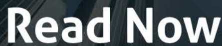
PREPARING A PRIVATE PLACEMENT

Structure, Documentation, and Regulation

By John S. Lore, Esq.



CAPITAL FUND
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Capital Fund Law Group

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To effectively raise capital through a Regulation D private placement, a company must safely navigate the complex regulatory structures that govern the offering. Unintentionally deviating from regulatory disclosure requirements can result in serious consequences for the issuer and its directors, officers, and managers. Experienced legal counsel plays a vital role in guiding companies through their various responsibilities and can help managers avoid devastating mistakes as they raise capital.

This white paper describes the process of conducting a private placement for an operating company in a debt or equity capital raise by a single company. For information on structuring an offering for a multi-asset pooled investment fund, such as a private equity fund, real estate fund, or hedge fund, please see our white paper entitled: *Investment Fund Legal Documents*.

STRUCTURE

A private placement offering's basic structure involves either debt, equity, or some combination of debt and equity. Within the basic structure, an issuer has numerous options, including convertible securities (debts that convert to equity upon certain events), and preferred equity, with varying priority distributions and other attributes. The offering structure is driven in large part by the company's negotiating power and investor appetite for the particular investment.

Debt

A debt structure involves the investors purchasing promissory notes of the issuer and receiving interest and principal payments according to the terms that the issuer chooses. Interest payments can be payable in installments: monthly, quarterly, or annually. Alternatively, they can be paid as a lump sum with the principal due on the maturity date. Investors become creditors of the issuer and typically have no voting or management rights. Debt instruments can be either secured or unsecured.

This structure is typically limited to companies that have an identifiable revenue stream. Since debt offerings have limited upside potential, investors tend to be hesitant to invest in debt offerings that entail unpredictable or uncertain returns. An issuer that fails to make a payment will usually be deemed in immediate default and can put the entire company at risk. Start-up companies in which losses are expected for the first few years can find it difficult to have to pay investors every month or quarter when the cash would be better suited to keep operations progressing.

Equity

An equity structure involves giving investors ownership interest in the company, such as stock in a corporation, membership interest in a limited liability company, limited partnership interest in a limited partnership, or other form of ownership interest. Many issuers are hesitant to offer equity interests because of concerns about giving up voting control. However, there are strategies that a company can pursue to limit investor control.

Valuation for an Equity Offering

Part of establishing an equity structure is determining the value of the equity offered. Valuation is simply the amount that investors are willing to invest in exchange for a given percentage of the equity of the company. However, to set a price per equity interest, a company must establish a valuation, which is a very subjective measure and encompasses many factors. These factors include the company’s need for the capital, the quality of the product or service and its intellectual property, the quality of the management team, the size of the market for the product or service, and past and anticipated revenue. Equity is much simpler to establish for a company that holds marketable assets or investments.

One method of determining the value is based on a multiple of the issuer's projected gross revenues, earnings before interest, taxes, depreciation, or amortization (EBITDA), or net income. After calculating that estimate, the issuer would calculate what percentage of the company an investor would need to receive in order for the investor to receive its money back plus a certain percentage of their investment (for example 200%).

Preferred Equity

Both debt and equity has its respective advantages and disadvantages, both to the company and to the investor. An equity investment presents the investors with the possibility of a larger upside participation, but does not require the repayment of capital. A debt investment provides a periodic, fixed return to investors, but can put the company at risk if the company cannot timely meet its debt repayment obligations. If your company wants the benefits of debt without the risk of default, consider a hybrid approach: preferred equity

Debt/Equity Hybrid

Preferred equity, such as "preferred stock" in a corporation or "preferred membership interest" in an LLC, can be structured to allow investors to receive fixed, periodic distributions (monthly or annually) in perpetuity as long as the preferred equity is owned. Preferred equity payments, as well as liquidation priority, are generally given in preference to the common interest holders. Hence the origin of the term "preferred" equity/stock.

Like equity, the investment capital need never be repaid. One of the key advantages to a company of preferred equity is that, unlike debt payments, which cannot be missed without risking default, preferred distributions may be suspended when the company is unable to pay, with omitted payments accruing to later years.

Flexibility

Preferred equity is a flexible instrument, and a company can structure it in a myriad of ways and combinations. Preferred equity can be voting or nonvoting, redeemable at a certain price, convertible to common equity, and can have liquidation preferences, or even liquidation multiples, allowing an investor to be returned a multiple of its investment upon liquidation. Preferred equity can also be "participating," meaning that in addition to generating a fixed periodic return, they also participate in distributions with other equity classes. Of course, used in this way, preferred equity would no longer resemble a debt instrument.

