment to other managerial and operational matters and prove difficult to work with as important issues arise.



Key No. 3: Recognize and Be Honest About Your Weaknesses. Every company has vulnerabilities or other weaknesses, and you can be assured that yours is no exception. It may be an unproven market, the presence of a competitive

technology, insufficiently protected intellectual property, recent revenue reductions, poor margins or any number of a host of other issues, but there is at least one issue out there that could cause things to go wrong for your company, and, in all likelihood, there are actually probably several or more. While not every investor will be savvy enough to identify the weaknesses in your company, you would be wise to assume that many probably will. So don't try to hide those weaknesses or avoid having to discuss them. Be forthcoming and honest about them in your disclosure document (if you have a good securities lawyer, he/she will insist upon it), and be prepared to sell *through* these weaknesses—and to explain how they are being managed, contained, reduced, eliminated or otherwise overcome.

Key No. 4: <u>Do a 506</u>. Private placements are stock issuance transactions exempt from registration at the federal level under the Securities Act of 1933. There are a number of different exemptions in this regard, each of which have different requirements and associated advantages and disadvantages. Failure to successfully qualify an offering under at least one of the exemptions could result in rescission rights on the part of all investors in the offering. While a discussion of each of these exemptions is beyond the scope of this article, suffice it to say that, all things considered, you should do a Regulation D Rule 506 offering (commonly referred to as a "506"). Some of the reasons for relying on Rule 506, as opposed to any of the other exemptions, include the following:

- Unlike some of the other exemptions, 506 provides relatively clear and explicit requirements, and therefore provides a greater degree of certainty in terms of fulfilling its requirements;
- Compliance with 506 is easier to defend against after-the-fact claims of non-compliance should they be made;
- Unlike most other exemptions, 506 contains no limitation on the amount of funds that can be raised;
- Because there is no limit to the amount that can be raised in a 506 offering, the risk of having the exemption disqualified under a securities doctrine known as "integration" (because it is combined with other offerings that *do* have limits) is dramatically reduced;
- 506 concerns itself only with the number of actual *purchasers* involved, not the number of *offerees* (as is the case with certain other exemptions); and
- 506 preempts state laws such that any otherwise applicable state securities requirements are entirely avoided (with the exception of a notice filing and payment of a fee).

Note: The only way to establish months or years after the fact that an offering (506 or otherwise) was properly qualified under a given exemption is to pull the files and examine the documents and records that were kept. So be sure to keep neat, organized records. You will be very happy that you did.

Key No. 5: <u>Go Out With A Book Deal</u>. While private placements may be viewed on a number of different levels, at one level, they can be divided into either so-called "book deals" or negotiated transactions. Book deals are offerings the terms of which have been pre-structured by the company and packaged in the form of a printed (and often very substantial) private offering memorandum (or "PPM"). These documents are typically delivered to prospective investors together with a subscription agreement, a relatively short, simple document pursuant to which investors purchase securities. When the PPM is circulated to prospective investors, it basically presents as a take-it-or-leave-it proposition. For this reason, investors are less apt to attempt to negotiate a book deal, thereby giving an issuer a potential (and mostly psychological) upper hand in terms of valuation and other terms. In contrast, a negotiated transaction is just as its name implies, a deal negotiated between the company and the investor(s), and which usually involves a rather voluminous stock purchase agreement (rather than a subscription agreement) that may or may not involve an accompanying PPM, albeit a relatively abbreviated one. Negotiated deals are the result in virtually *all* cases in which institutional or other professional investors are involved (*e.g.*, venture capitalists) and in *many* cases where high-net worth investors are involved. Such deals are generally a function of negotiating leverage. Very experienced, sophisticated investors typically have lots of deals to choose from and will only be interested in making a given investment to the extent that they're able to get the terms they want (and that they're used to getting). Because they make these types of investments frequently, they *know* exactly what those terms are. They typically consider deals strictly on the basis of business plans submitted (as follow-ups to executive

summaries), and will generally prepare and submit to the company a proposed term sheet if and when they decide to make an offer. Confronted with a book deal that they otherwise like (which would be rare in any event), most would simply say, "O.K. … let's put that aside now and talk about a possible deal."

