

## **Questionnaire: Key Considerations for Private Placements**

### *General Focus and Objective of Venture?*

In order to properly inform investors and provide disclosures where necessary, either through a Private Placement Memorandum, or other disclosure materials, a robust understanding of the venture's overall purpose and goals is useful. Can you please describe in a paragraph or so what the ventures go to market strategy is, or is not?

### *Target Amount of Raise?*

- What is the amount of money the venture requires in order to execute its business model?
- Is the target raise threshold for a particular project, with a pre-established or predefined budget, or is the target raise for ongoing venture finance, with the anticipation of future investment rounds?
- Does the company require a minimum raise threshold, which is subject to escrow, before any of the investor monies can be released the company, either by industry norm or statute (e.g., real estate offerings in the state of New York)?

### *Which Regulation D Rules will be Leveraged?*

Private placement offerings for early-stage companies tend to fall under three different rules under the overarching safe harbor known as Regulation D: *Rule 504*, *Rule 505*, *Rule 506*. With very few exceptions, the bulk of private placement offerings are conducted under Rule 506, which allows for an unlimited potential raise threshold, and in some instances, reduced disclosure paperwork, PROVIDED that the investors are BOTH accredited and sophisticated. In addition, as discussed below, Rule 506 can also permit general solicitation. As a result, reliance on Rule 505 is almost nonexistent, while reliance on Rule 504 (which allows a maximum raise threshold of \$1 million) is sometimes warranted based on the desire to have non-accredited investors, and other considerations that are particularly unusual.

As a result, our analysis tends to focus on why your particular offering would NOT be a 506 offering.

### *Proposed Offering Terms?*

What are the proposed deal terms to be offered to your investors? Terms include such things as return on investment, hurdles before management can participate in revenue streams, interest on debt, preferences on liquidation, etc. Some of the prototypical private offering finance terms are delineated below:

#### Common or Preferred Equity

- Is the venture seeking to provide the same class units and/or shares that the venture founders are to receive (e.g. common), or are the investors getting their own class of stock and/or units with special preferences?
- Why?

#### Investor Economic Preferences

- Does the venture anticipate providing economic preferences to the investors? In the event the venture issues equity (and sometimes debt) to the investors, it is common practice for the investment instrument to carry special "preferences" that favor the investors economically (but not necessarily in terms of management).



- Liquidation Preference
  - For example, the liquidation preference often specifies that the investors as a class are entitled to receive monies from a liquidity event (e.g., a sale, merger, etc. of the venture), in order to make them whole and return their investment, prior to the management sharing in any revenues. There are many other details in and around such liquidation preference that can be further negotiated (e.g., participating or not participating).
- Hurdles/Preferred Returns
  - For example, there might be hurdles or preferred returns/dividends that mandate that the management or common stakeholders do not get to participate in the net revenue of the venture (but they can still be on salary or receive an asset management fee), until such time as the investors, as a class, receive a preferred return and/or dividend.

### Non-Convertible or Convertible Debt

- Is the venture selling debt, instead of equity (e.g., promissory notes)?
- Is the debt a straight debt interest (meaning the notes entitle the holder merely to repayment and interest)?
- Or does the debt carry special terms, like potential conversion into company equity and/or participation rights in company revenue streams?

### Special Management Rights

- Does the venture anticipate having special management rights designed to protect the management?
- For example, a Drag Along Right, allows the management to dictate to minority investors the obligation to sell their equity, in the event a predetermined threshold of equity holders determines the total sale is advisable.

### Proposed Investor Rights

- Does the venture anticipate having special management rights designed to protect the management?
- For example, Informational Rights provide debtholders the same level of insight that perhaps equity holders received by virtue of being equity holders in the issuer company.
- For example, Co-Sale rights operate as a form of “reverse” “drag along” rights, in that they provide the investors the opportunity to take obligate the company to sell their equity a third-party, if a predetermined threshold of equity holders are selling their equity to such third party.

