GENERAL CAPITAL RAISING ACTIVITIES

By Alan S. Gutterman[1]

Companies must usually consider a number of different sources for capital—venture capitalists, private individual investors, commercial lenders and public offerings—and the negotiations with each of these sources raise unique issues. However, there are certain generic activities that must be completed in every fund-raising situation. Management should develop what is, in effect, a capital-raising marketing plan designed to enhance the visibility of the business and its products and services and build the company's image around its perceived strategic advantages. For example, through advertising and other types of promotion, the company should develop name recognition amongst editors in the business press, industry analysts, brokers and various specialty publications. Management may also retain a professional financial public relations firm, attend trade shows, technical conferences and trade association meetings and develop a network for press releases and other pertinent information about the company. However, any marketing campaign should be designed in consultation with counsel to make sure that the activities do not violate applicable securities laws, and managers should not allow its enthusiasm to lead to claims or guarantees that are untrue.

1. Disclosure Documents

Without exception, the company should always plan on preparing a business plan or offering circular for prospective funding sources that describes the business and the investment opportunity, as well as the proposed terms of the investment. Preparation of the business plan is an important exercise in and of itself since it forces the management team to describe the business and its strategic plans and develop a budget that can be used to compute the financing needs of the business. In addition, a disclosure document is a good opportunity to highlight all the material risks and uncertainties associated with the business that may cause an investor to be disappointed.

2. Financial advisors

Obviously, one of the biggest issues for any business, regardless of its size and stage of development, is locating potential funding sources. Ideas about finding specific types of investors and commercial lenders are described below; however, it should also be noted

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that companies might engage a financial advisor to assist in locating investors and bringing the financing to a successful conclusion. These financial advisors can provide assistance with respect to development capital, start up financing, acquisition finance, securing short-term funds for working capital, and finance for troubled companies. In many cases, the same firms can also be tapped for mergers and acquisitions and divestiture or liquidation of business assets.

As a general rule, financial advisors will ask for a reasonable retainer fee to fund the work that is required during the capital-raising process, including the preparation of the company's business plan and arranging meetings with prospective investors. The advisor will also be entitled to a larger fee upon completion of the transaction, typically based on the amount of monies raised. In some cases, the "completion fee" may be reduced by the amount of any retainer paid prior to the closing of the transaction. Historically, financial advisors also bargained for equity compensation; however, this practice is somewhat out of fashion given the recent economic downturn and resulting inability of the advisors to obtain liquidity for their equity stakes in client companies.

3. Presentations to Prospective Investors

A major hurdle for management in the fund-raising process is the oral presentation to investors about the business and the investment opportunity. The presentation may be informal, as when the principals get together over a meal to discuss the business plan, or may include one or more formal presentations to a group of persons responsible for financing decisions at the investing body. Management should not forget that the manner in which the information regarding the company is presented to prospective investors is, in large part, a measure of the abilities of the managers themselves. The presentation should reflect a clear understanding of the business, including its strengths and weaknesses, a realistic appraisal of the company's potential, and a clear understanding of how the day-to-day operations are reflected in the historical financial performance of the company. In preparing for these presentations, management should be willing to seek specialized assistance from professionals (e.g. attorneys, accountants or investment bankers) and other people experienced in the area of finance. While much of the information in the presentation will be the same for each investor, management should always make an effort to understand the specific objectives of the particular investor and focus on those aspects of the business that might be of particular interest to that investor. Before making the presentation, management should carefully evaluate the investor's past and current portfolio of investments and should make an effort to speak with managers at other companies who may have worked with the investor. This should provide some insight into the types of questions that will be asked during the presentation meeting.

4. Due Diligence

Due diligence refers to the general process of investor review of the company's technical assets, financial condition and business prospects. The scope of the investigation will depend on the particular situation; however, it will generally be quite comprehensive and

include questionnaires, reviews of major contracts and policies and interviews with executives, senior managers and other key personnel. Due diligence in the US is often conducted by the partner within the funding source (e.g., a venture capital firm) with responsibility for the investment, often with the help of in-house analysts and outside counsel; however, due diligence in other countries such as the United Kingdom relies more heavily on external consultants. For example, outside experts may be brought in to appraise the company's technology and provide independent verification of the size and demands of the market described in the company's business plan. Investors may also rely heavily on the work of the company's independent accountants and may commission other written reports on issues such as the company's title to operating facilities and intellectual property rights, compliance with environmental laws and the status of active litigation or material threatened claims. Investors will also commission reference checks with suppliers, customers, bankers and previous employers of members of the management team. Interviews will often be conducted with existing bankers and other financial sources. While the due diligence process can be time-consuming, and often seems intrusive, it is a sign that the prospective investor is seriously interested in making a proposal to provide funding to the company.

5. Offer Letters

It is customary for the results of preliminary negotiations with outside investors to be documented in the form of an offer letter, sometimes referred to as "Memorandum of Understanding," "Agreement in Principle," or "term sheet." While the offer letter is typically not binding on the investor, it does demonstrate a serious commitment to working with the company and, hopefully, reaching a consensus on the terms of the proposed funding and direction of the company's business plan after the deal is done. In addition to establishing the parameters of the proposed transaction, the use of an offer letter can serve as a mechanism for educating management about the expectations and requirements of the investors. Also, the offer letter facilitates getting a number of potentially sensitive issues "out on the table" before a good deal of time and effort has been expended by the parties. For example, the offer letter generally outlines any vesting restrictions the investors may wish to impose on shares held by the founders, as well as the composition of the board of directors after the financing has been completed. In addition, the offer letter will establish anticipated investor preferences with respect to dividends and liquidations. The contents of a typical term sheet for a venture capital investment are explained below in the discussion of venture capital. When funding is being obtained from a commercial lender, such as a bank, the comparable document is generally referred to as a "commitment letter," although it will be worded in such a way as to avoid any binding obligation on the lender to close the financing until all of the specified conditions have been satisfied.

