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Securities Issues in Financing an Emerging Business - A Practical Guide When Raising Capital

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Securities Issues In Financing An Emerging Business—A Practical Guide When Raising Capital

by Laurence S. Lese

As a company grows or expands, it needs additional capital. Without this capital, expansion will be difficult. Various methods are available to raise capital, including borrowing from banks, insurance companies or other financial institutions, selling stock to venture capital companies and funds, and selling stock to investors in private or public offerings. Raising captial, however, may trigger aspects of the securities laws which must be considered by the business executive or provider of capital.

This article focuses on the practical aspects of raising capital by way of a "private placement" or by means of a public offering. It also discusses business and legal considerations important to a business executive who is interested in raising capital. Additionally, this article addresses those aspects of securities laws that a business executive should consider at the initial planning stage of the transaction. These areas of consideration are intertwined; thus, knowledge of the assorted substantive provisions and implications of these criteria is crucial to successful financing.

What is a Security?

Financing maybe required for a proposed corporate project—whether it is to purchase real property and equipment, to finance its inventory, to develop new products or services, or to acquire another company. It is likely that any program or scheme to obtain needed capital for a business will involve securities.

The Securities Act of 1933[1] (the "Securities Act") defines the term "security" to mean, among other things, any note, stock, treasury stock, bond, debenture, evidence of indebtedness, transferable share, investment contract, or "in general, any interest or instrument commonly known as a 'security'." Courts' rulings on federal and state statutes have held that many seemingly unlikely enterprises have constituted the offer and sale of a security and, therefore, were within the regulatory ambit of the securities laws. For example, the courts have determined that the sale of interests in an orange grove,[2] contracts for the sale of chinchillas,[3] contracts for the sale of undivided interests in specific real estate parcels together with collateral agreements for management contracts,[4] an investment in condominiums,[5] and the purchase of an aircraft as a tax shelter[6] have each involved the sale of a security.

Obviously, the operation of every business enterprise will not necessarily involve securities. Nonetheless, in raising capital, it is necessary to understand the fundamentals of federal and state securities laws. One basic investment concept is that of an "investment contract," which is a "security." An investment contract has been defined as "a contract, transaction or scheme where individuals invest money in a common enterprise with the expectation that they would earn a profit *solely* through the efforts of the promoter or a third party."[7] However, the courts in recent years have broadened the definition of "investment contract" by substituting "substantially" for "solely." The courts, in effect, have included in the definition of an investment contract those essential managerial efforts which affect the failure or success of the enterprise.

Thus, a significant consideration that business executives must focus upon *during the planning stage* of their proposed enterprise is whether the federal and state securities laws will apply to their efforts to fund the enterprise. Where the offer and sale of a security are involved, strict adherence to the securities laws is essential because of the penalties imposed for their violation. For example, federal law imposes a penalty of up to a $10,000 fine and/or up to five years imprisonment upon conviction of a willful violation of the law.[8]

Initial Planning

During the initial planning stage of a venture, it is crucial to seriously consider the potential securities implications of the project. If it is determined at any point in the planning stage that raising capital involves the offer and sale of a security, various aspects of securities law must be considered. These include:

- whether the proposed financing will be a private offering or a public offering;
- whether broker-dealers and/or underwriters will offer and sell the securities or whether the promoters of the enterprise will sell the securities themselves;
- the states in which the securities will be offered and sold;
- how to structure the financing in order to comply with state law;
- the costs of the financing, who will pay the costs, and when must payment be made; and
- the amount of time required to raise the needed capital.

These issues are interrelated so they must be considered collectively as well as individually.

A business executive must focus, preferably at the early stages of the project, upon the legal requirements imposed by the federal and state securities laws and upon how the venture must be structured to successfully complete the venture. Good initial planning and the development of a sound financing structure will shorten the time required to obtain funding and will reduce, although not eliminate, headaches and anxiety.

Private or Public Offering

The business executive must initially decide how much capital will be required to accomplish the stated goal. At the same time, the executive must decide whether the goals will be most efficaciously achieved by raising capital through a private offering or through a public offering.

A private offering (often called a "private placement") is exempt from statutory registration provisions.[9] Exemption must be obtained not only under the federal Securities Act, but also under the state securities or "Blue Sky" law of each state where the securities will be offered and sold. Notwithstanding the fact that the offering may be exempt from registration, the offering and sale of securities are *never* exempt from the anti-fraud provisions of the relevant statutes.[10]

Current Securities and Exchange Commission ("SEC") regulations afford the issuer of securities great latitude in structuring a private offering. On the basis of the amount of capital to be raised, the issuer is able to choose upon which exemption to rely and to whom and where the securities can be sold. For example, Rule 504 of Regulation D,[11] promulgated under the Securities Act, permits the sale of as much as $500,000 ($1,000,000 in certain circumstances) of securities to an unlimited number of persons. In structuring a financing where Rule 504 is relied upon, the Rule must be dovetailed to the state securities law exemptions where the securities are to be sold.