In the final analysis, and if the profile of your target investors permit it, a book deal will almost always provid a strategic advantage.

Key No. 6: <u>Avoid Selling to Non-Accreds, But Use A Full-Blown PPM</u>. When a company does a 506, it's permitted to sell its securities to 35 non-accredited (but "sophisticated") investors and an unlimited number of accredited investors. *Forget* the non-accredited investors. Although there is invariably a huge temptation to take advantage of the opportunity to sell to non-accredited investors (which are generally much easier to find and convince to invest), exercise restraint and avoid the temptation. It's not worth it. Determining "sophistication" can be tricky, and, in any case, non-accred's (as they are often referred to) are the first to sue when a company's performance falls short of expectation.

So what's an accredited investor? For an entity, the definition essentially includes a number of different types of institutional investors, funds, businesses, organizations, trusts and the like, all of which have to have $5 million in assets and none of which can be formed for the purpose of making the investment. For a natural person, the definition is essentially anyone with (i) a net worth of at least $1 million, or (ii) income in the last two years of $200,000 per individual or $300,000 per couple. In order to determine accreditation, and as evidence to substantiate it, you should have all investors complete and return an investor questionnaire which contains representations as to their qualification.

If a company sells to non-accredited investors under Rule 506, it is required to deliver a private placement memorandum that is extremely comprehensive in scope and that, among other things, includes audited financial statements. By contrast, the disclosure requirements are dramatically simpler if a 506 offering is limited exclusively to accredited investors. However, even though this obligation can be legally avoided if you don't involve non-accredited investors, do yourself a favor and prepare the comprehensive document and, if audits are available, include them. For reasons having to do with potential liability under the antifraud provisions contained in Rule 10b-5 of the Securities Exchange Act of 1934, technical compliance with the requirements as they relate to disclosure is *not* always the best approach. When it comes to securities, *full disclosure* is the best approach, and the disclosure mandate for non-accredited investors is a very good standard for achieving full disclosure. Moreover, the credible impression that a well-prepared and comprehensive PPM will create in the minds of prospective investors is likely to go a long way in helping to sell your deal.

Key No. 7: <u>Back-Up or Back-Down; Don't Overstate or Make Promises</u>. When it comes to disclosure, avoid making any assertions that you can't substantiate by way of an authoritative and reliable third party publication. Have solid back-up for your assertions, in other words, or back down from making them. If you believe something to be true that you are unable for any reason to substantiate, qualify it as being your own belief. While these rules apply to written disclosures, including private placement memoranda, business plans, executive summaries, PowerPoint presentations and correspondence, note that they apply equally to oral statements.

Similarly, avoid overstating facts or presenting financial projections that are anything other than carefully conceived and extremely conservative. To do otherwise invites later claims of misrepresentation that are likely to prevail.

Key No. 8: <u>Do An All-or-Nothing or Min/Max Offering</u>. When you raise funds from investors, the securities laws deem you to be irresponsible if you raise too little, while basic business sense dictates that you're being foolish if you raise too much. The problem with raising too *little* is that your company is left undercapitalized after the offering and the investors who did invest will have a strong case when they drag you into court and argue that you *should have known* that and either raised more or none at all. Raising too *much* money, by contrast, will have you selling a greater percentage of your company than is necessary at a time when your company's valuation is relatively low. A commonly used mechanism to avoid undercapitalization in this regard is the so-called "all-or-nothing" offering. Under such an arrangement, the company agrees that it will *only* close on any subscriptions received to the extent that it is able raise the *entire* stated amount of the offering. A "min/max" offering is similar, but involves a minimum threshold amount which, if met, is (at least in theory) enough to avoid

undercapitalization, but which may also be exceeded to further capitalize the company's needs. The "max" concept is designed to provide comfort to investors that they will not be diluted down below a certain percentage ownership threshold, at least not in the current round.

