Raising Equity Capital: 9 Items to Consider at the Planning Stage

For companies that need or want to raise capital, an equity-financing transaction may be an attractive option. These transactions can be complex and require a significant amount of planning. The following is a brief overview of nine items to consider at the planning stage.

Do your due diligence. Your company's charter documents and material contracts may contain provisions that could negatively affect, or outright prohibit, your business from raising equity capital. Accordingly, the planning process for an equity-financing transaction should start with a review of such documents to identify any problematic provisions. Specific attention should be paid to loan agreements, since a change in the ownership of the company may constitute an event of default under such agreements.

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Viewpoint

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Keep your accountants in the loop. You'll need to consider your company's tax structure when planning an equity-financing transaction. For instance, if your business has elected to be treated as a subchapter S corporation under the tax code, your company will face certain limitations on the types of equity securities that it can issue. To avoid any problems, it is important that you discuss the structure and terms of any proposed equity financing transaction in detail with your company's accountants.

Resolve any ownership disputes with former shareholders. Investors are hesitant to invest in companies with actual or simmering disputes with former shareholders regarding ownership of the business. If a founder, co-founder, or other equity investor in your company has ceased to be a shareholder, the sale or forfeiture of that person's shares should be clearly documented.

Prepare a form of confidentiality agreement. Investors will request significant amounts of information about your company as part of their due-diligence process. This could include information that may be non-public, proprietary, and/or sensitive. Your business will almost certainly want to protect the confidentiality of such information through the use of a confidentiality agreement with each investor. Accordingly, you should prepare a form of confidentiality agreement that you can send to each investor at the outset of the investor due-diligence process.

Develop financial projections. As part of the investor due-diligence process, investors often request financial projections for the 3-5 years after the completion of the equity-financing transaction. Your company's management will need to prepare such projections and should be prepared to discuss those projections and the assumptions underlying them in significant detail.

Be prepared to address governance issues. You should expect investors to request certain governance rights regarding your company. Investors may request representation on your company's board of directors. They may also ask for consent or veto rights, whereby your company would be prohibited from taking certain actions without the consent of the investors. When planning an equity capital raise, it is critical to consider how you expect your company to be managed following the completion of the transaction.

Be prepared for multi-party negotiations. If your company is not 100 percent owned by the founder, you should expect your existing equity investor(s) to be involved in the governance negotiations referenced above. Companies with multiple groups of equity investors should also expect that their equity investors will negotiate with each other, and with the company, regarding participation in liquidity events, rights to purchase each other's stock, and other matters.

Comply with federal and state securities laws. If your company offers or sells equity securities, it will be required to register such securities with the U.S. Securities & Exchange Commission (SEC) unless an exemption from registration is available. The exemptions from registration, which include Regulation D, are complex and must be navigated with care. In addition, each state has its own securities laws, referred to as blue-sky laws, [that regulate the offering and sale of securities to protect the public from fraud.]. Blue-sky laws may be preempted by federal law depending on the structure of the offering. In the absence of such preemption, your company will be required to comply with the blue-sky law of each state in which offers and sales of securities are made. The consequences of failing to comply with federal or state securities laws can be dire, and can include criminal liability.

Determine whether to engage a placement agent. Many companies that raise equity capital find it advantageous to engage a placement agent for the offering. Placement agents are typically compensated in the form of a "success fee" if they introduce the business to people who participate in the transaction. Your company should be mindful that there are legal restrictions on paying such "success fees" to placement agents, if they are not registered with the SEC as broker-dealers. In addition, "success fees" must be disclosed in writing to investors and paid only in accordance with a written agreement between the issuer of the securities and the placement agent. ■

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