Some states, however, have not enacted a rule similar to federal Rule 504. The result in these states is that the issuer may have to rely upon other exemptions equivalent to those provided for by Rules 505[12] and 506[13] of Regulation D, which permit the sale of securities to a maximum of thirty-five purchasers plus an unlimited number of accredited investors.[14]

By carefully choosing the states where the securities are to be sold, the issuer can maximize the effect of exemption provisions of both federal and state law. For example, securities sold in reliance upon the Rule 504 exemption (at the federal level) can be sold in the District of Columbia, where the Blue Sky law makes no provision for registration of securities; in Colorado, where the Blue Sky law exempts interstate offerings from registration; in New York, where the Blue Sky law regulates real estate syndications, certain theatre syndications, intrastate offerings of securities, and broker-dealers, but no other types of securities; or in New Jersey, where the Blue Sky law limits sales to thirty-five New Jersey residents, but does not count sales to persons who reside in states other than New Jersey. If, however, the Rule 504 offering is sold in states such as California, Virginia and certain other states, the number of purchasers will be limited to thirty-five *in toto*. These states include sales made to out-of-state residents. Once again, caution must be exercised in structuring and planning the financing. One must never lose sight of the fact that, in a private offering, exemption from registration must be perfected not only under federal law, but also under each Blue Sky law where the securities are to be sold.

> *"[T]he and most states generally do not interfere with the structure or the terms of the financing"*

In those cases where the issuer finances its enterprise in a private offering that is exempt from registration, the SEC and most states generally do not interfere with the structure or terms of the financing. The securities statutes require full and accurate disclosure through the private placement memorandum ("PPM") regarding all material aspects of the financing and impose civil liabilities for inaccurate or false and misleading disclosure under the anti-fraud provisions. The responsibility for perfecting the exemption lies with the issuer and its legal advisors.

However, some states require the issuer to apply to the state securities commission to obtain an exemption from registration. For example, before any security may be offered or sold in reliance upon an exemption from registration in Pennsylvania or Indiana, a formal application must be filed with the respective state requesting that an exemption be granted. Similarly, before a real estate syndication offering can be offered and sold in reliance upon an exemption in New York, the issuer must formally apply for the exemption.

After the offering has commenced, the SEC and most of the states require the issuer to file reports of the sales that have occurred in reliance upon the exemption. If the reports are not filed in a timely fashion, the exemption from registration may be lost. Federal law requires reports to be filed with the SEC no later than fifteen days after the first sale of a security.[15] Some states have patterned their filing requirements after federal law. Several others require the filing of reports periodically until the offering has been completed, while other states require that a report be filed within a certain number of days after the last sale.

A public offering of securities, however, poses more problems for an issuer. Whereas an issuer can generally manage, if not control, the time required to bring a private financing to completion, the ability to manage the timing of a public offering is far less within the control of the issuer. In view of the SEC's and various states' close inspection and review of the offering documents (generally, the prospectus and supporting exhibits), the issuer must understand that a substantial period of time might pass between the initial filing of the registration statement with the SEC and the various states and the time when the offering has been declared "effective" by the respective agencies.[16] The process can take anywhere from a couple of months to as much as a year or longer, depending upon the complexity of the offering and the quality of the disclosure and the preparation of the offering documents.

"Disclosure" and "Merit" Statutes

There are two basic types of statutes regarding securities regulation in the United States—disclosure statutes and merit statutes. The Securities Act and many securities statutes are "disclosure statutes."[17] These laws do not focus upon the substance of the proposed financing, but instead require that full and fair disclosure of all aspects of the proposed financing be presented to the prospective investors. In theory, as long as full and accurate disclosure is provided in the prospectus, the SEC and the various "disclosure states" will declare the registration effective and thereby allow the sale of the registered securities. In practice, however, the effort to achieve disclosure which both the SEC and the states consider full and fair can become quite laborious and time-consuming. Usually, the effort will require extensive and sometimes onerous staff discussions. Nonetheless, in time, most registration statements will be cleared by the SEC and the disclosure states, and will be declared "effective."

The Blue Sky laws of many states are structured to prohibit or restrict sales of securities which such states consider for various reasons to be highly speculative or to involve low quality securities. These are the so-called "merit states." While various issues raised by the SEC and disclosure states can generally be cured by disclosure, several issues raised by the merit states can be cured only by making substantive changes to the structure of the proposed financing. Therefore, in the initial planning stages of the proposed financing, the issuer must know the state in which the securities may be sold. This will allow the deal to be structured for successful registration in those merit states where the securities will be sold. If a financing is not structured correctly, merit review can be burdensome and time-consuming, in addition to having little chance for success. It should be emphasized that the issuer must address merit issues early in the planning process in order to prevent problems, delays, and, possibly, even failure later on in dealing with the merit states.

Many states, including Massachusetts, Tennessee and Iowa, have a great deal of interest in the provisions of corporate or partnership documents which provide for indemnification of directors and officers. Before effectiveness will be declared, the issuer will not only have to disclose the various indemnity provisions, but will also have to conform the provisions to the standards of the particular state. Otherwise, the issuer will not be able to sell its securities in those states.