### *Are there any “Bad Actors”?*

Under Rule 506(d), certain “bad actors” are potentially barred from participating in a Rule 506 private placement offerings. Furthermore, their unlawful participation can undermine or extinguish the safe harbor that Rule 506 provides. Accordingly, please explain if any of the following items described in the link below apply to you, your co-founders, partners, or co-venturers: <https://www.sec.gov/info/smallbus/secg/bad-actor-small-entity-compliance-guide.htm#part3>

### *How will you Approach, Identify, and Solicit Investors?*

How do you intend to solicit investment from your investors? Are you approaching a group of investors that you have a pre-existing and substantial relationship with? In the alternative, do you intend to advertise or solicit generally through various channels, such as print ads, radio, Internet, email mass mailings, etc.?

Or, in the alternative, are you using a combination of investors that are known to you, as well as general advertising and/or solicitation?

## *Does the Venture Already Have Business Planning Collateral, Copy, and Materials?*

Generating a Private Placement Memorandum or related disclosure materials, for purposes of investor edification, often derives much of its content from pre-existing business plan and marketing collateral already in the possession of the venture. In other words, the more the venture has copy and materials in its possession that describe the following items, the more robust, effective, and efficient the drafting process will be. Please let us know if you have any of the following materials and/or responses to any of the following items that are typically detailed and disclosure documents (Note: the below generically refers to such disclosure documents as the “PPM”):

### 1. Potential and Actual Investment Risk Factors

This is one of the most critical sections of the PPM and is the first defense against fraud allegations by investor and third parties. This section expansively and thoroughly lays out the actual and potential threats the issuer may face that result in unfavorable returns to the investor or total loss of investment. Such risks are often bifurcated to address industry wide risks and risks that pertain to the specific issuer. Business related risks typically include industry level concerns, such as risks that are native to the specific industry, and/or uncertainty within the business environment overall. Conflict of interest risks are often delineated in this section as well, such as relationships with other entities such as parent and affiliate companies and/or service providers, such as legal. This section typically requires the review of attorneys with PPM and private placement offering experience to assure maximum efficacy.

### 2. Executive Summary

The executive summary, or management summary, is a brief section that summarizes the investment proposal to facilitate the investor’s rapid understanding of the overall issuer’s business, management, and investment terms. Moreover, it is intended to assist investors in decision-making. It also commonly contains a brief statement of the business opportunity and a summary of the various documents involved in the offering process.

### 3. Management Bios

Since typically the issuer delegates management authority and oversight duties to a select group of managers or officers, it typically discloses the biographies of these parties for disclosure and information purposes. Hence, the PPM gives the investors an idea of whom is managing the company, what experience they have, and how successful they have been in order for the investors to consider the company’s management skills when deciding whether or not to invest. Critically, however, PPMs typically disclaim prior management success as a predictor of future success.

### 4. Financing Plan and Capitalization

The PPM gives the investor information about the company’s financial situation, objective, and strategies. The PPM may also provide information on the company’s current capitalization (e.g., what other securities are issued and outstanding).

### 5. Terms of the Offering and Type of Interests Offered

The PPM discusses the type of security being offered (e.g., shares versus units, preferred versus common, debt, etc.), proposed investor investment terms, and return on investment after certain contingencies or conditions occur, (e.g., *pari passu* status, distribution or dividend preferences, preferences on liquidation, conversion rights, dividends or interest, current pay or accrued, warrants,



collateral, affirmative and negative covenants, etc.). Often a so called “waterfall” may be included, which lays out which party shares in company revenues, at what point, and for how long, before another class of parties or securities may do the same.

## 6. Comparable Transactions

The PPM discusses similar transactions to inform and illustrate the kind of outcomes that have resulted from similar situations and the type of market the company is in so the investor can make an informed decision. However, PPMs typically disclaim prior management success as a predictor of future success.

## 7. Minimum Investment

The PPM will often specify a minimum investment amount for an investor which may be a single or multiple of the type of security offered (e.g., shares, units, notes, etc.). This is usually done to prevent an influx of too many investors, which may carry additional overhead, reporting, and liability.

## 8. Accounting and Reports

The private placement memorandum may also commit management to furnish certain financial and other reports to investors on a periodic basis (e.g., quarterly or annual) to inform investors of company operations and/or provide them the necessary information to complete their tax returns.