Some Cautions

For many of our clients, substituting debt for preferred equity has been an attractive option. However, companies need to remember that preferred equity financing represents a perpetual payment obligation. Unlike debt, for which obligations to investors cease upon repayment, preferred equity only terminates upon redemption of the equity. This can be mitigated by reserving for the company an option to redeem the preferred equity at a pre-determined price calculation.

Another consideration is the difference in tax treatment of debt and preferred equity. Under a debt instrument, interest expense is tax deductible and the company can recoup a portion of the interest payment in tax savings. Under a preferred equity instrument, dividends and distributions are after-tax payments.

REQUIRED DOCUMENTS

When thinking of a private placement offering, most companies focus solely on the PPM itself. There are three categories of documents that must be in place to properly conduct a securities offering: (i) formation documents; (ii) offering documents; and (ii) certain regulatory filings.

(i) Formation Documents

Formation documents are the documents filed with the appropriate government authority to establish the existence of the entities, including the fund, the general partner and investment management company. These include certificates and articles. The formation documents are among the most basic of the fund documents.

Because of the simplicity of filing formation documents, some clients make the mistake of forming entities before consulting with legal counsel. Formation documents should be filed only after thoroughly considering the appropriate legal structure of the company and potential tax ramifications.

(ii) Offering Documents

The offering documents are the documents that are provided to a prospective investor prior to the investor making an investment in company. These include the PPM, governing documents and purchase documents.

Private Placement Memorandum

A private placement memorandum (PPM) is the securities disclosure document that provides investors with material information about the company to enable an investor to make an informed investment decision. Similar to a prospectus in a public offering, the PPM provides potential investors with specific information about the terms of the investment, the structure of the company and the background of the principals.

The private placement memorandum contains risk factors that an investor should consider prior to making an investment in the fund. A thoroughly prepared private placement memorandum should protect directors, managers and officers from investor claims of lack of disclosure. For an in-depth discussion of the various sections of a private placement memorandum, see our blog post entitled: *What's in a Private Placement Memorandum.* For an example of the contents and level of thoroughness that a private placement memorandum should contain, refer to our Operating Company sample PPM excerpt.

Governing Documents

Each type of entity has specified organizational documents such as: operating agreements for limited liability companies, bylaws for corporations and limited partnership agreements for limited partnerships.

The organizational documents are the foundational documents of a company and direct how a company will operate. They include such items as how and when distributions are to be made, rights and responsibilities of the management and owners, and allocations of income to the owners.

Because the organizational documents control the operations of the issuer, they must be tailored to conform to the terms of the offering. For example, if there are multiple classes of equity, then the organizational documents must authorize each class and set forth, the preferences of distributions, the voting rights of the classes, and other rights of each class. An equity investor must sign a countersignature page of the company's operating agreement, limited partnership agreement, or shareholder agreement (as applicable) as part of the subscription process.

The organizational documents should be revised or rewritten by the private placement attorney to correlate to the PPM to ensure that they correspond as to the terms of the offering. Failure to do so could result in investors receiving the wrong investment attributes, which could materially alter the investment terms and potentially subjecting the company to liability.

Purchase Documents

A subscription agreement provides investors with a description of the steps necessary to purchase the investments and provides fund managers with eligibility information about the investor. For an equity offering, this is the investor's contract with the company, which specifies the subscription amount and outlines the terms under which the investment is being made. This document requires investors to attest that they meet the accreditation requirements and other suitability standards.

For a debt offering, the promissory note and associated security agreement should be signed in connection with the subscription agreement.

REGULATORY FILINGS

Regulatory filings are filings that need to be made with the federal and state jurisdictions (in addition to the formation documents) that are needed to satisfy federal and state securities law.

For a single-company offering required filings are SEC Form D filings and state Form D notice filings (blue sky filings).

SEC Requirements

Form D is a federal notice of an exempt securities offering and is the only disclosure document that is required to be filed with the SEC. This document discloses biographical information about the offering, the company, use of proceeds, and the principals of the company. Form D is not subject to a review or approval by the SEC, but is a required notification document, and must be filed within 15 days of the first sale to investors. If the offering is ongoing, Form D updates must be filed again each year the offering is open.

State Requirements

However, states have their own notice-filing requirements that must be complied with when offering securities to a resident of its state. Each state's requirements differ on the content requirements and due date of the required notice-filing. Most states require the notice-filing to be made within 15 days after a resident of the state makes an investment; however, certain states (including New York) require that the notice-filing be made prior to any offer of securities within the state. We offer state Form D filing services on a state-by-state basis.

John S. Lore, Esq. is the managing partner of Capital Fund Law Group, a boutique securities law firm providing expertise focused on private placement offerings. Call 212.203.4300 or email us to schedule a consultation to discuss your offeing.