In the states with merit review, an issuer which proposes to syndicate a real estate project will have to conform to the real estate syndication standards imposed by those individual states. States such as New York and Pennsylvania require strict conformance to their respective guidelines and will deny registration unless that state's standards are satisfied. New York, Pennsylvania, Ohio and several other states have adopted as state policy, the guidelines regarding real estate programs established by the North American Securities Administrators Association, Inc. (the "NASAA guidelines"). Other states, such as California, have adopted stringent real estate syndication standards similar to the NASAA guidelines. The NASAA guidelines have established exacting ***minimum*** standards with regard to the following:

- requirements of sponsors and the suitability of investors in the syndication;
- suitable fees, compensation and expenses to be paid by the program and the amount of investor funds which must be invested in properties;
- conflicts of interest and investment restrictions; and
- rights and obligations of investors and various other substantive requirements, including some related to voting rights of investors, the maintenance of adequate reserves, the reinvestment of cash flow and financial information.

"In theory, as long as full and accurate disclosure is provided..., the SEC will declare the registration effective...."

Fair, Just and Equitable Standards

With regard to offering of common stock, partnership securities and other securities, merit states may not permit registration and sale of those securities in the state unless the offering is determined by the state to be "fair, just and equitable." The issuer must be able to comply with this requirement before selling securities in these states. Merit states take a particular interest in:

A. **"Cheap stock."** Securities are considered cheap stock if sold or issued within two or three years prior to the public offering date to underwriters, promoters, finders, officers, directors, employees or controlling stockholders of the issuer for consideration less than the public offering price or for intangible consideration, such as services. The states may require that the cheap stock be placed into escrow under the control of the state securities commissioner[18] and that the stock may be released only upon achievement by the issuer of certain financial goals.[19] Blue Sky clearance of the registration statement can be obtained where there is cheap stock if the issuer can justify the issuance of the cheap stock. This requires a showing that: (1) the issuer is in the promotional stage; (2) the number of shares of cheap stock is reasonable in amount;[20] and (3) the consideration paid has a reasonable relationship to the proposed public offering price.[21]

B. **Offering price and dilution.** Merit states are concerned with whether the public investors are paying too much for too small a portion of the venture. Specific state-by-state guidelines should be consulted.[22]

C. **Options and warrants.** The total number of shares reserved for issuance upon exercise must be reasonable. Generally, the number is presumed to be reasonable if the number of shares acquired upon the exercise of options and warrants does not exceed ten percent of the number of shares that will be outstanding upon completion of the offering.

D. **Loans to officers, directors, affiliated persons and employees.** Loans are permitted only for specified purposes, such as advances for travel and entertainment, business expenses, relocation, and loans for bona fide personal emergencies. Generally, loans must be repaid in full before registration will be granted.[23]

E. **Voting rights.** Some states prohibit qualification of securities which have inferior voting rights.[24]

F. **Preferred stock.** Many states require special provisions for election of directors if there are dividend arrearages[25] and other protective provisions for preferred shareholders.[26]

G. **Underwriters' warrants.** Merit states usually limit the number of warrants to be issued (generally, not to exceed ten percent of the shares to be outstanding upon completion of the offering), the exercise price, the date of exercise, transferability and the life of the warrant.

H. **Transactions with affiliates ("self-dealing").** These states require such transactions to be on terms no less favorable than could be obtained from unaffiliated third parties and to be approved by a majority of the disinterested directors.

I. **General limitation of expenses.** Many states impose a maximum permissible limit; some relate to underwriters' compensation plus all other expenses.[27]

NASD Consideration

In general, every public offering of securities must be reviewed by the National Association of Securities Dealers, Inc. (the "NASD") to determine whether the offering complies with the NASD's Rules of Fair Practice. The NASD reviews the arrangements, terms and conditions of underwriter compensation of all public offerings of securities filed with the NASD, but does not pass upon or evaluate the merits of any issuance of securities or the fairness of the public offering price.

The primary function of the NASD is to make a determination as to the fairness and reasonableness of the underwriting arrangements. The sole test applied by the NASD is whether the arrangements, terms and conditions of the underwriter's compensation appear fair and reasonable in each case.[28] This determination by the NASD takes into consideration all elements of compensation to the underwriters, all of the surrounding circumstances and any other relevant factors.

In its definition of "underwriter and related persons" for the determination of fair and reasonable compensation, the NASD includes a wide variety of parties. Its interpretation covers underwriters, underwriter's counsel, financial consultants and advisors, finders, members of the selling or distribution group and any and all other persons associated with or related to any of the aforementioned persons.[29] The NASD will consider, evaluate and make its determination on the basis of the compensation, in whatever form, to be received by these persons.