6. Investment Documentation

Once the offer letter has been negotiated and approved, counsel for both parties will turn to the preparation of the documentation required for completion of the transaction. Assuming that the financing involves the issuance of equity securities (e.g., common or

preferred shares) the key elements of the documentation, which may be dispersed among several agreements, include the investment agreement, which sets out the essential economic terms of the investment; representations and warranties from the company (and the founders in certain instances) covering the legal, technical, business and financial condition of the company; covenants and restrictions relating to the use of funds and the conduct of the company's business following the closing; amendments to the articles of incorporation (and bylaws) to modify the capital structure of the company to conform to the terms of the securities offered to the new investors; agreements with the founders and other senior executives regarding their duties and compensation, as well as restrictions on their other activities and the consequences associated with any termination of their employment with the company; and other closing documents such as officers' certificates and legal opinions.[2]

a. Investment Agreement

The central legal document in any investment financing transaction is the investment agreement, often referred to as the "stock purchase agreement" in the case of an equity investment and a "note purchase agreement" in the case of a debt investment. Not only does the investment agreement serve as the detailed record of the substantive understanding between the company and the investors, it also provides a means for the company to disclose all of the historical, business and financial information that may be relevant to the transaction. In addition, depending on the circumstances, the agreement serves as the vehicle for collecting the ongoing covenants that will continue to have effect after the financing is completed. The investment agreement should be read and interpreted in conjunction with the common ancillary agreements described below.

b. Representations and Warranties

The investment agreement will always contain detailed and extensive representations and warranties on behalf of the company, including various exhibits and schedules of information. Although failure of the company to adhere to any representation may well create liability to the investors, the primary purpose of requiring representations is to compel disclosure of all of the material information necessary in order for the investors to be fully informed about the company's business and financial affairs. In fact, by the time that the company has prepared the representations and warranties and related schedules,

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[2] The documentation for other types of financing transactions is actually very similar to an investment transaction although the names of the documents may differ and other documents may be needed due to the type of investment and the specific institutional requirements of the funding party. For example, a credit facility provided by a commercial lender will be documented using a credit agreement that includes representations and warranties, as well as covenants, similar to those found in an investment agreement and the lender will also require a promissory note that describes the terms of the loan and security agreements that describe the rights of the lender with respect to any assets of the company pledged as collateral for repayment of the loan.

the investors should have received the information during the due diligence investigation.[3]

The content of the representations and warranties has become somewhat standardized, although variations will occur depending on the stage of the company's development. For example, in the case of a start-up company, the representations usually focus upon the right of the founders to invent, produce and distribute each of the products described in the company's business plan. On the other hand, public companies will generally base their representations on the accuracy of disclosures previously made in documents that are otherwise available to the public. In some cases, one or more of the company's founders will provide their own representations and warranties in the agreement. In those cases where the company is quite small and the affairs are clearly managed by the founders, they may be asked to warrant that the representations made by the company are true and correct. In addition, a founder may be required to represent that he is free to perform the anticipated services for the company, without any conflict with any agreement that might have been entered into with a former employer. Similarly, a founder may represent that he has assigned to the company all of his rights in any technology or business ideas described in the company's business plan. Warranties and indemnities from founders and other key shareholders create personal liability for such persons; however, the amount of liability may be limited by agreement with the investor. Note also that the disclosure letter provides an opportunity for the directors and shareholders to limit and control their potential liability for breaches of the warranties.

c. Covenants and Restrictions

As part of the financing transaction, the company, as well as the founders and other major pre-existing shareholders, may agree to be bound by various covenants and restrictions. For example, it is common to include provisions that cover the right of investors to receive, on a regular basis, detailed business and financial information regarding the company; the right of investors to participate in future financing transactions, as well as the right to purchase securities that may be offered for sale by the founders and other major shareholders; restrictions on the ability of management to take certain actions without the consent of the investors, including expenditures in excess of specified amounts; procedures for electing members of the board of directors; and restrictions on the amount of shares allocated for employee incentive arrangements, as well as rules

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[3] The schedules provide an opportunity to supplement the representations and warranties included in the investment agreement, including creating a record of any exceptions to the language that is included in the main body of the agreement. For example, while the investment agreement may include a representation by the company that it is not a party to any litigation the schedules may modify that representation and disclose relevant information to the investors by explaining that "the company is not a party to any litigation except for . . . " and then describing the litigation and the impact it is expected to have on the company's business and financial condition. The schedules should be delivered to the investors for review prior to the proposed closing and any surprises in the schedules generally trigger a right for the investor to call off the transaction.

regarding the terms upon which such shares may be issued to employees (e.g. "vesting"). As appropriate, the covenants and restrictions may be set out in the investment agreement, the articles or memorandum, or in one or more separate shareholders' agreements executed and delivered at the time the investment agreement is consummated. These provisions are discussed below in the context of venture capital financings.

d. Closing Documents and Procedures

The consummation of the purchase and sale of the securities will occur at a closing provided for in the investment agreement. Many investments will "close" simultaneously with the execution and delivery of the investment agreement. Accordingly, there is no technical need for a set of conditions designed to cover the time period between execution of the agreement and a subsequent closing. Nevertheless, it is usually the case that the agreement will contain various "conditions precedent to closing" for both the investors and the company. The conditions serve as a valuable checklist for insuring that all material business and legal conditions have been satisfied (e.g. completion of a loan agreement satisfactory to the investors), that all ancillary agreements have been executed, and that all required legal opinions and certificates are delivered.