Key No. 9: Avoid "Professional" Finders. Almost invariably, owners of small companies find themselves introduced at some point to one or more of the many individuals who refer to themselves as independent financial consultants or investment bankers and who hold themselves out as, among other things, capable of raising money for companies. Because the challenge of raising capital on their own is daunting to many, and because the likelihood of their attracting the attention of a licensed broker-dealer to serve as a placement agent for their deal is slight (as it is for *any* offering involving a very early-stage company or an amount less than $10 million), many entrepreneurs are tempted by the lure of these often fast-talking self-promoters. However, unless they can prove that their firm is a registered broker-dealer, and that they themselves are appropriately licensed, both of which are necessary for them to lawfully engage in capital-raising initiatives on your behalf, steer clear of these individuals. The reality is that the overwhelming majority of them are not, nor are they affiliated with, registered broker-dealers. Most entrepreneurs that allow themselves to get swept into a deal by one of these independent consultants soon come to very much regret it. The problem is that any investors who purchase securities through an unregistered broker-dealer (which is what a professional finder is) have automatic rescission rights, which means that they can demand an immediate return of their entire investment at any time, no questions asked. And the Form D which is required to be filed with the SEC for any Regulation D offering (including a 506) requires specific disclosure of any parties that have received compensation in connection with the offering.

When faced with having to explain how they intend to raise money without a broker-dealer affiliation, these individuals will generally respond by explaining that they are merely "finders" and that there is an exception under the securities laws that allows them to pursue this activity without such an affiliation. Don't believe it. While it is true that an exemption for finders does exist, it is *not* true that these types of independent consultants qualify to rely on it. The federal finders' exemption is a narrow one applying only to those who receive compensation for introducing investors to the extent that (i) their introductory services are merely incidental to their primary business and something they only do infrequently from time to time, and (ii) they strictly limit their activity to making an introduction, and have no part in negotiations or any other aspect of the transaction. So while these unscrupulous types cannot themselves rely on the federal finders' exemption, because raising money for companies *is* their primary business, note that your lawyer, accountant and other professionals probably *can* act as finders for your company, because it is *not* their primary business. Bear in mind, however, that many investors will insist that all of their investment proceeds go directly into the company to further its development, not into the hands of an intermediary. In such instances, any finder's fee will have to be payable in stock or warrants.

Note: Many of these independent consultants charge significant, non-refundable up-front fees for their services (with no guarantees of success), and, often times, never end up raising a dime for their clients.

Key No. 10: Create Your Own Prospects. More often than not, the single most challenging aspect of completing a private placement is finding investors. Unfortunately, though, under the federal securities laws, securities sold in a private placement can only be sold to persons who are relatively wealthy and with whom those trying to raise the money (typically management and/or other owners) have a "pre-existing relationship". This means that you can't advertise, cold call, or do anything else that would constitute a "general solicitation", and, in fact, you can only approach people that you actually already know or have otherwise dealt with in the past. For most, this means that after a couple of calls, their universe of potential investors has been exhausted. The unfortunate reality is that most small company owners simply don't have an existing network with lots of rich doctors, dentists, lawyers, accountants, investment bankers, entrepreneurs and other high net-worth country club types.

So, what's the answer? Plan ahead so that you can build your network over time and actually *establish* "pre-existing relationships" with those to whom you ultimately intend to market your deal. Selling securities, like selling your products or services, requires planning and work—identifying your target market through research, and then plotting a course of access to that market.

So, plan ahead and do your homework, ideally six months to a year ahead of time. Exhaustively

research other companies in your business segment (or related segments if you're in a relatively new or narrow space) that have been built up and sold within the past 4 to 5 years, and identify the entrepreneurs behind them. Track these people down, contact them, and try to *hire* them—even if only for a day—as consultants for your business. Don't be a nuisance, but be persistent. Once a relationship is established, consider inviting them to serve on your company's board of directors or advisory board. Spend money to develop these relationships. It'll be worth it in the long run, probably many times over.