In making its determination of the fairness and reasonableness of underwriting compensation, the NASD will consider and evaluate all of the different forms of compensation, including cash payments, stock payments, stock options and stock purchase warrants, consulting fees and other fees. The NASD also considers the presence of arms-length bargaining between the issuer and the underwriter, and the existence of a potential or actual conflict of interest.

If the NASD determines that the underwriting arrangements are unfair and unreasonable, the NASD will conclude that "it shall be deemed conduct inconsistent with high standards of commercial honor and just and equitable principles of trade and a violation of Article III, Section 1 of the Rules of Fair Practice" for an NASD member to participate in any way in the public distribution of these securities.[30] A member violating the Rules of Fair Practice can be expelled or otherwise disciplined by the NASD.

An issuer need not submit for NASD review the underwriting arrangements of a private offering that is exempt from registration with the SEC pursuant to Sections 4(2) or 4(6) of the Securities Act and the rules and regulations promulgated thereunder. In addition, even in the case of a public offering of securities, a submission of the offering to the NASD for its review is not required so long as there is no use of NASD members in the solicitation and sale of the company's securities. For practical purposes, this means that the offering is "self-underwritten," with the securities being offered and sold by the issuer, its directors and/or its employees.

"The sole test applied by the NASD is whether. . . terms. . . appear fair and reasonable in each case."

Registration of Broker-Dealers and Agents

Another substantial legal (and practical) issue relates to who will sell the company's securities. As with the registration of securities, anyone who sells securities must be registered at the federal level *and* at the state level (in those states where the securities will be sold) or fall within an exemption from registration requirements. Both federal and state laws impose significant civil and criminal penalties for violation of the broker-dealer registration provisions. These registration issues, therefore, should be considered and resolved in the initial planning stages of the offering.

The Securities Exchange Act of 1934[31] (the "Exchange Act") declares it unlawful for a broker or dealer to effect transactions in securities in interstate commerce unless such broker or dealer is registered under the Exchange Act. It is significant to note that "interstate commerce" is defined to mean "trade, commerce, transportation, or communication among the several States, or between any foreign country and any State."[32] The jurisdictional basis includes use of the mail, as well as the telephone, in transactions not only between two or more of the states, but also between a state and a foreign country. Therefore, the sale of American securities by a resident of the United States to non-American residents or citizens in a foreign country would come within the scope of the Exchange Act, and the brokers would have to be registered.

The SEC has adopted Rule 3a4-1,[33] which provides a "safe harbor" exemption from registration as a broker-dealer under the Exchange Act. The rule provides a convenient exemption for a self-underwritten offering by allowing non-registered officers, directors and employees of an issuer to offer and sell the issuer's securities if, among other things, the following conditions are met:

1. They are not statutorily disqualified as a result of a previous violation of securities laws.
2. They are not associated with a broker or a dealer.
3. They are not compensated in connection with their participation by payment of commissions based upon transactions in securities.
4. They will perform substantial duties for the issuer at the end of the offering other than those connected with transactions in securities.
5. They do not participate in selling or offering securities for an issuer more than once every twelve months.

After considering the federal registration requirement, the issuer must determine whether its underwriter, broker-dealer, agent, or salespersons must be (and are in fact) registered under the law of each state where the securities are to be sold. If individuals associated with the issuer are to sell any securities, whether in addition to the underwriter's selling efforts or directly in a self-underwritten offering, the issuer must determine whether it and/or these individuals need to be registered with the state(s). State registration may be required, regardless of the Rule 3a4-1 exemption at the federal level. If an individual needs to be registered at the state level, he or she may be required to take one or more examinations in order to qualify.

There are various exemptions from registration which the issuer and individual can seek. In some states, formal application needs to be made in obtaining exemption from registration. Several states require minimal compliance in order to register the issuer or individual for a particular transaction. Other states do not require that affirmative action be taken by the issuer or individual in obtaining exemption.

Costs and Timing of an Offering

Executives should focus upon two important considerations at the outset of the initial planning process. The first is the costs involved in raising capital either publicly or privately. The second is the time it takes from commencement of the planning process until the issuer has received the funding from the successful completion of the offering.

Costs. In considering the costs of an offering, the promoters must understand that some of the costs are "back end" (i.e., the underwriting commission), payable only upon successful completion of the offering. A substantial amount of other fees and expenses can be "front end," *i.e.*, payable in advance regardless of the success or failure of the offering. These include various retainer fees and expenses to be paid to the underwriter, attorneys, accountants, other professionals (such as engineers), financial printers, and state and federal agencies for filing and registration. Some of these front-end fees can be negotiated to be deferred either to the closing of the offering or to be paid in installments. The cost of an offering, other than the underwriting commission, can equal $100,000 or more, depending upon the complexity of the offering.

