

EQUITY FINANCING PRIMER: RAISING CAPITAL THROUGH PRIVATE PLACEMENT

Founders of closely held businesses often need capital to expand operations or grow through acquisitions. If the business is in its infancy stage, debt financing will be challenging. However, it is possible to raise capital through a private placement, which involves offering shares of the business to a select group of accredited investors. Choosing this path requires specific steps to ensure compliance with legal and regulatory frameworks.

Prior to seeking outside investment, it is critical that the founders review the corporate governance structure of the company and be assured that it is in legal good standing. Governance involves the establishment of bylaws and the election of officers. Investors will want to review the original articles of organization, amendments and bylaws to ensure the company in which they are investing has a solid corporate structure.

The first step in the process of issuing shares through a private placement involves the development of a detailed business plan that includes financial statements, revenue projections and a valuation of the company. Potential investors will be interested in reviewing the financial health of the business, growth opportunities, as well as an exit strategy that projects their potential return on investment.

In connection with the development of a business plan, the founders will be required to determine the capital needs of the company; i.e., how much capital is needed to accomplish the stated goals in the business plan and how the funds will be used which for working capital expansion or targeted acquisitions. It is also important for the founders to decide how much equity they are willing to offer as this could impact the ownership structure and potential dilution of existing shareholders.

It is strongly recommended that the founders engage financial advisors and legal counsel to assist in this process, as well as to obtain guidance with respect to compliance and regulatory issues. If the offering becomes complex it may be necessary to engage investment bankers to assist in the valuation of the business, structuring the offering and identifying potential investors.



Private Placement Regulations

Selling an interest in a business is considered a security, which is regulated by the *Securities Act of 1933* (“Act”). A private placement must comply with securities regulations; however, the goal in simplifying the process is to make certain the offering qualifies for an exemption from full registration under public offering rules under the Act. The main exemptions in the U.S. fall under *Regulation D* of the Securities Act of 1933. The following steps ensure regulatory compliance:

- **Accredited Investors:** Most private placements are offered to accredited investors (e.g., individuals with a net worth of over \$1 million or income above a certain threshold). *It is important to know your investor base and confirm their eligibility.*
- **File Form D:** In the U.S., issuers conducting a private placement under *Regulation D* must file a *Form D* with the Securities and Exchange Commission (SEC) within 15 days of the first sale of shares.
- **State Compliance:** State regulations must be reviewed to make certain that the offering is in compliance with individual state regulations, often referred to as “blue sky” laws, depending on where your investors are located.

The next step in the private placement process is to prepare a private placement memorandum (“PPM”) that details the terms of the offering financial risks, use of funds and the rights of the investors. A *subscription agreement* will become a part of the offering, serving as the contract between the company and the investors that outlines the number of shares being purchased, purchase price of each share and other conditions essential to the offering. The company’s counsel will also prepare a *term sheet* detailing the critical terms of the investment, including pricing, investor rights and percentage ownership.

Identifying potential investors, typically accredited or high-net-worth individuals, is the next step in the process. Marketing of a private placement is limited by regulation, yet using the existing network of the founders or using licensed placement agents is common. If the offering falls under Rule 506(b) of Regulation D, soliciting the general public is not permitted. However, under Rule 506(c), a general solicitation is permitted if all purchasers are accredited investors.

Once potential investors show interest, you may need to negotiate specific terms, such as valuation, control rights, and board representation. Terms should balance your capital needs with protecting your company’s control and governance. Investors will conduct thorough due diligence on your company, which may include reviewing financials, intellectual property, contracts, and legal standing. Be prepared to provide transparency and clear documentation to address investor concerns.

In the final steps of the private placement process, after the terms are agreed upon, the parties will finalize the subscription agreements, PPM, and other legal documents. Once the investors have transferred funds, new shares will be issued and the company’s shareholder register will need to be updated. If applicable, make any necessary changes to the company’s board of directors or governance structure based on the terms agreed with investors. Depending on the terms of the investment, you may be required to provide ongoing reports and financial statements to your new investors. It is also important that the funds raised through the private placement are used as outlined in the PPM or business plan. Maintaining good communication with your investors is key. Regular updates on the company’s progress, financial performance, and significant developments are important for fostering trust.

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In conclusion, raising capital through private placement can be an effective means to grow the business, especially when debt financing is not a viable option. In order to do so, the founders of the business must follow very specific steps and comply with all federal and state regulations. Engaging the assistance of legal and financial professionals is always recommended and effective capital deployment will be key to delivering the returns expected by your investors.

For further information on private placements and other financing methods, please contact Attorneys Gary R. Pannone or Paige E. Macnie at 401-824-5100; gpannone@pldolaw.com or pmacnie@pldolaw.com.



Gary R. Pannone
Principal



Paige E. Macnie
Associate

PANNONE LOPES
DEVEREAUX & O'GARA LLC
c o u n s e l o r s a t l a w

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