After a few months, you'll hopefully have a group of prospects for your next round of financing not only with whom you've already established a "pre-existing relationship," but who already know and understand your business, are very familiar with early-stage companies generally, and who probably have money to invest in speculative ventures. If you're successful in either getting them on your board of directors or your advisory board, and/or getting them to invest, and if they're willing to do it, you can then pursue *their* network of contacts as investor prospects as well since, at that point, they, too, will be part of your company.

If that all seems a bit too complicated, the alternative is to join a country club and start rubbing elbows with all of those doctors, dentists, lawyers, accountants and investment bankers.

Key No. 11: <u>Sell Securities Most Likely To Appeal To Your Target Investors</u>. The sophistication and experience of your target investors should dictate the type of securities that you sell in your offering. If you're appealing, for example, to a group of semi-retired entrepreneurs who have been in and around the world of venture capital financing for a while, they're likely to want to purchase—and may even insist on purchasing—convertible preferred stock, which is a senior security that can carry with it a number of advantages relative to common stock (*e.g.*, liquidation preferences, anti-dilution protection, redemption rights, special voting rights, consent rights, board seats). Or they may want unsecured notes (or debentures) coupled with warrants. If, however, you're selling to a group of practicing physicians who may not be so versed in the subtleties of corporate finance, you might be wise to go out with a simpler deal that involves straight common stock. Although at times difficult to know, the point here is that you should be selling a package of securities that is likely to satisfy the demands of the market, but not exceed them.

Note: Whatever type of securities are sold should be bundled in the form of "units" priced to coincide with the lowest total investment amount expected to be received by any single investor (*e.g.*, $25,000). Where stock is being sold, each unit should be comprised of a certain number of shares (as well as a warrant, if that's how the securities package has been structured). Where the securities package consists of notes coupled with warrants, each unit should consist of one note and one warrant.

Key No. 12: <u>Forget About Exit Strategies</u>. For most high net worth investors, any passive investment into a small growing private company is pretty much viewed as a flyer. If they score at all, it'll be big, but there's a good chance that they'll never see their money again. Sophisticated investors know that you've either got to sell your company or go public in order for them to recoup their principal investment and/or realize any return on it. No one can possibly have any idea whether one of these events is ever going to occur. So don't bring it up, it's sophomoric.

Key No. 13: <u>Limit Your Offering Period</u>. Successful book deals are typically structured so that the term of the offering period lasts for no more than 60 to 90 days. There are several reasons for this. First, because of a concept referred to as "integration" under the federal securities laws (alluded to briefly in Key No. 4), which can result in lost exemptions, offerings are best spaced apart from one another by a period of at least 6 months and must, therefore, have fairly well-defined beginning and end points (against which to measure those 6 month periods). Second, and assuming the offering involves an operating company rather than a pure start-up, it usually takes about 60 to 90 days for material information contained in the PPM to become stale as a result of intervening events and circumstances. Third, and finally, a deal simply starts to look less appealing, psychologically, if it's been out there being shopped around for any longer than 90 days. The existence of a firm end date creates a dynamic whereby prospective investors are forced to make a decision one way or another about investing.

Key No. 14: <u>Time Your Offering Strategically</u>. Because they typically occur over a period of only a few months, book deals are typically timed to optimize the likelihood of receiving the most

attention. Well-planned offerings either commence in mid-September and are closed out before Thanksgiving, or, in the alternative, commence in mid-to-late February and are closed-out before Memorial Day. As a general rule, people tend to be much more willing to devote time to new opportunities during these periods.

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As noted previously, for emerging companies in need of equity financing, a private placement is probably the single best answer. But the path to actually getting a deal done and avoiding the many not-so-obvious traps along the way is a challenge for most. With careful planning, however, as well as attention to detail, observance of applicable requirements and some practical advice, this challenge can be met.

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