However, it is important to remember that, although the costs of the offering may be high, the fees and expenses can be reimbursed from the proceeds of the offering. Therefore, one must factor in the anticipated costs of the offering *at the beginning*, when structuring the offering, in order to be sure that a sufficient amount of capital will be raised for the issuer's required uses as well as for the expenses of the offering. Thus, the costs constitute an "add on" — that is, the issuer should determine the least amount of funding it requires for its purposes, including sufficient working capital, and literally add to that amount the anticipated costs and expenses of the offering. It is vital for the issuer to conduct an offering in such a fashion as to ensure that it will raise funds sufficient to accomplish its goals. It is difficult for an enterprise which is undercapitalized to be successful. Therefore, it is incumbent upon the promoters not to allow their enterprise to have a shortage of capital upon conclusion of the offering.

Timing. It takes a long time to raise capital, whether by public or private offering, and therefore, timing is important. The entire process can realistically take, from the initial planning stage until the closing of the offering and disbursement of the proceeds, anywhere from six months to over a year. The length of time depends upon:

- The complexity of the transaction;
- The effectiveness of the planning stage to identify and enumerate potential hurdles and propose effective solutions to the various problems;
- In the case of a public offering, the time required to obtain clearance from the SEC and various state agencies;
- The number and quality of the underwriters and whether registration need be obtained for members of the selling group; and
- Various other foreseen and unforeseen problems.

The promoters or enterprise must have sufficient current capital during the securities offering period, not only to pay its professionals and others who are involved with the offering, but more importantly, to carry on the present operations, if any, of the enterprise. In effect, the enterprise must have capital sufficient to allow it to bridge the gap between the present time, and the date when it will receive the proceeds of the offering.

> *"Congress and the state legislatures have established severe penalties for violations of their respective statutes."*

Sanctions

Congress and the state legislatures have established severe penalties for violation of their respective securities statutes. The penalties may be criminal, in the form of fines and/or imprisonment; administrative, in the form of injunctive relief; and civil, in the form of money damages. A violator may be prosecuted by federal and state governments and may also be sued by individuals who claim they were damaged.

In cases where a person is engaged or is about to engage in acts or practices constituting a violation of the securities statutes, the SEC and the respective states have the authority to obtain a court-ordered injunction preventing the offer and sale of the securities, thereby halting the fund-raising efforts.

Additionally, a person who is convicted of a willful violation of the Securities Act may be fined up to $10,000 and/or imprisoned up to five years. The penalties imposed by the Exchange Act may be as much as a $1,000,000 fine and/or imprisonment of not more than ten years for a natural person, and up to a $2,500,000 fine for a corporation or other entity.[34] State laws also impose substantial criminal penalties. These penalties are even more severe because what may appear to be but one scheme may involve many violations, each punishable as a felony.

Both federal and state laws provide that private parties who have been damaged by a violation of the securities laws may bring civil actions, to obtain money damages and equitable relief.[35] These actions may arise from a prospectus or private placement memorandum containing false and misleading statements or omissions of material facts necessary to make the statements not misleading. Actions may additionally be brought under the anti-fraud provisions of the statutes as a result of any device, scheme, or artifice to defraud.

Furthermore, federal and state laws expand the scope of liability for violation of the securities laws to include any person who controls any person who is liable for violation of the law.

The Insider Trading and Securities Fraud Enforcement Act of 1988.

This Act (the "Insider Trading Act"),[36] signed into law in November, 1988, is designed to provide greater deterrence, detection and punishment of insider trading violations. The Insider Trading Act dramatically broadens sanctions against such conduct.

First, it expands the scope of civil penalties to include controlling persons who fail to take adequate steps to prevent insider trading. The penalty for a person who has committed a violation may be up to three times the profit gained or loss avoided. The penalty that may be imposed upon a controlling person who fails to control the person who committed the violation may be as much as the greater of $1,000,000 or three times the amount of profit gained or loss avoided.[37] Second, the Insider Trading Act initiates a bounty program, giving the SEC discretion to reward informants who provide assistance to the agency. Third, it requires broker-dealers and investment advisors to establish and enforce written policies reasonably designed to prevent the misuse of inside information. Fourth, the Insider Trading

Act provides for an express private right of action against inside traders and tippers. Buyers and sellers allegedly injured by illegal conduct can sue in federal court for damages sustained as a result of the wrongful conduct of the inside traders.

Finally, the Insider Trading Act increases the criminal penalties for securities law violations occurring under the Exchange Act. The maximum jail terms have increased from five years to ten years.[38] The limit on criminal fines for individuals has risen from $100,000 to $1,000,000, and the maximum criminal fine for corporations and other non-natural persons has multiplied five-fold, from $500,000 to $2,500,000.[39]

Recent Development — Leveraged Buyouts

Leveraged buyouts ("LBOs") have proliferated in recent years. In an LBO, a group of investors take a company private, largely with borrowed money. The leveraged transaction, "leveraged" meaning use of borrowed funds, is structured to allow the investor group to commit a small amount of its capital, together with a substantial amount of borrowed funds, to acquire another company. An LBO, by its very nature, increases the financial risk of the acquired business by subjecting it to significant additional debt, the proceeds of which are not invested in the company. Nevertheless, an LBO, if properly structured, can be a sound method of financing the acquisition of an ongoing business that can provide each financial tier of a buyout with a return commensurate with the risk taken. However, an LBO will not create value where none exists.

