Arnall Golden Gregory LLP

Client Alert

Top Headaches for Conducting a Private Offering

Preparing and completing a private offering of securities in compliance with federal and state securities laws can be a daunting task. There are many pitfalls along the way. We have listed below our top list of the headaches we have encountered in practicing in this area over the years.

Explaining securities laws to clients. Federal and state laws are obtuse and opaque. Clients frequently do not fully understand them. My primary goal is to make sure that the client understands the basics outlined below:

- All offerings of securities require state and federal registration, absent an exemption.
- The term "security" is broadly defined.
- Registration is impractical and expensive for small offerings.
- Exemption generally involves keeping the offering "private".
- Exemption does not shield the issuer from liability for fraud.
- Regulation D is one of the primary federal exemptions.
- Investors must be given access to all material information regarding the offering.

Complying with the ban on general solicitation. Regulation D is comprised of Rules 501 through 508 and includes three exemptions from registration under the Securities Act. The three exemptions are contained in Rules 504, 505, and 506. Rules 501 and 502 contain definitions and conditions for these three exemptions. Both Rule 505 and Rule 506 offerings are subject to Rule 502(c)'s restriction on general solicitation and general advertisement. Specifically, Rule 502(c) provides that "neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising." The terms "general solicitation" and "general advertising" are not defined in Rule 502(c). Rule 502(c) does, however, state that soliciting investors through "(1) any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; [or] (2) any seminar or meeting whose attendees may have been invited by any general solicitation or general advertising" would constitute general solicitation or advertising. Beyond that there is a considerable amount of SEC interpretive material and case law that discuss the problem of general solicitation.

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The SEC has stated that determining whether a particular action constitutes a general solicitation is always a product of individual facts and circumstances. In evaluating potential instances of general solicitation, the SEC has focused on the relationship between the solicitor and the potential investor and determined that a general solicitation is not present when there is a "substantive" and "pre-existing" relationship between an issuer, or its broker-dealer, and the offerees. While the SEC expressed in several no-action letters that this type of relationship is not the only way to show the absence of general solicitation, the SEC has not issued any guidance on any other way to evaluate a potential general solicitation. Therefore, the relevant inquiry in determining whether a particular communication constitutes a general solicitation is whether the relationship between the issuer/broker dealer and the offeree is substantive **and** pre-existing. Issuers often find this approach to be too restrictive when raising capital so there is frequently pressure to exceed the acceptable limits on general solicitation. We have to counsel clients against broad dissemination of offering material. To avoid inadvertent violations we also recommend that issuers take some or all of the following steps:

- Pre-number the offering books.
- Maintain a list of all offerees.
- Designate a very limited number of company representatives who are authorized to disseminate information.
- Document the basis for believing that offerees are accredited investors.
- Obtain confidentiality and non-disclosure agreements prior to dissemination of offering materials.
- Either engage a registered broker/dealer or document the substantive, pre-existing relationship between the issuer and each offeree.
- Avoid the use of unregistered intermediaries such as "finders" (see discussion below).

Integration. Issuers attempting to evade the limitations of the various offering exemptions may be tempted to make a series of sales over a short period of time and claim each sale is a separate offering. The courts and the SEC address this problem through the doctrine of "integration" – taking the purportedly separate offerings and combining (or "integrating") them into one offering to test compliance with limits on offering amounts and number of purchasers. Regulation D summarizes the factors used to determine whether a series of offers will be integrated, as follows:

(a) whether the sales are part of a single plan of financing;
(b) whether the sales involve issuance of the same class of securities;
(c) whether the sales have been made at or about the same time;
(d) whether the same type of consideration is being received; and
(e) whether the sales are made for the same general purpose.

Regulation D provides a "safe harbor" for offerings made under its conditions at least six months apart from one another. If two offerings occur close in time and do not satisfy the safe harbor, the integration analysis will be a facts and circumstances determination, and it may be difficult to achieve complete certainty that the private offering exemption remains available.

Unregistered finders. Given the current challenging economic environment, many entrepreneurial companies struggle to find the growth capital they need. Companies must explore options to grow the business. To do so, many companies turn to outside sources to identify financing. If history is any guide, many companies will use "finders" – a match-maker of sorts for the cash needy and the financially flush. A finder's role can be varied, from assisting companies in identifying potential investors to providing consulting services or promoting the sale of a new issuance of securities. Essentially a "finder" is a person who assists a securities issuer in locating investors but is not registered as a broker-dealer under the Securities Exchange Act of 1934. The problem lies in the status of finders as unregistered broker-dealers. Persons acting as unregistered broker-dealers are generally prohibited from effecting securities transactions by both federal and state securities law (subject to limited exception). The risks can be great to companies who choose the finder route for capital-raising. First, registered broker-dealers are allowed to engage in certain activities that finders are not---effecting transactions in securities for the account of others, for example. A finder may run afoul of this restricted activity and not even know it. A registered broker-dealer is required to have met certain educational and testing requirements that presumptively should make him aware of the laws and regulations governing his activities. As such, an unaware finder may be more likely than a registered broker-dealer to engage in wrongful conduct under either federal or state law in connection with an offering.

While this may create obvious problems for the finder, it can also create significant problems for the company attempting to raise capital. The purchasers of the securities sold with the assistance of the unregistered broker-dealer may be able to rescind their entire investment in the company. A purchaser seeking rescission or damages may use one or more of several theories of liability: (1) the purchase contract for the securities may be void due to the finder's violation of the law; (2) the finder's activities may constitute general solicitation, which may invalidate the issuer's federal securities exemption, giving the purchaser a rescission right due to the registration violation; (3) many state exemptions prohibit the use of intermediaries who are not registered in the state, thus giving the purchaser a rescission right under the applicable state law; and (4) if the issuer did not fully disclose the use of the finder, and the risks attendant with such use, the purchaser may claim that the disclosure was materially misleading, providing for damages under Rule 10b-5 or state antifraud rules. The use of the unregistered finder also subjects the issuer to the risk of a federal or state enforcement action for conducting an illegal offering or for aiding and abetting the finder in its violation of law.

The potential disclosure problem places the issuer in a difficult dilemma. In fulfilling the disclosure requirements regarding the risks associated with the unregistered finder, the issuer may create a roadmap for regulators to detect the violation or for investors to seek rescission. This problem is exacerbated by recent changes to the Form D which is required to be filed in Regulation D offerings. The Form D now requires disclosure of the amount of any finders' fees paid. Furthermore, the botched placement could taint the company's reputation, thereby limiting capital raising and alerting regulators that the company has a troubled history.

Disclosures regarding the securities offered. Rule 502(b) mandates disclosure in any offering to nonaccredited investors. If the offering is to accredited investors only, these information requirements do not apply, but the antifraud provisions of the federal and state securities laws remain applicable and may require certain written disclosure. One of the securities lawyer's thorniest issues is the determination of the level of disclosure required. The investor is entitled to know what the investor is buying. The disclosure must include a thorough description of the terms of the securities. Investors frequently tend to think in terms of ownership after the offering. Issuers can mislead investors with unclear disclosure about the ownership structure post-closing. The term sheet or disclosure document should describe the current capitalization of the company and the expected capitalization post-offering.

Problems can arise when management has made many promises of stock, stock options or other equity interests to be issued to employees, officers, directors, consultants or investors and these interests are not carefully documented or disclosed to the investors in the present offering. We recommend that issuers prepare a pre- and post-offering capitalization table, disclose any existing potentially dilutive securities, and disclose (to the extent practicable) any plans to issue additional securities.

Financial projections. Issuers sometimes provide investors with financial projections. A good understanding of financial projections requires a thorough knowledge of the assumptions underlying the projections. Disclosing projected numbers without robust disclosure of the assumptions could mislead investors and create liability for the issuer. In addition, projections made upon the basis of overly optimistic or unrealistic assumptions can be inherently misleading. We usually recommend that issuers engage a CPA or other competent financial advisors to review the projections for reasonableness. Some issuers decline to do so for cost reasons, potentially increasing liability.

Valuation. Related to the problem of projections is the problem of valuation. Assertions about the valuation of securities are often based upon projections, so again the assumptions are key. In addition, valuation in various industries often is based upon key industry statistics, e.g. number of subscribers. By exaggerating historical or projected statistics, the issuer may mislead investors regarding the value of the company and the securities. An issue related to valuation is the determination of the offering price. By setting the price, the issuer is implying that the securities are "worth" that price. Issuers should be careful in discussing how they arrived at the price. Ideally, the disclosure document should include risk factors that address dilution and the uncertainty of the value of the securities.

Min-max offerings. Most private offerings fall into one of three structures: non-contingent offerings, "all-or-none" offerings or "minimum-maximum" offerings ("min-max"). In a non-contingent offering, the issuer states that it is seeking to raise any amount, usually up to a specified maximum, and does not represent that any particular minimum amount will be achieved. However, this structure is not appropriate, and can be misleading to investors, for many offerings where the object of the offering is to achieve a specified objective which requires a minimum amount of capital. For instance, a start-up company may need to achieve a certain level to begin operations, or a real estate syndication offering may require enough capital to purchase, renovate or construct the real estate project. For those types of offerings the issuer generally must use either the all-or-none structure or the min-max structure.

In an all-or-none offering the issuer sets a target offering amount. If the offering fails to achieve that target, the issuer will have to return all the funds to investors. Of course setting such a certain target can be a challenge. One way to ease that challenge is to use a min-max structure instead. In a min-max offering, the issuer discloses a minimum offering amount and a maximum offering amount. Until the minimum is achieved the offering proceeds have to escrowed.

There are many other technical requirements to properly complete a min-max offering, which are included in Rules 10b-9 and 15c2-4 and the SEC's interpretive letters. For instance, if the sponsor of the offering intends to allow a portion of the minimum to be satisfied by commitments by the sponsor to invest or lend funds to the issuer, any such commitment must be described in the offering documents and be an unconditional obligation of the sponsor. In addition, the offering materials must contain full disclosure of the terms of the offering, including the extent and nature of the sponsor's commitment and its ability to satisfy such commitment, and the risks associated with the sponsor's commitment. We have seen many offerings where the technical requirements are ignored or violated, which could lead to a rescission right for the investors. Issuers should consult with counsel to ensure compliance.

Blue sky laws. The federal exemptions discussed above generally do not provide an exemption from state securities law provisions. The laws of the state of residence of the company and each offeree should be checked <u>prior to</u> commencing the offering.

Some additional conditions frequently applied by the states include:

- prohibition on paying commissions other than to broker/dealers registered in that state;
- additional limitations on the definition of "accredited" investors or additional "suitability" requirements for investors;
- additional state filings with fees, sometimes even prior to any <u>offer</u> within the state;
- special legends to be placed on offering materials; and
- occasionally, the state exemption will require an extensive review by state authorities prior to sales.

Under the National Securities Markets Improvement Act of 1996, state registration laws are preempted if the Rule 506 exemption is used, but states may impose a state filing requirement and fees. However, practitioners should be aware that Rule 506 compliance does not provide protection from state securities fraud liability or state broker/dealer registration requirements.

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