A substantial portion of the debt incurred by the investor group is in the form of high yield, so-called "junk bonds." These are riskier than traditional unsecured or secured debt securities and, therefore, bear a higher interest rate. The cost of the capital borrowings used to finance an LBO is generally greater than more traditional and conservative debt financing transactions. Thus, they are more expensive to the borrowing investor group and more lucrative to the lender.

In general, lenders provide funds for an LBO based upon cash flow, whereas more traditional loans are secured by the borrowing company's assets and accounts receivable, which are less frequently relied upon in LBO financing. In an LBO, the investor group and lenders expect to repay the debt incurred with funds from one or two sources. The first is profits from the company's post-acquisition operations, i.e., cash flow. The second is capital derived from a comprehensive restructuring of the acquired company's business, especially from the sale of some of its subsidiaries, operating divisions, real estate, or other assets.

A company or investor group (a "suitor") engaged in attempting to acquire another company through an LBO transaction must consider a significant number of business and legal issues. As with other securities, tax and business matters, the preparation of an LBO demands significant preliminary planning and analysis, and the investment of substantial amounts of time and money. To ensure the success of the group's effort, the following must be considered before the possibility of an acquisition is first broached to the potential target.

"[A]n LBO, if properly structured, can be a sound method of financing the acquisition of an ongoing business. . . ."

- **Suitor's goals:** What does the investor group wish to accomplish? What size company does it want to acquire? What industry? Location? What can the investor group afford to acquire, since it will have to make some equity investment? These determinations can be made by the suitor in-house.
- **Nature of the target:** Can you identify potential targets or analyze them? How do you analyze its industry? What will it cost to make an acquisition? The suitor can do must of the work required here by itself through networking, business and professional contacts and in other ways. A comprehensive analysis of the assets, business, industry and potential post-acquisition operations of the target company is required for two reasons. One is to determine the sufficiency of the cash flow of future operations of the potential target. The second is to provide an evaluation of a possible restructuring (including sales of assets) of the target, all of which is undertaken to ensure that the debt incurred in the LBO will be repaid when and as due. The suitor may also wish to retain an investment banker or other professional organization which can help locate potential targets, provide analysis, and assist in structuring the chosen transaction and in locating investors.
- **Structuring the LBO:** What structure to utilize? How much equity investment by the suitor? What mix of securities to utilize — common stock, preferred stock (payout five to twenty years), short- or intermediate-term senior debt (payout two to six years), long-term senior and senior and junior subordinated debt (payout five to fifteen years)? How much of each type of security to use? What is the term of maturity of each security? How to price each security? The suitor will be able to use the services of an investment banker to assist in making these determinations.
- **Funding the LBO:** Who will invest in the various securities issued by the suitor? How to locate, identify, and attract investors? How much mezzanine or bridge financing is required until the permanent financing is in place, and who will provide this financing? Once again, the services of an investment banker can be invaluable. Potential investors in an LBO transaction are commercial banks, life insurance companies, LBO funds, pension plans, venture capital companies, and investment bankers.

An LBO presents special problems for the target company and its board of directors, who, as the elected representatives of the target's shareholders, owe a fiduciary duty to the shareholders. As fiduciaries, the target's directors must act to enhance the best interests of the target's shareholders as opposed to their own best interests. In so doing, they must make decisions as to whether the target's and its shareholders' interests are best advanced by the target's rebuffing an LBO quest and remaining independent, or by concluding that a merger will best serve the target and its shareholders. A determination by a court that a director has breached his fiduciary duty to the company can result in personal liability to the director for damages sustained by the company as a result of the director's decisions.

It is advisable for the target to select an independent, non-employee committee of directors and to hire independent consultants to evaluate any offers made and to evaluate the worth and prospects of the target. In fact, a court could determine the target's board of directors failed to fulfill their fiduciary duty to the target and its shareholders if the target did not select an independent committee and/or independent advisor.

If the directors determine that the target interest will be best served by the target remaining independent, the directors may choose to adopt various defensive measures, the adoption of which requires the express approval of the shareholders. Directors may also decide to use some or all of these measures against the suitor to defeat an LBO or other acquisition attempt.

In general, the directors will be protected in asserting their defensive strategies by the so-called "business judgement rule." As applied to actions taken by directors in corporate control transactions, this rule states that, in responding to a takeover proposal, the directors of the target must analyze the nature of the takeover and its potential effect on the target in order to ensure that any defensive measure taken is reasonable in relation to the threat imposed.[40] Presumably, there is a point at which the suitor's offer is so favorable to the target that the target's directors must accept the offer to merge and forego its independent status.

If the board of directors determines at some point that a merger or buyout with the suitor or some third party is in the best interests of the target, and the sale of the target becomes inevitable, the duty of the board changes. Instead of being defenders of the corporate bastion, they become auctioneers charged with getting the best price for the shareholders at a sale of the target.[41] The board, in order to achieve the highest price for the target, may take defensive measures.

Once the target is to be subject to a change in control, measures formerly taken to defeat a potential suitor must be designed to maximize shareholders' returns. Thus, in such a changed setting, defensive steps such as poison pills, lock-up options, or asset sales are valid when designed or intended to promote higher bidding in the auction process. However, they are invalid if designed to favor one bidder and, in fact, stop the bidding.[42]

Regardless of whether a company, in any particular situation, is a suitor or a target in an LBO transaction (whether a friendly or hostile merger or tender offer), the board of directors will be faced with formidable challenges and responsibilities involving business and legal decisions. The board must be aware of, among other things, a plethora of legal issues, including federal and state securities laws, takeover statutes, banking laws, and tax laws.

At present, the United States Congress, the Department of the Treasury (including the Internal Revenue Service), the Board of Governors of the Federal Reserve and the Securities and Exchange Commission are analyzing LBOs. Each is considering the methods utilized in LBOs, their effects on the United States economy, and perceived abuses wrought by LBOs. It is likely that one or more of these institutions or other government agencies, such as the Justice Department or the Federal Trade Commission, will take action in the not-too-distant future to address the perceived excesses of LBOs.

Conclusion

In order to expand its operations and to grow, a company at various stages of its existence will need to raise capital from outside sources. The raising of capital very likely will involve the federal and state securities laws. The business executive must be cognizant of these laws and must focus upon them during the planning stage of the project and must structure the venture to enable the successful completion of the financing in the most expeditious manner. Good initial planning and development of a sound financing structure will assure the company of greatly improving its chances of a successful financing venture.

Endnotes

1 15 U.S.C. § 77a-77aa (1988).
2 *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946).
3 *Hollywood State Bank v. Wilde*, 160 P.2d 846 (Cal. Dist. Ct. App. 1945).
4 *Great Western Land & Dev., Inc. v. SEC*, 355 F.2d 918 (9th Cir. 1966).
5 *Wooldridge Homes, Inc. v. Bronze Tree*, 558 F. Supp. 1085 (D. Colo. 1983).
6 *Investors Credit Corp. v. Extended Warranties, Inc.*, Fed. Sec. L. Rep. (CCH), ¶94,343 (M.D. Tenn. 1989).
7 *SEC v. W.J. Howey Co.*, 328 U.S. at 298.
8 Section 24 of the Securities Act of 1933, 15 U.S.C. § 77x.
9 Section 4(2) of the Securities Act of 1933 exempts from the registration requirements "transactions by an issuer not involving any public offering." 15 U.S.C. § 77d(2).
10 Section 4 of the Securities Act of 1933 (the "Act") provides an exemption only from Section 5 ("Prohibitions Relating to Interstate Commerce and the Mails") and not from the anti-fraud provisions of § 12(2) of the Act or from the anti-fraud provisions of Rule 10b-5 (17 C.F.R. § 240.10b-5(1988)) promulgated under the Securities Exchange Act of 1934. *Nor-Tex Agencies, Inc. v. Jones*, 482 F.2d 1093 (5th Cir. 1973), *cert. denied*,415 U.S. 977 (1974).
11 17 C.F.R. § 230.501-.506 (1988).
12 17 C.F.R. § 230.505.
13 17 C.F.R. § 230.506.
14 *See* 17 C.F.R. § 230.501(a) (definition of "accredited investor").
15 Rule 503 of Regulation D, 17 C.F.R. § 230.503.
16 Absent an exemption from registration, a security cannot be sold until it has been registered and, for federal purposes, the SEC has declared the registration effective. Section 5(a) of the Securities Act of 1933, 15 U.S.C. § 77e(a).
17 The preamble to the Securities Act of 1933 states: "An act to provide full and fair disclosure of the character of the securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purpose."
18 Missouri requires the escrow of cheap stock for three years, extendable by the state for an additional two years. Mo. Code Regs. tit. 15, § 30-52.080 (1988).
19 Iowa requires the cheap stock to be held in escrow for at least ten months, after which one-third of the shares of each depositor may be released for transfer purposes for each year in which the issuer has earned a profit of at least six percent of the offering price of the securities per share. Iowa Code Regs. ch. 50, § 191-50.37 (502), 1A Blue Sky L. Rep. (CCH) ¶ 25, 437 (1989).
20 California considers as presumptively reasonable a number of shares which does not exceed 25% of all the common shares issued and to be issued by the corporation. Cal. Admin. Code tit. 10, ch. 3, Rule 260.140.31 (1985), 1 Blue Sky L. Rep. (CCH) ¶ 11,882 (1989). Washington provides that high-tech companies are exempt from the cheap stock limitations. Wash. Admin. Code § 460-16A-109 (1988), 3 Blue Sky L. Rep. (CCH) ¶ 61,562B (1989).
21 Wyo. Stat. Regs. ch. V, § 3 (1986).
22 California provides that in the absence of any reliable indicator such as public market price, the initial public offering price shall not be less than $2.00 per share. Cal. Admin. Code, tit. 10, ch. 3, Rule 260.140.50 (1983), 1 Blue Sky L. Rep. (CCH) ¶ 11,901 (1989). Missouri provides that the offering price of common stock of a company not in the promotional stage may be deemed unfair to purchasers unless it meets one of the following requirements: (1) the price for the stock does not exceed twenty-five times the issuer's net earnings for the last fiscal year; (2) information is filed showing there exists an adequate public market for the stock; and (3) if no public market exists, information is filed justifying the proposed price-earnings ratio in relation to price-earnings ratios of companies comparable to the issuer in terms of size, history of operations, industry and products, and other relevant factors. Mo. Code Regs. tit. 15, § 30-52.050 (1984), 2 Blue Sky L. Rep. ¶ 35,455 (1989).
23 Ohio considers loans to insiders grossly unfair to investors. In order for registration to be granted, Ohio requires such loans to be repaid within six months after the initial public offering date and that

there be no future loans unless approved by a majority of the disinterested directors and unless the loan is for a bona fide business purpose. Blue Sky Policy Statement of Division of Securities of Ohio, May 1986, 2 Blue Sky L. Rep. (CCH), ¶ 45,709.

[24]California requires that common shares and similar equity shares normally have equal voting rights on all matters where such vote is permitted by applicable law. Cal. Admin. Code, tit. 10, ch. 3, Rule 260.140.1 (1985), 1 Blue Sky L. Rep. ¶ 11,851 (1989).

[25]Minnesota requires that holders of preferred stock have a right to reasonable representation on the board of directors upon default of payment of dividends on such preferred shares, for a reasonable, specific period, whether consecutive or not, and that the right to elect a majority of the board of directors is considered by Minnesota to be presumptively reasonable. Minn. R. ch. 2875, Part 2875.3510 (1983), 1A Blue Sky L. Rep. ¶ 33,508 (1989).

[26]Minnesota requires that the charter documents of a corporation proposing to issue preferred shares which are nonparticipating provide: (1) that the dividends on such shares shall be cumulative; (2) that no dividends on common stock be paid during the existence of any dividends arrears on the preferred shares; (3) for the approval by the vote of a specified percentage of the preferred shares regarding any adverse change in the rights of such shares and the issuance of any shares having priority over such preferred shares; and (4) for appropriate dividend restrictions on the common stock. Minn. R., ch. 2875.3520 (1983), 1A Blue Sky L. Rep. ¶ 33,509 (1989).

[27]Missouri states that the expenses of marketing securities paid by the issuer (including a limited partnership) shall not exceed 15% of the gross proceeds of the offering. Marketing expenses include all underwriting compensation, fees and expenses of underwriter's counsel, printing costs, registration fees, filing fees, issuer's attorney's fees, accounting and other professional fees, transfer agent and registrar fees, finder's fees, and other marketing expenses. Mo. Code Regs. tit. 15, 30-52.040 (1988), 2 Blue Sky L. Rep. ¶ 35,454 (1989). In its private placement exemption, Ohio limits the aggregate commission, discount, or other remuneration, excluding legal, accounting, and printing fees, paid or given directly or indirectly for the offer and sale of securities, to not more than 10% of the initial offering price. Ohio Rev. Code Ann. § 1707.03(Q)(2)(Anderson 1985). Ohio will not permit the sale of securities in Ohio if the sales commissions and compensation exceed 10% in any state — that is, the offering cannot be tailored to provide for a 10% commission for sales in Ohio, a 12 1/2% commission for sales in Indiana, etc. A transaction so structured is not in compliance with Ohio law and therefore no sales can be made in Ohio. With respect to fully-registered public offering, Ohio deems an offering to be grossly unfair if the sales commissions exceed 15% of the proceeds of the offering. Ohio Securities Bulletin, May 1986, 2 Blue Sky L. Rep. (CCH) ¶ 45,705 (May 1986).

[28]Interpretation of the Board of Governors of the NASD of Article III, Section 1 of the NASD's Rules of Fair Practice, NASD Sec. Dealers Man. (CCH), ¶ 2151.02.

[29]*Id.*

[30]*Id.*

[31]15 U.S.C. §§ 78a-78jj (1988).

[32]Sections 3(a)(17) of the Securities Exchange Act of 1934.

[33]17 C.F.R. § 240.3a4-1 (1988).

[34]15 U.S.C. § 78ff.

[35]Sections 11 and 12 of the Securities Act of 1933, 15 U.S.C. §§ 77k-l.

[36]Public Law 100-704, 102 Stat. 4677. This Act amends the Securities Exchange Act of 1934.

[37]Section 32(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78ff(a).

[38]*Id.*

[39]*Id.*

[40]*Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. Super. Ct. 1985).

[41]*Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. Super. Ct. 1986).

[42]*Freedman v. Restaurant Assocs. Indus., Inc.*, Civ. Action No. 9212 (Del. Ch.) Oct. 15, 1987.

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